Can Privatization Come Too Soon?

Politics after the Big Bang in Post-Communist Societies

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November 2002

Economists have long recognized the importance of law for behavior, but we are just beginning to recognize that the law is endogenous. One of the most important instances of social change in recent years is the transition in Russia and Eastern Europe from public to private ownership of the means of production. These countries share a stated objective of establishing market economies: not only privatization of state enterprises but also systemic change—the creation of an institutional environment, based on the “rule of law,” where competitive market transactions can take place.¹

In the early 1990s, the dominant paradigm in the West regarding the transition was that granting individuals the control of property would create a political constituency for the rule of law, where there is protection for private property rights.² All over the

¹ By the rule of law I mean a legal regime where property rights are secure, since there are rules on which even the ruler cannot infringe; access to legal rights is broad; and rules for solving legal disputes are predictable. The rule of law is the institution that makes possible a competitive market economy as formulated in the neoclassical model. Empirical work confirms that the rule of law is critical to the success of actual market economies. Three strands of this literature are: macro-studies on the security of property rights (e.g. Barro 1997 and La Porta et al. 1998), firm-level studies (e.g. Johnson et al.), and case studies on the breadth of access to property rights (e.g. Kahn and Sokoloff 1998).

² The phrase “dominant paradigm in the West” is due to Sachs et al. (2000). A summary of that paradigm is provided by Murrell (1993). We use the term “control” in this context to distinguish it from “ownership,” which implies a clear legal framework defining rights
post-communist world, Western donors promoted “Big Bang” privatization—the mass transfer of state-owned assets to private agents (Przeworski et al. 1995, p. viii, at note 2). But there was no theory to explain how this process of institutional evolution would occur and, in fact, it has not yet occurred in Russia, in other former Soviet Union countries, in the Czech Republic, and elsewhere. A central reason for that, according to many scholars, is the weakness of the political demand for the rule of law. For example, Black et al. (2000) observe that in Russia, it was hoped that broad private ownership would create a constituency for strengthening and enforcing [the new Civil and Commercial Codes]. That didn’t happen. Instead, company managers and kleptocrats opposed efforts to strengthen or enforce the capital market laws. They didn’t want a strong Securities Commission or tighter rules on self-dealing transactions. And what they didn’t want, they didn’t get (p. 1753, emphasis added).

Figure 1 gives a snapshot view of property rights insecurity and growth for all transition countries for which such data are available. The horizontal axis plots the fraction of firms in a 1999 EBRD/World Bank survey that report that they do not trust the legal system to uphold their property and contract rights. In response to the question, “Do you agree with the statement, I am confident that the legal system will uphold by and obligations. To be sure, in any society there is some “legal framework,” and control rights are circumscribed by that legal framework. For instance, in a highly primitive society one could imagine no enforcement of basic criminal codes, e.g. against murder and theft. In such a world, actual practical control rights are highly circumscribed: a person can do as he pleases with an asset only so long as no one takes it away from him. Larger individuals (who can beat up on others) or those who can organize larger groups to fight in their defense have more effective control rights.
contract and property rights in business disputes?” a staggering 75 percent of firms in Russia, Kyrgyzstan, Moldova and the Ukraine disagreed. The vertical axis plots the ratio of GDP in 2000 to GDP in 1989. In each of the six economies where property rights are most insecure, GDP has contracted by more than 30 percent. (By comparison, the US GDP contracted by 27 percent in the Great Depression.)

Those who forecast that Big Bang reforms would create a powerful lobby for the rule of law were wrong. Why were they wrong? Or is it still too early to judge? The fact that political interactions do not play out in idealized competitive markets, but instead are often best modeled as interactions in markets with externalities or as bargaining games, suggests that one needs to be circumspect about allegations of the efficiency of the process.

This chapter is designed to provide an overview of my work, joint with Joe Stiglitz, that explores the political economy of property rights in the transition economies. While it is of course true that some legal framework will follow mass privatization, we argue that the framework is not necessarily the rule of law. We focus on two “technologies” that can cripple the demand for the rule of law in equilibrium: (1)

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3 Hoff and Stiglitz (2002a,b,c,d). This work relates to two other literatures: work on the Nash equilibrium choice of the enforcement of property rights (e.g., de Meza and Gould 1992 and Greif 1994); and work on the political economy of reform (e.g. Fernandez and Rodrik 1991, Dewatripont and Roland 1995, and Hellman 1998). Like de Meza and Gould, the model of Section I demonstrates the possibility of a coordination failure. But Hoff and Stiglitz (2000b) go beyond existing literature on coordination failures in institutions by showing in a fully dynamic model how a “bad” equilibrium can persist.
Asset stripping, which can give individuals a stake in prolonging the no-rule-of-law state; and (2) bribery, which can lead to the protection of monopolies and so deter entry by “political outsiders”, who make up the natural constituency for the rule of law.4

The two main sections of this chapter focus, respectively, on these two “technologies.” Section 1 considers a set of assumptions seemingly highly favorable to the creation of the rule of law: political power is widely dispersed; an individual can obtain contract enforcement only through the rule of law, not by “buying” rules just for himself; and all agents are better off building value under the rule of law than stripping under no rule of law. Yet I show in a simple example that a unique stable equilibrium may exist where the constituency for the rule of law is very small.

Section 2 considers “oligarchic entrenchment.” Taking into account the asymmetries in political power, some individuals may believe that they can extract for themselves more rents from the arbitrary exercise of their economic influence than they can obtain through any rule-bound system. Individuals for whom the rule of law is not desirable may “drive out” those for whom it is desirable, and who would otherwise have formed a powerful business constituency for the rule of law. Sequencing matters because it affects the ability of one group or another to engender a pernicious or broadly beneficial institutional consolidation.

I met Joe Stiglitz in the fall of 1984 when I arrived as a graduate student in

4 The empirical importance of both “technologies” is well documented. The extent of capital outflow in Russia in the period 1995-2001 was $15-20 billion (Loungani and Mauro, 2001; Reuters, Feb. 20, 2002). Extensive data for the transition economies on bribery aimed at securing special treatment from the state is in Hellman et al. 2000.
Princeton, with a background as a French major in college. Much of literature is an exploration of the humanly created constraints facing individuals. In contrast, in the then central paradigm in economics, scarcity arises only from physical constraints: allocations under existing institutions replicate allocations under markets and are efficient; humanly created constraints do not matter. I knew something important was missing. Joe in his lectures applied the machinery of neoclassical economics to upturn the standard results. Like a magician drawing rabbits from a hat, he could make demand curves slope up, supply curves slope down, markets in competitive equilibrium fail to clear, cross-subsidies make everyone better off, students over-educate themselves, and farmers produce the ‘wrong’ quantities of goods. And then Joe would show how the magic reflected some very human and rational response to imperfect information. The theorem

References are respectively to: (i) Stiglitz 1987, where higher prices have selection and incentive effects; (ii) Stiglitz 1974, where a fall in the unemployment rate brought about by the creation of government jobs increases turnover costs by more than it increases aggregate output; (iii) Shapiro and Stiglitz (1984), where unemployment disciplines workers; and Stiglitz and Weiss (1981), where the interest rate influences the quality of the loan portfolio; (iv) Rothschild and Stiglitz (1974), where a pooling equilibrium may Pareto dominate a separating equilibrium, (v) Stiglitz 1975, where a sub-optional equilibrium is driven by the desire of high ability individuals to separate themselves from less able ones; and (vi) Newbery and Stiglitz 1981, where farmers do not internalize the effect of their production decisions on aggregate risk. This work radically expanded ideas about the sources and pervasiveness of externalities, an idea emphasized by Greenwald and Stiglitz (1986) and, in the context of development, by Hoff (2001).
that individual rationality leads to social rationality applies to a special case, not the general case. Humanly created constraints did matter after all! The work described below is inscribed in that perspective.

I. “Ex Nihilo, the Jungle”

Yegor Gaidar, Prime Minister of Russia in 1991-92, retrospectively characterized the leap from the collapse of socialist institutions to Big Bang privatization as “ex nihilo, the jungle.” (Speech at the Annual World Bank Conference in Development Economics, Oslo, June 2002). In this section I present a model in which an economy might fail to coordinate on the rule of law and instead coordinate on something more like the law of the jungle, which may be worse for everyone.

Consider an economy in which the possible legal structures vary only along the dimension of the security of property rights. There are two possible legal regimes, which capture the ends of the spectrum: the “rule of law” and “no rule of law,” that is, a legal regime that does not enforce property and contract rights.

Agents with control rights over privatized property seek to maximize their wealth and choose between two strategies: building value, whose payoff depends on the legal regime in place, and stripping assets, which provides a sure return. The probability of the

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Since many important externalities are local, some of the tools that Stiglitz and his co-authors developed to study externalities (such as single-crossing properties) have proved useful in modeling spatial sorting. An example from my own work is Hoff and Sen (2002), which develops a kind of a “community sharecropping” model, where each individual’s return to civic effort depends on the distribution of civic actions in the population.
establishment of the rule of the law depends on the political constituency for it in
equilibrium. I will set out a very simple example of this framework. The example points
up a “chicken and egg” problem, where the legal environment leads individuals to adopt
certain economic strategies and, given the economic choices that they have made, they in
fact do not support the rule of law.

*Agents*. Time consists of two periods. Each agent exercises some control rights
over enterprises in the first period, and chooses between two actions:

- **Build value**: Make an irreversible investment to increase the enterprise’s value.
- **Strip assets**: Strip the assets of the enterprise, whisk capital to a safe place, and
tunnel value out.

The economy consists of a continuum of agents indexed by $\theta$, where $\theta$ is
uniformly distributed on $[0,1]$. Those with a higher value of $\theta$ strip better. (The payoff
from stripping an enterprise is larger, the more liquid its assets and the greater the equity
of minority share-holders.)

*Political environment*. The initial state is one without the rule of law. Agents who
build value demand reform—the rule of law—because it is the only legal regime that
enforces contracts. Asset-strippers, who follow a strategy of “take the money and run”
and may illegitimately profit from their control rights, do not. The economic strategy of
an agent thus determines his political position.\(^6\) Let $x$ denote the fraction of agents who
support the status quo, “no rule of law”. The probability $\pi(.)$ of the establishment of the
rule of law depends on the size of the constituency that supports it, $1-x$. This assumption

\(^6\) This is not the case in the dynamic extension of this model, (Hoff and Stiglitz 2002b)
but the results remain robust.
is captured as $\pi(x) = (1-x)^2$.

*Payoffs.* Technology is constant returns to scale. An agent of type $\theta$ who strips obtains a return $\theta$ per unit asset. An agent who builds values obtains a return of 1 if the rule of law is established, and $\frac{1}{4}$ if it is not.

Given $x$, the threshold below which agents build value and demand the rule of law, and above which they do not, is a type $\theta^*$ such that

$$\theta^*(x) = \pi(x) + [1-\pi(x)] \frac{1}{4}$$

**Switch line** (1)

and so a population fraction $1-\theta^*$ strips and supports the status quo (“no rule of law”).

*Equilibrium.* An equilibrium is a value of the constituency for the status quo, no rule of law, that solves

$$x = 1 - \theta^*(x).$$

Equation (2) states that for a fraction $x$ of the agents, the expected return to stripping assets exceeds the return to building value. Substituting from (1), eq.(2) implies $x = \frac{3}{4} - \frac{3}{4} (1-x)^2$. Equilibria are $x^* = 0$ and $x^{**} = \frac{3}{2}$; see Figure 2.

This simple example illustrates several points. Even if building value under the rule of law dominates stripping assets for every agent, a small constituency for the rule of law may be the unique stable equilibrium. At $x = 0$, the “switch line” in (1) is steeper than the “stripping ability curve” (defined by the uniform distribution of stripping abilities). Any slight increase in $x$ above zero lowers the switch point by more than it lowers the return of the marginal asset-stripper, which induces movement away from the equilibrium. Thus the efficient equilibrium, where the transition to the rule of law occurs with certainty in the next period, is unstable. By similar reasoning, the inefficient
equilibrium, where only 1/3 of the agents support the rule of law, is stable. In this unique stable equilibrium, the probability of the establishment of the rule of law is just 1/9.

But do the implications of that model extend to a dynamic framework? Shouldn’t the forward-looking behavior of the agents affect their political actions of voting? If so, even an asset-stripper might vote for the rule of law.

In order to analyze this problem, we have extended the model to a dynamic framework (Hoff and Stiglitz 2002b). In our extension, two variables link an agent’s current decisions to his future opportunities. First, a current decision to strip assets reduces the *stake* that an agent has in the future legal regime. Second, such a decision reduces his *relative return* from the rule of law (relative to no-rule-of-law) because the establishment of the rule of law at the end of a given period constrains his ability to strip.\(^7\) Given these links between present and future, stripping can give agents an interest in prolonging the no-rule-of-law state. We are thus able to show that the qualitative results of the static model carry over to a dynamic framework with politically sophisticated agents.

In the model, how agents vote influences other agents’ actions (a *spillover effect*), and how each agent acts influences his political position (an *intertemporal incentive effect*). Each individual, in attempting to influence the choice of the environment, focuses on the impact on himself, not on others. Externalities that affect political outcomes beget

\(^7\) The basis for the rule of law cannot be only power; the rules must have some legitimacy. This limits the extent to which under any rule of law the returns from stripping can be grandfathered.
externalities that affect economic choices.

A deeper point is that if there were perfect capital markets (with non-governmental enforcement), then the prospect of the establishment of the rule of law in the future would make it in the interest of each individual to take actions that maximize the social value of the assets he controls because he could “capture” that value. In that case, all agents in the model would build value and all would support the rule of all. In this view, the imperfections in capital markets cause the inefficient behaviors that, in turn, cause the inefficient outcomes in the political equilibrium. As in the children’s story “The house that Jack built,” one problem leads to another.

II. Oligarchic entrenchment

In practice, the privatization in Russia was more adverse to the establishment of the rule of law than the preceding analysis would suggest, for it led to the creation of a small group of oligarchs, with vast fortunes and influence over the media and political processes. Here, I analyze some aspects of what might be called an “oligopolistic” model. Three salient differences between that world and the one analyzed above should be noted. (i) In such a world, of course, it is not true that participants will believe that their actions will have no affect on the behavior of other participants. (ii) The oligopolists/oligarchs will typically obtain significant rents and will accordingly direct some of their political energies to the preservation of these rents. To the extent that they succeed, the legal framework that emerges will not be one that promotes economic

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8 See Note XV.
efficiency.\(^9\) (iii) In some cases, the oligarchs may actually be against a rule-based system, believing that they can extract for themselves more rents from the arbitrary exercise of their economic influence than they can obtain through any rule-bound system. Such a result is predicated on the existence of plausible constraints on the kinds of rules that they can impose, e.g. under the political process, they may be restricted from writing down rules that are too patently discriminatory. Because “bargaining” goes on behind closed doors, the oligarchs may be able to achieve more under such behind-the-scenes bargaining than through any rule-based system. They may be willing to bear the risks associated with the non-rule based system, given the amount that the oligarchs as a whole would have to transfer to the non-oligarchs under the alternative.

This section first sets out an hypothesis about the “logic of reform,” and then sketches a simple model to shed light on the equilibrium constituency for the rule of law.

A. An hypothesis about the logic of political constraints

At the outset of the collapse of socialist institutions in Russia and Eastern Europe, most observers agreed that were it politically feasible to establish quickly the rule of law to underpin a market economy as or before state enterprises were privatized, it would be

\(^9\) To be sure, one might argue that these problems would be eliminated if all the wealth were given to a single individual; a monopolist would have an incentive to promote economic efficiency. From this perspective, the problem with the privatization is not that it was too undemocratic, but that it was too democratic. But in few countries would political processes condone such an arbitrary exercise of power; and monopolies are efficient only under highly restrictive conditions, e.g. that they can act in a perfectly discriminating way, which requires perfect information.
desirable to do so. It was, however, argued that it was politically infeasible to do so. This section explores the possible implications of that statement.

Assume two reforms $a$ and $b$ are under consideration. Let $P_{ab}$ denote the power of the coalition in favor of $a$ over $b$. The statement that a particular coalition is stronger in a certain circumstance than another coalition means that it is either larger, or that those within the coalition are willing or able to provide more resources to pushing for (or against) a certain set of proposals than another set of proposals.

It is alleged that $a$ is not politically feasible, and $b$ is observed to occur. Together this implies that

$$P_{bs} > P_{as}, P_{bs} > P_s \text{ and } P_{as} < P_s.$$  

The coalition in favor of $b$ over the status quo ($P_{bs}$) is stronger than the coalition in favor of $a$ over the status quo ($P_{as}$), the coalition in favor of $b$ over the status quo is stronger than the coalition in favor of remaining in the status quo ($P_s$), and the coalition in favor of $a$ is weaker than the coalition in favor of remaining in the status quo.

Consider one such alternative reform and look at the reform process from the perspective of reformers within a government that is divided between reformers (R) and nomenklatura (N). Reformers are considering two alternative reforms: Reform $r$: Regulation and restructuring, followed by privatization; Reform $p$: privatization without prior regulation and restructuring.

Let $P_{ps}(R)$ denote the political power of the reformers in favor of $p$ over the status quo, and let $P_{ps}(N)$ denote the political power of the nomenklatura in favor of $p$ over the

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10 This formalizes the idea of a divided government in Boycko, Shleifer, and Vishny, 1996.
status quo. We suppose for simplicity that power is additive.

The usefulness of the logic of reform can be seen in evaluating the following often-heard assertions:

A. The reform \( p \) is politically feasible, but \( r \) is not. Formally,

\[
P_{ps}(R) + P_{ps}(N) > P_s(R) + P_s(N) \quad (3)
\]

\[
P_{rs}(R) + P_{rs}(N) < P_s(R) + P_s(N) \quad (4)
\]

B. The nomenklatura are currently using their control over the public sector to obtain rents for themselves, impeding its efficiency.

C. Privatization will result in owners who have the incentive to use those resources efficiently. That is, while \( p \) is feasible but \( r \) is not, \( p \) will result in increased efficiency. Those who get “control rights” under the privatization will use their new power to lobby for reforms in the legal structure (which by hypothesis were not feasible earlier) that will protect property and contracts and restrict anti-competitive practices. That is, reforms that could not be implemented initially, can be implemented later.

Two implications follow. First, under the assumption that regulation is socially efficient, \( (3) \) and \( (4) \) imply that before privatization actually occurs, bargaining within government fails to yield the efficient outcome.\(^{11} \) Second, \( (4) \) implies that if reformers

\(^{11}\) Subtracting \( (3) \) from \( (4) \) gives \( P_{rs}(R) - P_{ps}(R) < - [ P_{rs}(N) + P_{ps}(N) ] \), which can, equivalently, be written as \( P_{rp}(R) < - P_{rp}(N) \). In words, the power of the reformers to impose regulation rather than privatization is less than the power of the nomenklatura to resist regulation rather than privatization.
have no power under the status quo,\footnote{That is the case where $P_{ps}(R) = P_{s}(R) = 0$} and yet privatization is feasible, then for the 
\textit{nomenklatura} privatization and the \textit{status quo} are \textit{equivalent}. That, in turn, implies that if privatization occurs, then government officials must prefer privatization to the rents that they receive under state ownership.

There is a clear, and highly disturbing, implication: there must be more corruption (in dollar value to those currently in power) associated with the privatization process than with the process in which enterprises remain under government control. Privatization may allow those currently in power to extract the present discounted value of future rents—in effect, to capitalize corruption. This was not difficult to do in the 1990s in Russia. A common method was to “convince” the local privatization committee to physically bar anyone outside one’s own group from participating in the privatization auction. One oligarch, after explaining how he proceeded, commented,

“’We didn’t shoot anyone and we didn’t violate any laws. These are the normal business practices in Russia’” (Klebnikov, 2000, p. 131).

The point is that the logic drives us at least to consider as a serious possibility that privatization provided an enormously powerful tool for redistribution towards those currently in political power.

To be sure, one may \textit{still} decide that privatization enhances welfare, because the distortions associated with rent extraction in the one-time privatization process are less than those associated with rent extraction out of on-going government operation. That is, hypothesis C may be true even if the corruption under privatization is greater, in some sense, than under government ownership. The model I sketch below will question that
implication in the context of societies with ill-defined property rights. The premise of the
model is that incumbents have the ability to shape economic institutions in their favor
after privatization, and political outsiders can reveal their preferences for more public
protection of property rights only once they have entered a business activity. In the
model, the method of privatization may have implications for political evolution, i.e. for
the power of various coalitions in the future, and thus, for the design of—or even the
existence of—the rule of law.

**B. A Model of entrenchment**

The economy has a continuum of goods. Each good is produced in its own sector. In a
proportion γ of these sectors, there is a single, privatized firm. In addition, in each sector
there is a competitive fringe of potential entrants. After the agents in the competitive
fringe have moved, the legal framework is established and agents obtain payoffs
conditional on the legal framework.

The probability of the establishment of the rule of law, π, depends on the size of
the constituency that supports it. By assumption, only agents who are active in business
have the information and the “concentrated” interests to lobby government and thereby
reveal their preferences.

In each sector, individuals in the competitive fringe are of measure one and are
indexed by f. A higher value f corresponds to a higher fixed cost of production. f is
uniformly distributed on [0,1].

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13 Under that assumption, those who argued that quick privatization would create a
constituency for free market institutions, including the rule of law, were looking for
lobbyists in the wrong place.
In a monopolized sector, the payoff to new entry is negative; hence, no individual enters such a sector. In a sector that is not monopolized, the payoff is $y - f$ if the rule of law is established and otherwise it is $-f$. I assume that $y \in (0,1)$. Then there is a critical value of $f$,

$$f^* = \pi y$$

which is the type of the marginal entrant who is just indifferent between entering or not.

The fraction of potential entrants in the competitive fringe who choose to enter is $f^*[1-\gamma]$: this is because a fraction $1-\gamma$ of the sectors is not monopolized, and a fraction $f^*$ of the competitive fringe of each of these sectors enters.

I write the probability of the establishment of the rule of law, $\pi$, as a function of the size of the constituency for it. The equilibrium value $f^*$ solves

$$D \equiv y\pi(f^*[1-\gamma]) - f^* = 0.$$  \hspace{1cm} (6)

Equation (6) says that the difference between expected return and fixed costs for the marginal entrant is zero. There always exists at least one equilibrium, and it is stable if

$$\frac{\partial D}{\partial f}(f^*) = y\pi'[1-\gamma] < 1.$$ \hspace{1cm} (7)

Restructuring, which reduces $\gamma$, gives the constituency for the rule of law ($f^*[1-\gamma]$) a double boost: evaluated in the neighborhood of a stable equilibrium, a fall in $\gamma$ not only increases the set of sectors into which new entrants flow, but also increases the number of new entrants in each sector by

$$\frac{df^*}{-d\gamma} = \frac{\partial D / \partial \gamma}{\partial D / \partial f} = \frac{y\pi' f^*}{1 - y\pi'[1-\gamma]} > 0.$$ \hspace{1cm} (8)

The outcome of a high value of $\gamma$ and weak support for the rule of law may
actually be worse than that captured in this simple model. In the absence of the rule of law, political insiders can monopolize new sectors—sectors which were not monopolies before privatization.

A notorious example of the capture of new markets is the takeover of the Lada car distribution in Russia. A police investigation in 1997 (following an earlier attempted investigation had ended with the assassination of the chief investigator), found that gangsters connected to the automaker had waged a kind of war to establish the monopoly. There was evidence of more than 65 murders of company managers and business rivals (Klebnikov 2000, p. 368).

Conclusion

The presumption of Big Bang reforms was that the faster state property was turned over to private hands, the faster a true market economy, including the legal regime to support it, would be established. This presumption was not based on a theoretical analysis of how the process would work. This chapter has described two “technologies”—stripping assets and bribery—that may block the emergence of the “natural” constituency for the rule of law. Our analysis shows that, even if eventually a rule of law is established, the Big Bang, by increasing the profitability of these technologies, may put into play forces that delay its establishment.

Without privatization, control would have resided in the hands of government officials, who would also have stripped assets (the process occurred widely under perestroika and came to be known as “spontaneous privatization”). The point is that their
ability to strip was enhanced by official privatization.\textsuperscript{14} Privatization prior to restructuring also created the means and incentives to use one’s wealth and influence to preserve monopoly rents and bar entry of new firms.

If, in particular, natural resource-rich sectors had not been privatized,\textsuperscript{15} then both the ability to strip and the power to capture the state and block entry would not have been so great. The \textit{manner} of privatization influences the \textit{constituency} for a beneficial legal regime. If there had been more time—more time to ensure that privatization had more political legitimacy than the loans-for-shares privatization (they could hardly have had

\begin{footnote}
\textsuperscript{14} Whether inefficient stripping by government is better or worse than inefficient stripping and monopolistic rent-seeking by the private sector is a question that is outside the scope of this chapter.
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\begin{footnote}
\textsuperscript{15} Many of the major enterprises in these sectors—the industrial jewels of Russia—were privatized under the “loans-for-shares” program in 1995-97. This was a second wave of privatization. The first wave was a voucher privatization program through which 14,000 medium and large enterprises were privatized in 1992-94. But the two programs are not viewed as independent events. In 1995-96, President Yeltsin feared the loss of the election in part because the population didn’t see the benefits of the mass privatization of ‘92-94. The loans-for-shares arrangement was a ploy in which a top business elite was persuaded to support Yeltsin’s re-election in exchange for Yeltsin’s agreement to transfer to them shares in some of Russia’s most valuable enterprises.
\end{footnote}
less legitimacy), then it might have been easier to provide security for those insiders who
invested inside the country rather than sending their assets abroad. In this case, there
would have been more political support for the rule of law and thus a better political and
economic equilibrium might have emerged.
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Figure 1. Growth and property rights insecurity in 20 transition economies

Note: The index of insecurity is the percentage of respondents who disagree with the statement: “I am confident that the legal system will uphold my contract and property rights in business disputes.” Response categories are “agree in most cases, tend to agree, tend to disagree, disagree in most cases, strongly disagree.” In constructing the index, the response “tend to disagree” is counted as disagreement.

Figure 2. The inefficient equilibrium is the unique stable equilibrium.

\[ \theta^* = \frac{1}{4} + \frac{3}{4} (1-x)^2 \]

\[ x = 1 - \theta \]

Decreasing support for the rule of law