POLICY RESEARCH WORKING PAPER

2444 SYNTHESIS

"Seize the State, Seize the Day"

State Capture, Corruption, and Influence in Transition

Joel S. Hellman
Geraint Jones
Daniel Kaufmann

Synthesis. For full paper in both English and Russian, please visit our website at http://www.worldbank.org/wbi/governance or write to governancewbi@worldbank.org.

In a decade of transition, fear of a *leviathan state* is giving way to increased focus on *oligarchs* who "capture the state." In the capture economy, the policy and legal environment is shaped to the captor firm's huge advantage, at the expense of the rest of the enterprise sector. Improved property rights protection and civil liberties can significantly reduce the capture economy. The analysis and findings have major implications for policy.

The World Bank
World Bank Institute
Governance, Regulation, and Finance Division
and
Europe and Central Asia Region
Public Sector Group
and
European Bank of Reconstruction and Development
Office of the Chief Economist
September 2000

Summary findings

The main challenge of the transition has been to redefine how the state interacts with firms, but little attention has been paid to the flip side of the relationship: how firms influence the state—especially how they exert influence on and collude with public officials to extract advantages. Some firms in transition economies have been able to shape the rules of the game to their own advantage, at considerable social cost, creating what Hellman, Jones, and Kaufmann call a "capture economy" in many countries. In the capture economy, public officials and politicians privately sell underprovided public goods and a range of rent-generating advantages "a la carte" to individual firms. In the capture economy the 'captor' firm derives significant private benefits at an enormous social cost to the overall enterprise sector—whose overall growth rate over a three-year period is reduced by about ten percentage points.

The authors empirically investigate the dynamics of the capture economy on the basis of new firm-level data from the 1999 Business Environment and Enterprise Performance Survey (BEEPS), which permits the unbundling of corruption into meaningful and measurable components.

They contrast *state capture* (firms shaping and affecting formulation of the rules of the game through private payments to public officials and politicians) with *influence* (doing the same without recourse to payments) and with *administrative corruption* ("petty" forms of bribery in connection with the implementation of laws, rules, and regulations). They develop economywide measures for these phenomena, which are then subject to empirical measurement utilizing the BEEPS data.

State capture, influence, and administrative corruption are all shown to have distinct causes and consequences. Large incumbent firms with formal ties to the state tend to inherit influence as a legacy of the past and tend to enjoy more secure property and contractual rights and higher growth rates. To compete against these influential incumbents, new entrants turn to state capture as a strategic choice—not as a substitute for innovation but to compensate for weaknesses in the legal and regulatory framework. When the state underprovides the public goods needed for entry and competition, "captor" firms purchase directly from the state such private benefits as secure property rights and removal of obstacles to improved performance—but only in a capture economy.

Consistent with empirical findings in previous research on petty corruption, administrative corruption—unlike both capture and influence—is not associated with specific benefits for the firm.

The focus of reform should be shifted toward channeling firms' strategies in the direction of more legitimate forms of influence, involving economic competition, societal "voice," transparency reform, and political accountability. These implications are consistent with the empirical findings in this paper on the origins of state capture: improving civil liberties from partial to fuller liberalization can reduce the extent of the capture economy by 15–30 percentage points.

This paper—a product of the Governance, Regulation, and Finance Division, World Bank Institute; the Public Sector Group, Europe and Central Asia Region; and the Office of the Chief Economist, European Bank of Reconstruction and Development—is part of an empirical project on governance in transition. Copies of the paper are available free from the World Bank, 1818 H Street NW, Washington, DC 20433. Please contact Diane Billups, room J3-131, telephone 202-473-5818, fax 202-334-8350, email address governancewbi@worldbank.org. For an electronic version of this paper and related research papers and governance data, visit www.worldbank.org/wbi/governance/. Policy Research Working Papers are also posted on the Web at www.worldbank.org/research/workingpapers. The authors may be contacted at jhellman@worldbank.org or dkaufmann@worldbank.org. September 2000. (44 pages)

Abstract

The main challenge of the transition has been to redefine the way in which the state interacts with firms. However, little attention has been paid to the flipside of this relationship, namely the way in which firms exert influence *on* the state. In only a decade, the fear of the *leviathan state* has given way to an increasing focus on *oligarchs* with the power to "capture the state" and shape the policy making, regulatory and legal environments to their own advantage, generating concentrated rents at the expense of the rest of the economy.

We unbundle the notion of corruption and in particular examine empirically the phenomenon of *state capture* on the basis of data from the 1999 Business Environment and Enterprise Performance Survey (BEEPS). We contrast state capture with two other types of relationships between firms and the state – *influence* and *administrative corruption.* Whereas state capture refers to the capacity of firms to *shape and affect the formation* of the basic rules of the game (i.e., laws, regulations, and decrees) through private payments to public officials and politicians, influence refers to the same capacity without recourse to such payments. Administrative corruption refers to so-called "petty" forms of bribery in connection with the *implementation* of existing laws, rules and regulations.

Economy-wide measures are developed for these phenomena, showing that in many transition countries a *capture economy* has emerged, where rent-generating advantages in the form of policies, laws and regulations are sold by public officials and politicians on an 'a la carte' to private firms. We find that state capture, administrative corruption and influence all have distinct causes and consequences.

Influence tends to be inherited as a legacy of the past by large, incumbent firms with existing formal ties to the state. These influential firms enjoy advantages in terms of greater security of property and contract rights and superior firm performance. By contrast, state capture is a strategic choice made primarily by *de novo* firms trying to compete against influential incumbents. "Captor" firms seek to purchase advantages directly from the state -- such as individualized protection of their property rights -- in environments where the state under-provides the public goods necessary for effective entry and competition. Captor firms derive private benefits such as higher sales growth from their actions but only where the extent of the capture economy overall is high. Administrative corruption, in contrast to both capture and influence, is not associated with any specific benefits for the firm.

Despite the private gains to captor firms there are very large social costs associated with pervasive state capture. The capture economy – whose origins are shown to lie in the incomplete process of political liberalization – is characterized by a much higher degree of insecurity of property rights and weaker overall firm performance. In the capture economy, the overall growth rate of the enterprise sector is about ten percentage points lower in a 3-year period. The origins of the capture economy point to the empirical importance of fuller civil liberties and to security of property rights. This suggests the need to develop new mechanisms for transparent, competitive and legitimate channels of voice and influence for enterprises, complemented with de-monopolization, political competition and greater political accountability to redress the roots of state capture.

Keywords: Corruption, State capture, Transition economies, Influence, Bribery

The evidence and opinions presented here are the authors' responsibility and do not necessarily reflect those of their respective institutions or their Executive Directors. The authors are responsible for errors and omissions. This paper is an output of the joint research project on governance, corruption and influence in transition conducted by EBRD and The World Bank, co-managed by Joel Hellman and Daniel Kaufmann, and also serves as a contribution to the 'Anticorruption in Transition' Report (of the World Bank's Europe and Central Asia Region). Details on the survey and data utilized in this paper are contained in: 'Measuring Governance, Corruption and State Capture -- How Firms and Bureaucrats Shape the Business Environment in Transition', World Bank Working Paper Series # 2312 (April 2000). www.worldbank.org/wbi/governance

"I only want to draw your attention straightaway to the fact that you have yourselves formed this very state, to a large extent through political and quasi-political structures under your control. So perhaps what one should do least of all is blame the mirror."

Vladimir Putin's opening remarks to a roundtable of 21 of Russia's leading oligarchs (Washington Post, July 29, 2000)

1. Introduction

In designing reform strategies in the initial stages of transition in Eastern Europe and the former Soviet Union, the dominant challenge was to reduce and reorient the state's role in the economy. In particular, the strategies of liberalization and privatization were intended to change the way in which the state interacts with firms, shifting from command methods to market mechanisms. Throughout the transition, little attention has been paid to the flipside of this relationship, namely the ways in which firms exert influence on the state. Yet in the context of weak states and underdeveloped civil societies, such forms of influence have had a powerful impact on the pace and direction of reforms, on the design of economic and political institutions and, ultimately, on the general quality of governance in the transition countries. After only a decade of transition, the fear of the *leviathan state* has been replaced by a new concern about powerful *oligarchs* who manipulate politicians, shape institutions, and control the media to advance and protect their own empires at the expense of the social interest.

From a political economy perspective, our understanding of the main obstacles in the path of transition has generally been guided by an image of the state as a "grabbing hand" discriminating against firms with low bargaining power to maximize the private interests of politicians and bureaucrats.[1] Yet a recognition that powerful firms have been able to capture the state and collude with public officials to extract rents through the manipulation of state power suggests that there are other dimensions of the relationship between the state and firms that could further enrich our understanding of the political constraints on the reform process. By analyzing the dynamics of the *capture economy*, we can build a stronger foundation for incorporating the political constraints on reform into the development of feasible strategies to advance the transition.

In addition, a focus on the ways in which firms interact with the state has important implications for our understanding of the dynamics of corruption. Existing studies tend to treat corruption as a generic, one-dimensional phenomenon without distinguishing between forms of extortion in which rents are monopolized by public officials and forms of influence and collusion between firms and public officials in which the rents are shared.[2] Yet surely the roots of these relationships differ, as well as their consequences

[1] The 'grabbing hand' image of the state was proposed and developed by Shleifer and Vishny (1998). The view of bribery as the costly outcome of bureaucratic harassment is elaborated in Kaufmann and Wei (1999). Previous studies focusing on corruption to get around red tape regulations tended to portray corruption as an efficient informal deregulatory devise (the 'grease' argument, see Leff 1964; Huntington 1978; and Liu 1986), in contrast with the recent bureaucracy-induced 'sand' argument and evidence suggesting that bribery does not alleviate administrative harassment.

[2] Some studies of corruption do recognise different forms of the problem – most commonly, grand versus petty corruption -- although the emphasis has tended to be on the overall level of corruption and not the nature of relationship between the state and the firm. Existing studies also tend to assume, often implicitly, that all forms of corruption are highly

for the firm and for the broader economic environment. Unbundling the concept of corruption in transition economies should provide a richer basis for our analysis of the problem and for policy advice.

This paper is an initial step to investigate empirically what characterizes different types of relationships between firms and the state, and how they affect the performance of the firm, the state's role in the economy, and the development of a dynamic enterprise sector. We distinguish between three types of relationships marked by different distributions of rents between the firm and the state. – state capture, influence and administrative corruption. State capture is defined as *shaping the formation of the basic rules of the game* (i.e. laws, rules, decrees and regulations) through *illicit* and non-transparent private payments to public officials.[3] Influence refers to the firm's capacity to have an impact on the formation of the basic rules of the game *without* necessary recourse to *private* payments to public officials (as a result of such factors as firm size, ownership ties to the state and repeated interactions with state officials). Administrative corruption is defined as *private* payments to public officials to distort the prescribed *implementation* of official rules and policies.

Capture, influence and administrative corruption are examined from two perspectives – the firm level and the country level. First, we attempt to measure and compare the extent of these different phenomena across the transition countries. Then, we seek to determine the factors at the firm level that shape the degree of the firm's influence on the state and its propensity to engage in capture. Finally, we assess the private costs and benefits of different forms of influence to the firm and contrast them with the social costs at the country level.

The analysis of capture, corruption and influence is based on data from the 1999 Business Environment and Enterprise Performance Survey (BEEPS), a firm-level survey commissioned jointly by the EBRD and the World Bank to assess obstacles in the business environment across 22 transition economies.[4] The survey data allow us to unbundle the measurement of influence and corruption into specific components, as well as to examine a number of key questions regarding state capture for the very first time. Moreover, the BEEPS survey offers significant methodological improvements over existing governance and corruption indices in that it relies on the direct experience of firms rather than external assessments and, wherever possible, uses cardinal estimates of the extent of corruption.[5]

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correlated and that the causes and consequences of different forms of corruption are roughly similar. See, for example, Ades and di Tella (1997), Kaufmann (2000), and Wei (1999).

[3] Of course, firms are not the only organizations that can capture the state. However, we are primarily interested in the relationship between firms and the state as a foundation for understanding the political dynamics of economic reform.

[4] The BEEPS is the first stage of a world-wide survey of firms on the obstacles in the business environment conducted by the World Bank in co-operation with the European Bank for Reconstruction and Development (EBRD), Inter-American Development Bank and the Harvard Institute for International Development. It is expected that over 80 countries will be included in the survey encompassing countries at all levels of development. An earlier version of the World Business Environment Survey, comprising 69 countries, was carried out 1996 and presented in the World Bank's World Development Report 1997 (www.worldbank.org/wbi/governance). Some of the data from the BEEPS were first published in the EBRD's Transition Report (1999). For a full description of the survey and the main results, see Hellman, Jones, Kaufmann and Schankerman (2000).

[5] Until recently, most empirical studies of corruption have tended to rely on cross-country indices of corruption based mostly upon the assessments of external experts or foreign investors. Such indicators did not disaggregate corruption into

An analysis of the BEEPS data suggests a starkly contrasting picture of the nature of interactions between firms and the state across the transition countries. In one group of countries, which we refer to as capture economies, public officials appear to have created a private market for the provision of normally public goods (e.g. the security of property and contract rights) and rent-seeking opportunities which a relatively small share of firms can obtain either through influence or state capture. While such advantages bring substantial private gains to the individual firms, they generate significant negative externalities for the rest of the economy. In the other group of countries, this market for concentrated advantages to individual firms through state capture and influence is quite limited, though present. In these countries, capture appears to have few direct benefits to those firms who engage in it while producing a much more limited impact on the operations of other firms in the economy.

Beyond the variation across the transition economies, we can identify and differentiate among *captor firms* (i.e. firms that make private payments to public officials to affect the rules of the game) and *influential firms* (i.e. firms that have influence on those rules without recourse to private payments to public officials). We find clear distinctions between the profiles of these two groups of firms. Influential firms tend to be the classic incumbents inherited from the previous communist system. They are generally large, state-owned firms with a higher than average market share in their own sectors, reasonably secure property rights and close formal and informal ties with the state. Captor firms tend to have the opposite profile: they are likely to be *de novo*[6] private firms with less secure property rights and weaker ties to the state facing stronger competitive pressures from incumbent firms.

Our analysis suggests that while influence tends to be inherited from the past -- by particular state and privatized enterprises -- other firms choose to engage in state capture as a strategy to compete against these influential incumbents. Captor firms seek to purchase advantages *a la carte* directly from the state, including, but not limited to, individualized protection for their own property and contract rights in environments where the state continues to under-provide public goods necessary for effective entry and competition.

Comparing enterprise performance over time, we find that influential and captor firms grow at a substantially faster rate than other firms, controlling for country-wide determinants and for other firm-level characteristics. Yet these private gains to capture are only realized in high capture economies, i.e. where state officials have created a sufficiently extensive private market for key under-provided public goods and other rent-generating advantages and thus share some portion of the rents associated with state capture. In contrast, in countries with more limited levels of state capture, those firms that engage in state capture perform worse than other firms. Starting from a lower level of

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different forms and relied on generic questions about the extent of corruption. Without reliable measures of state capture, as distinct from other forms of corruption, empirical research has concentrated by default on conventional forms of administrative corruption, such as bribery to get around red tape. For an analysis of existing governance and corruption indicators worldwide, see Kaufmann, Kraay and Zoido-Lobaton (1999b). While world-wide comparative indices are mostly unidimensional proxies for corruption, in-depth diagnostic survey tools have been developed to unbundle corruption and measure other governance dimensions (World Bank Institute and ECSPE, 1999). However, these country specific diagnostics do not lend themselves to cross-county comparative indices for large groups of countries.

[6] We define de novo firms as those created without any state-owned predecessor.

property rights security, captor firms are also shown to gain much greater improvements in the security of their property and contract rights over time, especially in capture economies.
Despite these substantial private gains to captor and influential firms, we demonstrate that the social costs of capture and influence for all other firms in the transition economies can be considerable. Average firm growth rates are systematically lower for firms in high versus low capture economies, despite the concentrated gains to captor firms. Moreover, the success of captor firms in securing individualized protection for their property rights appears to weaken overall progress in strengthening the security of property and contract rights for all other firms. The private gains to capture and influence seem to generate considerable negative externalities for other firms, especially in high capture economies.

Whereas *de novo* firms have been the driving force of growth and a major constituency for further structural reforms in the most advanced transition economies, in the capture economy, these firms have strong incentives to engage in state capture in an effort to compete against influential incumbent firms. This can lead to a potential vicious circle in which a small share of dynamic firms gain concentrated advantages that further undermine the state's provision of necessary public goods and weaken economic growth.[7]

While this paper is empirically-oriented and does not formalize a conceptual model of the complex interaction between firms and the state, we advance an approach that moves beyond the 'grabbing hand' model, recognizing the ways in which firms exert influence on the state and identifying the private and social costs and benefits associated with different methods of influence. We also explore the determinants of state capture, at the firm level focusing on the initial conditions faced by the firm (especially security of property rights), and at the country-wide level emphasizing the progress made in the process of political liberalization.

The rest of the paper is organized as follows: Section 2 discusses the BEEPS survey. Section 3 outlines the empirical approach to measuring corruption, state capture and influence. Section 4 examines the micro-level determinants of these interactions between the state and the firm. Section 5 considers the private gains to the firm resulting from these interactions. Section 6 discusses the social costs of state capture in terms and firm performance and section 7 examines the link between state capture and reduced security of property rights that underlies the negative impact of the capture economy on firm performance. Section 8 presents a brief discussion of the origins of the capture economy in terms of social and political liberalization. Section 9 concludes. An appendix presents some additional results together with information on the sample composition of the BEEPS, and a summary table of all the variables used in the empirical analyses.

[7] For a multiple equilibria model of the unofficial economy in transition which underscores the nexus between governance variables and the provision (or lack thereof) of key public goods, see Johnson, Kaufmann and Shleifer (1997).

9. Summary and Conclusions

Though much of the existing literature on the political economy of transition has focused on the dynamics of state control over the economy, this paper has placed primary emphasis on the ways in which firms exert influence on and collude with public officials to extract advantages. The BEEPS data have provided a unique opportunity to differentiate channels of firm influence on the state and to unbundle corruption to examine variation both across and within the transition countries. The analysis has provided new insights into the origins and dynamics of the capture economy – an economy in which a relatively small share of firms has managed to capture public officials at various levels of the state to extract concentrated rents and to purchase individualized provision by the state of under-provided public goods. The analysis has also demonstrated that the private gains to capture are clearly associated with substantial social costs in capture economies both in terms of overall economic performance and the capacity or commitment of the state to provide critical public goods for the development of the market economy.[8]

State capture and influence are in evidence in all transition economies (as they are in all economies across the globe). However, the advantages to the firm of such activities can be sharply contrasted in different contexts. There is a group of transition economies in which the impact of state capture by a narrow group of firms is quite widely felt by many firms throughout the economy. In contrast, there are other transition economies in which firms may seek to influence the state through capture, but there are constraints which prevent the state from distorting the legal and regulatory framework to the advantage of a few powerful firms. The dynamics of state capture in each group are quite different.

In the capture economy, capture tends to be a strategy of innovative *de novo* firms trying to compete in a market dominated by influential incumbent firms with close historical and formal ties to the state and substantial advantages in terms of market share. As the state in such an environment tends to under-provide such critical public goods as the security of property and contract rights, the most dynamic *de novo* firms seek to purchase such services on an individualized basis directly from public officials along with other advantages to enhance their performance. They would appear to engage in capture not as a substitute for innovation in the marketplace, but as a complementary strategy to compensate for weaknesses in the overall legal framework.

The analysis has shown that capture does generate substantial gains to the firm both in terms of performance and improved security of property rights, but only in the capture economy. In settings where the state faces greater constraints in its capacity to distort the legal framework to advantage a narrow group of firms – in turn associated with greater political liberalization -- the few firms engaging in capture exhibit weaker firm performance and fewer gains in terms of the protection of property rights. In contrast with the capture economy, in such settings firm-level capture and market innovation do appear to be substitutes.

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[8] This pattern of concentrated gains to firms with the capacity to encode their advantages in the legal and regulatory structure at a high social cost is consistent with the argument that the main political obstacles to reform in transition economies have been the early winners from partial economic reforms as argued in Hellman (1998).

Thus, in the capture economy, many dynamic new firms have strong incentives to engage in state capture which further weakens the state's capacity or commitment to enhance security of property and contract rights. This, in turn, strengthens the incentives for other *de novo* firms to engage in state capture creating a vicious circle that can undermine growth and stymie further progress in economic reform. A recognition of the dynamics of the capture economy suggests a political economy framework for understanding the very divergent paths that are now clearly evident among the transition countries.

The need to shift the focus of reform to strategies for addressing the way in which firms interact with the state is the main implication of this paper. Though this implies deepening the process of economic and political liberalization that was the main challenge of the initial stage of transition, it also leads to a new focus on measures to channel the strategies of firms away from state capture to more legitimate forms of influence through a combination of societal 'voice', transparency reforms, political accountability and economic competition -- as suggested by our preliminary analysis of the positive impact of enhancing civil liberties once a threshold of reform has been reached.

Where state capture has distorted the process of reform to create (or preserve) monopolistic structures supported by powerful political interests, the challenge is particularly daunting. Strategies need to be formulated combining a gradual demonopolization with an activist stance on competition and entry policy, coupled with mobilizing societal voice – and *inter alia* making transparent the social costs of state capture to the population, to pro-reform constituencies and NGOs. Strategies aimed at mobilizing collective action and empowering competitive constituencies should be given greater prominence.

We end with a word of caution. This paper is an initial effort into the empirical investigation of state capture and other forms of high-level corruption in transition. Future research would need to aim to develop fully a conceptual framework modeling the interaction between firms and politicians where, as emphasized in this paper, the firm does play an active 'captor' role (as well as recognizing the activist role that some predatory politicians may also play). The literature on regulatory capture, suitably integrated with the recent analytical work in the field of corruption, offers particular promise in this context.

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State Capture and Administrative Corruption, by Country
(Selected countries 1999)

	State apture Index of irms ffected								*dminist-rative orruption*
ountry	*arlia-mentary egislation*	*resi-dential ecrees*	*entral an*	*riminal ourts*	*ommer-cial ourts*	*olitical arty inance*	*apture Index avg*	*apture lassi-fication*	*evel of bribery of firm revenues*
Albania	12	7	8	22	20	25	16	Medium	4.0
Azerbaijan	41	48	39	44	40	35	41	High	5.7
Bulgaria	28	26	28	28	19	42	28	High	2.1
Croatia	18	24	30	29	29	30	27	High	1.1
Czech Rep	18	11	12	9	9	6	11	Medium	2.5
Estonia	14	7	8	8	8	17	10	Medium	1.6
Georgia	29	24	32	18	20	21	24	High	4.3
Hungary	12	7	8	5	5	4	7	Medium	1.7
Kyrgyzstan	18	16	59	26	30	27	29	High	5.3
Latvia	40	49	8	21	26	35	30	High	1.4
Lithuania	15	7	9	11	14	13	11	Medium	2.8
Moldova	43	30	40	33	34	42	37	High	4.0
Poland	13	10	6	12	18	10	12	Medium	1.6
Romania	22	20	26	14	17	27	21	High	3.2
Russia	35	32	47	24	27	24	32	High	2.8
Slovakia	20	12	37	29	25	20	24	High	2.5
Slovenia	8	5	4	6	6	11	7	Medium	1.4
Ukraine	44	37	37	21	26	29	32	High	4.4
verall									3.0

Note: Individual estimates subject to margin of error, thus care ought to be exercised in the use of each individual estimate.
Source: Hellman, Jones, and Kaufmann, 2000; see also http://www.worldbank.org/wbi/governance

Figure 1 – State Capture and Civil Liberties

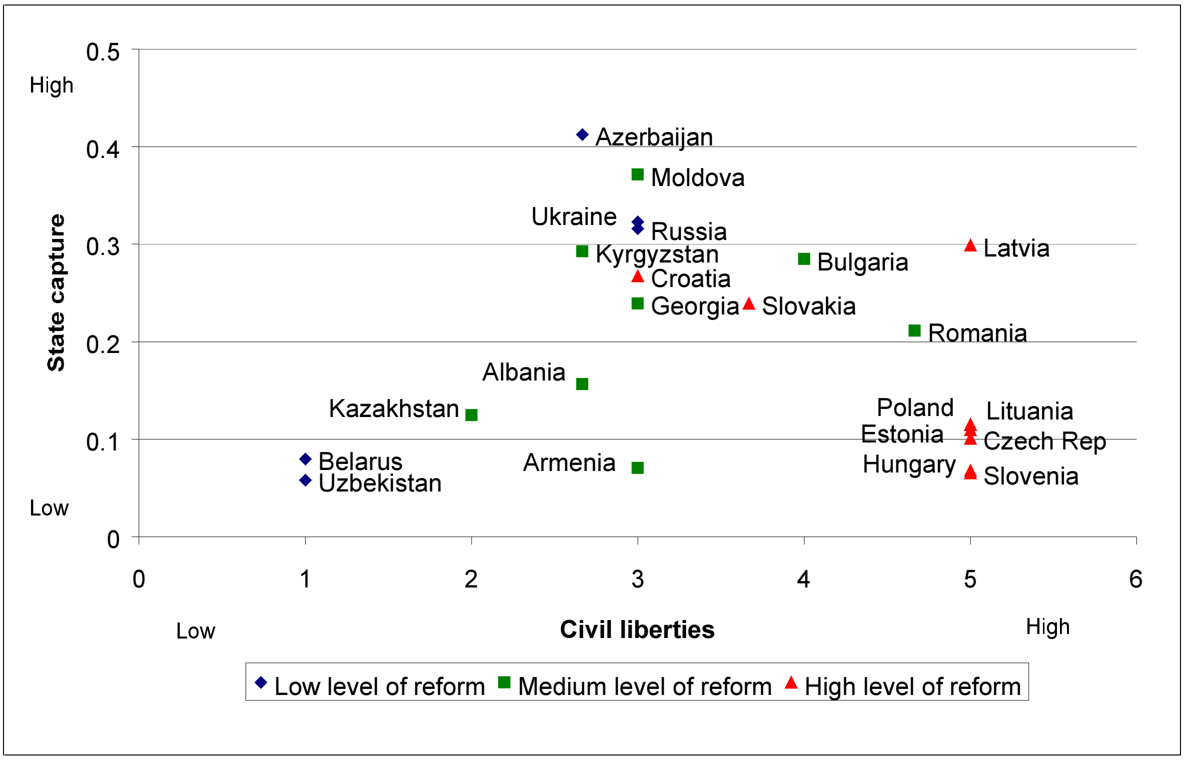

Figure 2 – The private and social costs of state capture and administrative corruption