Privatizatsiya and Kriminalizatsiya

How Organized Crime Is Hijacking Privatization

SVETLANA P. GLINKINA

Privatization in Russia has been carried out with great ruthlessness and with remarkable speed. At the beginning of July 1994 about 70 percent of enterprises were already in private hands. Is this good or bad? Does it represent a success or a failure for reforms in Russia? Of course, it depends on the quality of the privatization process and on other factors. Two worrisome features of privatization should be distinguished: its formal character and its high level of criminalization.

There are many reasons for the widespread criminal activity in the reform process in Russia. The first group of factors is connected to the general societal situation and its alarming degree of criminalization. New types of economic crime are evolving. Economic criminal conduct of businesses is becoming a necessary precondition for their very existence. The present-day situation is the result of several factors, including (1) the breakup of statehood; (2) the current economic policy; (3) an intentional weakening of the state's fight against economic crimes, backed by the government's hope to use the "shadow capital" as a resource base for economic reforms; and (4) a drastic stratification of the population's standard of living with a simultaneous loss, in a considerable part (especially among the youth), of socially important goals—replacing them with consumption ideals that have also contributed to the criminalization of the economy.

An essential factor in the criminalization of economic affairs is that monopolization of power has resulted in the formation of a state administration that seeks to derive benefits from businesses. As a result, economic bodies within the state and government structures are attempting to preserve their privileged positions in this age of capitalist reforms. According to estimates by the Research Institute of the Ministry of Internal Affairs, 25 to 30 percent of money obtained from criminal economic activity during 1990-1993 was used to nourish corrupt relations with government and state officials. Instead of fighting against corruption, modern political leaders announced the elimination of the state's role as an active agent in economic life. The resulting vacuum has substantially cleared the field for criminal economic behavior.

The result of this criminalization of the economic system is the trend to

---

Svetlana P. Glinkina is director of the Institute of International Economic and Political Studies at the Center for East European Studies, Russian Academy of Sciences, Moscow.

match the economic policy (and, in addition, the entire state policy) to the specific economic interests of criminal structures which, in turn, prevents much-needed reforms in the material and technological bases of production. Failing to create a modern technological structure leads to corresponding adverse consequences for the whole society.

There is another group of factors that influence the criminal character of privatization. They are closely connected with the very method of privatization that was chosen when the process was launched. The vast sell-off that was to return Russia to capitalism had to be carried out at a breakneck pace. It is not difficult to understand why. The first stage of the government's reforms—near universal price liberalization—had already released a storm of inflation and caused industrial output to plummet. Unless private ownership of industry and commerce could be set in place with extraordinary speed, economic collapse might well provoke broad popular resistance before privatization was complete. Now it is clear that the key consideration was not whether privatization was an economic success in the sense of promoting growth and providing jobs; much more central in the government's strategy was that the process should be "irreversible," creating a new class of large property owners ready to fight to retain their wealth. As a result, many of the investors who are participating in privatization were created from shadow economic activity—speculation, racketeering, extortion, looting and so on. Thus, Russia's privatization process is turning many of the country's prime assets over to swindlers and thieves. Analyzing the process of primary accumulation of capital in the country shows that the average Russian citizen has neither the desire nor the possibility to become an active owner in this vast new market.

". . . the average Russian citizen has neither the desire nor the possibility to become an active owner in this vast new market."

Where, on what levels, can the criminal character of Russian privatization be faced? The following scheme, which shows that Russian privatization went through four stages, can help answer this question.

Stages of Privatization in Russia

Stage One of the Russian privatization process, in 1988-1991, created the majority of the healthiest economic entities (see table). The start-up and infusion capital for some of the largest and most respectable private banks, stock companies, and joint ventures is closely connected with this process. President Boris Yeltsin launched an effort after the August 1991 coup to find the Communist Party's hoard, estimated to be tens of billions of dollars. But the investigation was suddenly dropped around the time that former Party officials connected with the money died mysteriously.

The easiest and most popular method of privatization in Stage Two was the so-called "milking the credit cow." It works as follows. The Russian Central Bank gives a special loan to a factory at a low (for Russia) interest rate of 25 percent per annum to pay overdue bills to other enterprises or back wages. The money, however, goes straight to the commercial bank associated with the factory, which re-lends it at something closer to the country's real interest rate of 250 percent per year. The difference then gets pocketed or deposited in an overseas bank account. The volume of such loans in the last nine months alone was 6.5 billion rubles. This may help explain why, although the Central Bank keeps pumping out more money, the country's enterprises never seem to get any healthier. Some managers and commercial bankers have made enormous profits, but Russia's factories are producing less, not more.

The process of Stage Three of privatization began not in July 1992 as some claim, but earlier, with the spread of so-called small cooperatives. At that time, pre-privatization of partial assets began through cooperatives created on the base of or near state enterprises.

Table: Subjects, methods and owners of the privatization process

Stage	*Subject of Privatization*	*Methods of Privatization*	*New Owner*
1	ownership of political and social orgs.	creation of commercial entities (joint cos.)	the people in or around these orgs., nomenklatura
2	state budget, social funds	wide system of special loans & tax benefits; commercial entities based on social funds	corrupt officials, receivers of benefits
3	assets of state enterprises	1987-1991: new cooperatives since 1992: sale of enterprises a) by auction, b) via commercial investing c) leasing assets d) changing the co. into a joint-stock co. (sale of stock)	depends on the quality of property: a) workers & staff b) bosses, racketeers, speculators, corrupt officials c) émigrés from USSR
4	citizens' savings	a) voucher funds b) banking orgs. c) new orgs of social security	a) fund officials b) swindlers c) investors?

Since cooperatives, unlike state enterprises, were for a long time entitled to cash accounting without restriction on the amounts involved, "unclean" relationships between cooperatives and state enterprises became increasingly common. Cooperatives frequently performed no work at all, although money was transferred to their accounts from state enterprises; money was then withdrawn from these accounts and dispersed. Trade-intermediary cooperatives offered cash in exchange for cleaning assets at a ratio of 1:3 (the cooperatives received three rubles worth of assets for every ruble in cash transferred to the account of a state enterprise). This device became a very convenient method for laundering money.

The activity of criminal groups in Stage Three of privatization depends on the quality of the privatized property. Where enterprises are making substantial profits, or own valuable property, workers have often failed to win control against the combined onslaught of bosses, racketeers, speculators and crooked officials. According to estimates made by the Ministry of Internal Affairs in mid-1993, there were 40,000 enterprises controlled or established by organized criminal organizations in Russia. Seventy to 80 percent of private and privatized firms and commercial banks were forced to pay criminal groups, corrupt officials and racketeers. In privatization, an economic nomenklatura still exists and enterprise directors often misappropriate shareholdings. In January 1993, workers at a cement plant in Vologda, north of Moscow, reportedly found that two-thirds of the shares in the plant were unaccounted for. The workers eventually discovered that the director and his mother-in-law had signed up for those shares. At the Orel Electronic Instruments Plant in central Russia, 2,000 workers early last year signed a petition demanding the help of trade union leaders in defending their rights during privatization. Plant bosses had sent most of the workers on forced leave before setting up a flagrantly illegal joint-stock company.

"The main portion of those swindled have been pensioners."

Criminal groups are very active in Stage Four of privatization as well. Hundreds of voucher funds—investment agencies resembling Western mutual funds—have sprung up to invest the vouchers of Russians who lack confidence in their ability to choose wisely in the share market. But investors who take this route still have to pick their voucher fund, and in a number of sensational cases, the funds have proven to be bogus. According to estimates for the last year-and-a-half alone, the different financial organizations in Moscow (banks, voucher funds and financial institutions) have cheated more than one million depositors, including approximately half a million citizens. The main portion of those swindled have been pensioners. Among the fraudulent companies are the Independent Oil Company, the Lenin Trade and Financial Corporation and the security company Aldzher. In mid-November 1993, 1,500 angry investors blocked traffic for two hours in central Moscow demanding that the government compensate them for their losses when the Technical Progress voucher fund shut its doors in July. As many as 30,000 investors may have been defrauded when the fund's directors vanished. Two similar cases occurred in St. Petersburg early last year. There is no reason to believe that this outcome was not foreseen, in considerable detail, by Yeltsin and his associates. But, as discussed above, openness to crime is an obvious feature of the path of Russian privatization.

Even where the methods used to acquire property are legal, and frequently they are not, the money used may be tainted. The role of criminal circles is especially important both for creating the seed money for privatization and for the laundering of money in all stages of privatization. Smuggling and illegal trade are main sources of primary accumulation of capital in Russia. The Soviet collapse left Russia with 8,400 miles of new international borders. The opportunities have opened widest for Russia's natural resources.

During the past four years, the smuggling of oil, gasoline, radioactive materials, timber and metals has sharply increased. The most popular metals to be smuggled out are nickel, copper and cobalt—which can still be purchased at subsidized prices for internal use and sold for much higher ones abroad. As much as 20 percent of Russia's oil and one-third of the metals mined were smuggled out of the country in 1992. Ten percent of the materials smuggled were destined for the Baltic states. In the first nine months of 1993, $35 million in nonferrous metals passed over the border from Russia to Estonia—most of it illegally—and then to the West. Tiny Estonia is now one of the world's largest exporters of nonferrous metals, even though it produces none. Similarly, about 70 percent of the raw materials crossing through Lithuania never reach Kaliningrad. According to information from the Ministry of Internal Affairs in Lithuania, four powerful mafia structures exist which specialize in such operations. As a result, virtually every day in 1993 a trainload of as many as fifty oil-tank cars (each of which can carry 147 barrels of oil) vanished. A train is taken to a siding at a train station that has oil storage facilities, where the oil is drained off for sale on the black market or for shipment out of the country. Eventually the empty train returns to Russia. Criminal structures have their own people working at railway stations in the Baltic states and have close connections with many corrupt officials, customers, etc. Also in Lithuania, mafia structures specialize in creating bogus commercial firms in Kaliningrad because, like other Russians, Kaliningrad residents can still purchase oil and other resources at subsidized prices. Smugglers have exploited this by setting up phony companies in Kaliningrad to buy oil and other materials. To avoid export duties, the smugglers would show customs officials a contract between a mainland Russian and a Kaliningrad firm. When customs officials checked to see if such a company existed, they usually found that it not only was properly registered, but also had a bank account. However, it was usually a 24-hour company set up for this single operation.

Another very important channel for primary accumulation of capital is exporting. There are many methods for and benefits from exporting in Russia. Fifteen billion dollars is siphoned out of the country every year, much of it by exporters tucking their earnings away in offshore bank accounts, safe from Russia's high inflation, high taxes and political instability. One scheme that has become popular is for a Russian businessman to negotiate a contract with a Chinese firm and ship the goods abroad. After a few weeks, the Russian claims he was never paid. Since there is little he can do about it, he writes off the deal. In the meantime, however, his Chinese partner has paid for the goods by making a deposit in the Russian's overseas bank account. Another method is for a Russian businessman to buy "services" abroad. For example, a Russian businessman may pay a foreign company $10,000 for consulting services. In fact, the Russian sends the money to a phony company abroad, which in turn transfers it to the Russian's bank account. No one will be able to prove that no services were received. There are dozens of firms that will perform this job for Russian businessmen, for a fee of five to seven percent of the transaction.

"Russia . . . has become the world's newest money-laundering center."

Although Russia has a commercial banking system less than six years old, it has become the world's newest money-laundering center. Billions of dollars are finding their way in and out of Russian banks and other enterprises. Likewise, Russian gangsters are finding ways to launder their new-found wealth, investing in legal enterprises and eventually transferring tens of billions of dollars out of the country.

The favorable climate for laundering dirty money in Russia is related to the special rules of depositing in Russia. If a person comes to a commercial bank in Russia and deposits one million dollars, he can only be asked for his passport. The bank cannot find the source of the money. Confidentiality laws forbid bankers from disclosing information about accounts except to the tax police. To get the information on a suspected criminal's account, the tax police must know at which particular branch among the country's 2,000 to look. As a result, it is almost impossible to trace the money, whether it is legal or not. Nor is it required that deposits be reported to the authorities, as it is in the United States where laws aimed at stopping money laundering necessitate that cash sums larger than $10,000 be reported to the federal government.

The cash nature of Russia's economy also creates unlimited opportunities for money laundering. For example, more than one-half of the Mercedeses sold in Europe are purchased in Russia. The luxury autos are purchased with illegal gains and thus constitute a form of money laundering. Since such car sales are not registered, there is no way to trace how they were bought or even who owns them. Numerous business deals also look suspiciously like money laundering. Owners of luxury hotels built in strife-torn regions of the former Soviet Union report large profits that observers believe to be phony, or at least hugely inflated. There is also the practice of setting up a bogus investment company offering 100 percent interest for one month's worth of investments, with the sole purpose of laundering money. The bogus investment company can afford to pay such high rates because of the vast sums involved.

Russia is certainly not the world's biggest money-laundering center, but it is already offering one of the most advanced forms of money laundering: control of the financial institutions. Moscow police have estimated that more than 25 percent of local banks are controlled by organized crime. Bank control is particularly easy in Russia, where no regulatory controls over ownership of banks exist. Even convicted criminals are not forbidden to buy or open banks.

High-level corruption, however, still remains one of the biggest roadblocks in getting a regulatory handle on money laundering and other financial crimes arising from the process of Russian privatization. But that is a subject for another article.