

The Political Economy of Crony Capitalism: A Case Study of the Collapse of the Largest Croatian Conglomerate

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Summary

Initially, cronyism was considered to be specific to Asian countries. Further analyses recognized characteristics of crony capitalism all over the world. According to the model presented in the paper, crony capitalism emerges in circumstances of political instability as a solution for the problem of economic growth. The model enables the analysis of cronyism in Croatia and an investigation into the question whether features of crony capitalism were a consequence of privatisation and the transition from socialism. The paper concludes that cronyism is primarily a political phenomenon and that crony capitalism cannot be reduced to its economic effects. Growth serves as a justification for the system of privileges. The collapse of Agrokor, the largest Croatian conglomerate, illustrates the development of crony capitalism in Croatia and its relation to the privatisation process.

Keywords: Crony Capitalism, Rent Seeking, Mutual Hostage Model, Transition, Privatisation

1. Introduction

The idea that cronyism was a significant feature of Croatian capitalism arose at the beginning of the 21st century. Crony capitalism and cronyism were observed in several papers written about the first decade of post-socialist transition (Franičević, 2001; 2002) and published after the banking crisis of 1999, a short economic recession linked to it and the death of Croatia's first president Franjo Tuđman, an authoritarian leader (Kasapović, 2001). In 2000 a new prime minister, Ivica Račan, was elected, and the government ordered the State Audit Office to investigate the process of privatisation of state companies. There was a widespread belief that the process of privatising socialist companies during the nineties had been full of corruption and criminal activity. The concept of cronyism and its relation to the eco-

conomic and political transition from socialism to capitalism and democracy emerged in Croatia again in the first half of 2017, after the collapse of Agrokor, the largest national and regional conglomerate, which employs 60.000 people in Croatia and neighbouring countries. Agrokor is a result of this privatisation process and its business was tightly intertwined with the country's political elites. When Agrokor collapsed, the Government took over the management of the corporation and the company's debt was frozen for 15 months by a piece of emergency legislation that was designed specifically for this conglomerate. The collapse of Agrokor provides a good example for the analysis of the nature of capitalism in Croatia.

1.1 The Term

Paul Krugman (1998) affirmed the phrase 'crony capitalism' at the end of the nineties with regard to the Asian financial crisis of 1997. Krugman used it as a concise description of a particular political and economic system that was considered to be specific to Far Eastern countries. However, further analysis recognises strong characteristics of crony capitalism in Russia, India, Africa and Latin America (Haber, 2002; Kang, 2002; MacIntyre et al., 2008; Razo, 2015), almost all over the world. The privileged market position of some companies that comes as a consequence of personal relationships between business and government, rent seeking, favouritism, clientelism, corruption and other similar features are not uncommon in the developed world. In the United States, for example, cronyism takes the form of lobbying, revolving doors between business and political organisations and the financing of political campaigns for furthering private interests. Cronyism allegedly intensified after the Great recession of 2008 (Lewis, 2013; Holcombe, 2013; Zywicki, 2015; Salter, 2014; OECD, 2015). Therefore, it is not easy to point to cronyism as a distinctive feature of a particular country. One can describe the political and economic system in Latin American countries as crony capitalism just as well as the one in Indonesia. The question is what exactly makes capitalism become "crony"; what is specific to cronyism? Is there capitalism that is not crony to a degree?

Initially, the idea of crony capitalism was an ambitious attempt to explain the Asian financial crisis and to find its roots in a specific political economy. Usually, research into the causes of economic and financial crises focuses on economic factors, such as investment (and savings), public (and private) spending, technological changes in production, etc. These explanations interpret economic crisis as a cyclical phenomenon. However, Krueger (2002: 1) asks "how cronyism... might have performed so well for so long and then have led to the crisis of late 1997". A similar question was raised by Haber (2002: xvii): "If crony systems are bad for growth, then why do they persist for so long?" This leads us to conclude that cronyism does not cause cyclical economic crises. This seems reasonable since cronyism can hardly

be considered cyclical. There are various types and different causes of crises. It might be that cronyism causes a crisis that is not cyclical.

The discussion led to another issue. Instead of observing crony capitalism as a cause of crises, the research focused on its roots. Since one cannot explain something (e.g. a crisis, stagnation, etc.) using an unexplained phenomenon, not viewing cronyism and crony capitalism as a cause, but rather as a consequence seems reasonable. When it becomes a subject of study, cronyism is considered to be a negative phenomenon and primarily bad for the economy. However, other research views crony capitalism to be a consequence of particular economic, social and political patterns and circumstances: big government, weak government, a developmental state, political instability, an authoritarian state, etc. For the developmental state, variants of cronyism are a solution to the problem of growth and sometimes even for the production of a public good (Franičević, 2002; Kang, 2002). According to studies of cronyism in Asia and Latin America, crony capitalism emerges as a consequence of an effort of weak governments to gain legitimacy by stimulating and achieving economic growth in unstable political conditions (Haber, Maurer and Razo, 2002).

From the above discussion two problems emerge. The first problem is the vagueness of the term. This is a terminological problem. Cronyism as a general term is not useful. In order to clearly distinguish the political and economic system of one particular country from that of another, one cannot use the term cronyism. To a degree it can be used in the analysis of almost every country. The second problem is the relationship between the political and the economic system. The question is whether cronyism stands for a political intervention in an autonomous economic system. It seems best for the beginning to understand cronyism as both a political and an economic phenomenon and crony capitalism as a system of political economy. Yet, even after accepting this, the question remains whether cronyism is bad only because it is bad for the economy, that is, for economic growth. Alternatively, can it be seen as a problem of malfunctioning of a political system which is also unjust? This is an ideological problem.

1.2 A Source of Cronyism

The transition from socialism of Eastern and Southeastern countries included the transformation of the political and economic system. The respect of democratic values and a functioning market economy were two formal requirements for these countries to become member states of the European Union. Croatia started the transition at the beginning of the last decade of the 20th century, formally applied for EU membership at the beginning of the 21st century and joined the EU on the 1st of July, 2013. The development of Agrokor fits into that timeframe, which makes the analy-

sis of the growth and collapse of the largest Croatian conglomerate both challenging and promising. The question is, what is the relationship between the Croatian transition and the history and collapse of Agrokor? Do the development of Agrokor and the Croatian transition both bear the same features of cronyism? If Agrokor was a source of cronyism, under what conditions does its collapse open the opportunity to reduce cronyism and dismantle crony capitalism in Croatia?

The point of this analysis is to show that Croatian crony capitalism shares its origins and patterns with the development of cronyism around the world. It is not a consequence of specifically Croatian business culture and tradition. Therefore, the theoretical part of the paper is extensive. According to the analysis, *crony capitalism emerges under conditions of political instability as a solution to the problem of economic growth*. In Croatia the transition and privatisation stimulated the development of crony capitalism.¹ The conclusion is that cronyism is primarily a political phenomenon and, basically, not an economic one. Crony capitalism is a consequence of underdeveloped democracy.

The paper is divided into several sections. Sections 2 and 3 are theoretical. Section 2 provides a brief description of crony capitalism and discusses some economic theories of cronyism. I will show that cronyism cannot be reduced to rent seeking and analyse the thesis that big government is a cause of cronyism. The beginning of section 3 discusses three intertwined political-economic theses which postulate that authoritarianism, weak government and the developmental state are in fact causes of crony capitalism. In the second part of section 3 the mutual hostage model and the development of crony capitalism under conditions of political instability are presented. This understanding of the development of crony capitalism is the basis for the analysis of Agrokor and the process of privatisation in Croatia that follows (section 4). Section 5 concludes the discussion.

2. Crony Capitalism

The purpose of this section is a brief description of crony capitalism. It will not offer a definition, but a description. Almost all researchers claim that the term is vague. As a consequence, the measurement of cronyism² is a doubtful task. The measurement of corruption, an associated phenomenon, is also of limited scien-

¹ The transition economies were understood as a “particularly good laboratory for understanding the dynamics of market evolution” (Estrin, 2002). Following that idea my paper aims to stimulate studies of cronyism in former socialist countries.

² However, *The Economist*, a weekly, publishes an informal crony capitalism index for 22 countries, similar to its famous Big Mac Index which is used to exemplify purchasing power parity. The crony capitalism index is of poor scientific reliability.

tific reliability (Kang, 2002) but nevertheless in widespread use. The meaning and significance of terms used by political and social scientists often depend on context and correspond with the nature of their research subject. Economists attempt to be closer to the exactness seen in the natural sciences. Most definitions of crony capitalism explain it as “an economy” or “economic system”.³ The impression that an exact definition and measurement of cronyism is possible and the belief that crony capitalism is primarily bad for economic growth fit this approach. However, crony capitalism is a political-economic system. As an introduction to the political analysis of cronyism, the following section presents an effort to capture cronyism in economic terms.

2.1 Cronyism and Rent Seeking

A key economic concept associated with cronyism is rent seeking (besides corruption, which is an economic but also a social and political phenomenon). The idea of rent seeking comes from public choice economist Gordon Tullock (1967).⁴ Recent economic discussions on cronyism frequently refer to public choice authors, e.g. Tullock, James Buchanan, Mancur Olson and others (Zywicky, 2015; Holcombe, 2013). The public choice approach identifies cronyism with corporatism. Advocates of the concept of corporatism claim that organised interest groups are equally harmful for the proper functioning of a market economy, regardless of whether they are organised labour interests (unions) or organised business (capital) interests (Olson, 1982). The public choice “uses economic tools to deal with the traditional problems of political science” (Tullock, 1987/2008).⁵ The reduction of cronyism to rent seeking fits to that approach. However, this reduction is not viable.

Rent is defined as “that part of the payment to an owner of resources over and above that which those resources could command in any alternative use” (Bu-

³ Bićanić and Ivanković (2017) refer to definitions of crony capitalism: “An economic system characterised by close, mutually advantageous relationships between business leaders and government officials” (Oxford Living Dictionaries, https://en.oxforddictionaries.com/definition/crony_capitalism); “An economy that is nominally free-market, but allows for preferential regulation and other favourable government intervention based on personal relationships. In such a system, the false appearance of ‘pure’ capitalism is publicly maintained to preserve the exclusive influence of well-connected individuals” (Business Dictionary, <http://www.businessdictionary.com/definition/crony-capitalism.html>).

⁴ The term is created by Anne Krueger (Hillman and Ursprung, 2015), but the idea of rent seeking comes from Tullock’s paper “The welfare costs of tariffs, monopolies, and theft” (1967).

⁵ “By assuming that voters, politicians and bureaucrats are mainly self-interested, public choice uses economic tools to deal with the traditional problems of political science”. In Buchanan’s words (1980: 14), public choice is “the extension of the basic tools of economics to nonmarket interaction” (http://www.dictionaryofeconomics.com/article?id=pde2008_P000240).

chanan, 1980: 3). The definition relies on a model of the economic system which assumes an ideal competitive market. This is its main weakness. However, Buchanan is aware that in the framework of competitive equilibrium rent seeking cannot be distinguished from profit seeking. Following Buchanan, Pasour (1987), an Austrian school economist, compares rent seeking to monopoly (and other market failures). He shows that “there is no objective procedure for distinguishing productive from wasteful activities” (*ibid.*: 132). From his conclusion it follows that rent seeking, in the framework of market equilibrium, that is as a pure market phenomenon, cannot be objectively recognized.

Therefore, Buchanan makes an effort to identify wasteful rent seeking in a political setting. He assesses several forms of lobbying (which is a clear case of cronyism) in the framework of competitive equilibrium. Yet, Pasour, following Posner, concludes that “assuming that supply is perfectly elastic... ‘at the margin, the cost of obtaining a monopoly is exactly equal to the expected profit’”. Consequently “the cartel gains would be completely dissipated through competitive rent-seeking activity” (*ibid.*: 127). It is not possible to identify the waste of lobbying using perfect equilibrium as a benchmark. According to Pasour, an “economist can identify waste in the actions of other people only by imposing his own standard of value” (*ibid.*: 130). He refers to Rothbard, another Austrian school economist, that “on strictly economic grounds, [the] economist cannot reject (or advocate) any public policy” (*ibid.*: 134).⁶ This implies that Buchanan’s effort to identify wasteful rent seeking in a political setting, “using economic tools” is futile.

If public education is considered a valuable achievement, then lobbying for public education is not a wasteful activity. This can be interpreted as “good lobbying”. The same can be said with regard to market deregulation, labour rights, government-run health insurance, and so on. Although Pasour concludes that “rent-seeking waste is a *matter of opinion* depending on one’s view of the appropriate role of the state, which must ultimately be determined *on the basis of ethics rather than economic theory*” (*ibid.*: 137, my emphasis), at the end he makes a concession

⁶ Buchanan’s effort relies on an ambiguous concept of social gain from market exchange postulated by Adam Smith. There are two sides of this concept. On the one hand, free private exchange is seen as the only certain way to achieve ‘socially beneficial consequences’. On the other hand, the idea of social gain is widely used reason for the demand for the intervention of the government (following externality theory, monopoly theory, public good concept, consumer ignorance concept, etc.). Pasour refers to Littlechild that “net social benefit is an artificial concept”, and Robbins: “Whenever we discuss distributional questions, we make our own estimates of the happiness afforded or the misery endured by different persons or groups of persons. But these are *our* estimates. There is no objective measurement conceivable. We cannot go further in the analysis of the concept of social gain” (1987: 131).

to public choice economists and accepts that “if emphasis is placed on the freedom of individual choice... limiting the role of the state is essential in minimising the effects of rent seeking” (*ibid.*).

2.2 Big Government

The idea that crony capitalism is a consequence of big government follows from the above concept that rent seeking is the key mechanism of cronyism. If fewer resources are available for private negotiation between politicians and interest groups, *opportunity* for rent seeking is reduced. Cronyism is considered a variant of corporatism (Holcombe, 2013). Although the conclusion seems persuasive, above is demonstrated that it is contradictory, at the same time. If a minimal state is proposed, then lobbying for a minimal state is not a wasteful activity (as well as lobbying for the protection of private ownership and business). Hence, lobbying, a form of rent seeking, is not a wasteful activity per se, although it was assumed to be at the beginning. On the other hand, a minimal state does not prevent the collection of rents (in the form of monopoly waste). From this it follows that lobbying for a minimal state is a possible form of cronyism, which is an opposite conclusion to the previous one.

Some empirical evidence also undermines the thesis that big government is the only cause of cronyism. In Scandinavian countries, where the government spends more than half of the national product, cronyism is weaker than it is in some countries with lower public expenditure. Corruption, a feature of cronyism, is pervasive in the undeveloped countries of Africa where governments do not control large parts of economy (Lambsdorff, 2007). Small government does not necessarily prevent the development of crony capitalism. The thesis that big government is the main cause of crony capitalism includes an additional empirical problem (related to the above recognized theoretical inconsistency). The growing role of government in the economy and the increasing share of government spending in GDP are distinguishing features of 20th century development all over the world, i.e. in both developing and developed countries. This implies that crony capitalism (insofar as it is a consequence of big government) is an unintended outcome of development. Besides the increase in social spending, healthcare and education, a further reason for the increasing role of government in economy are changes of technology and a related increase in the demand for intellectual property protection (OECD, 2015). (That demand is the above mentioned “good lobbying”.) These trends are somehow intertwined. Technological change increases business risk and personal uncertainty. From this follows an increase of the demand for social protection and government intervention. From this point of view deregulation is a myth. This clearly follows from the comparison of the regulation of stock exchanges in 1933 and “the deregulation” from 2010: “In contrast to the 37-paged 1933 Glass-Steagall Act, which

separated investment banking from commercial banking, the Dodd-Frank bill alone ran to more than a staggering 2,300 pages” (*ibid.*: 22). An unintended consequence of Thatcher’s famous privatisation was the growth of regulatory agencies, a hidden form of state ownership (Florio, 2004).

Above it has been shown that cronyism cannot be objectively identified as a purely economic phenomenon and that big government does not necessarily cause cronyism. The dominance of economic analysis in contemporary society does not enable the understanding of such a phenomenon as cronyism. Moreover, the growth of government spending and an increase of the role of the state in the economy are a consequence of development. This however creates a fertile ground for the establishment of personal relationships between businessmen and politicians. A famous quote from Adam Smith’s *Wealth of Nations* that a meeting of business people usually “ends in a conspiracy against the public” implies that an inclination of business to veiled activities is natural. No doubt that cronyism is a phenomenon of the same kind. Yet, the question remains: why is it considered bad? If bad, is it possible to prevent it and how? In the attempt to draft a framework for the analysis of crony capitalism in Croatia (following the example of Agrokör) I will present three intertwined political-economic theories of crony capitalism: (i) that an authoritarian environment is favourable for cronyism; (ii) that weak government is an opportunity for cronies; (iii) that crony capitalism is an outcome of the developmental state. Cronyism is considered a political phenomenon (with economic effects). Haber insists: “Crony capitalism is not solely an economic phenomenon. It is a political creation and has political consequences” (2002: xviii).

3. Political Economy of Cronyism

Initially it was argued that crony capitalism was specific to South East Asia, particularly South Korea, although the pattern was recognized in other countries. Kang (2002) compares South Korea and the Philippines. While the Philippines lag, South Korea is an example of a fast growing country. Kang’s effort is to debunk the pre-conception that South Korea’s faster economic growth is due to less cronyism and corruption. A professional and competent bureaucracy that strongly depends on political leaders was at a similar level in both countries. The same holds for a weak rule of law, nepotism, clientelism and corruption. What was different? Why was South Korea’s growth so much stronger? Kang observes the relationship between business and political leaders in both countries. According to his analysis, the lag of development in the Philippines was a consequence of an imbalance of power between business and government. The initial democratic period in the Philippines was characterised by weak government and the seeking of privileges from the wealthy side of society and business. Then the pendulum moves. The subsequent

Marcos government was predatory towards business. The development in Korea is different, partly because of different external conditions. Due to the military threat from the north, South Korea succeeded in developing lucrative export contracts with the United States. The concentration of both political power and business in Korea affects their mutual interdependence (Kang, 2002).

3.1 *The Mutual Hostage Model*

The above is a brief historical sketch of a balanced relationship between business and politics in South Korea and imbalance of political and business power in the Philippines. It is important to note that common features of cronyism were similar: clientelism, weak rule of law, corruption. The relationship between business and politics was different. Kang developed four types of that relationship in a nondemocratic environment (Figure 1, from *ibid.*: 14; I will use a different order of description than Kang, with the aim to prepare the framework for the thesis that crony capitalism is an outcome of political instability). The state can be *coherent* or *fractured* while business can be *concentrated* or *dispersed*. At the beginning, the state is fractured and business is dispersed. This is the *laissez-faire* type of the relationship between business and the state; next is *bottom up rent seeking* (state fractured, business concentrated); then comes *top down predatory state* (business dispersed, state coherent), and the fourth type is the *mutual hostage* model (state coherent, business concentrated). Kang claims that the fourth model decreases transaction costs the most, therefore this is the best for the development of non-democratic countries.

		state	
		coherent	fractured
business	small-N (concentrated)	I: mutual hostages type: PD collusion amount: medium	II: rent seeking type: bottom-up amount: large
	large-N (dispersed)	III: predatory state type: top-down amount: large	IV: laissez-faire type: residual amount: small

PD = Prisoner's Dilemma

3.2 *Democracy and Cronyism*

A similar framework of crony capitalism is further developed in Haber, Maurer and Razo (2002), and Razo (2015). The model proposes that crony capitalism is initially an outcome of political instability. The essence of the model is that crony

capitalism is a second best solution for the problem of growth under conditions of political instability. The model assumes that players come from two sides; one is the business side and the other is the political side. The key concepts used in the model are: political stability, political instability, limited government, authoritarian government, political factions, credible commitment, backward vertical and forward vertical integration of business and politics. The final conclusion is optimistic: the development of democratic institutions enables reforms of the patterns of crony capitalism (Haber, 2002).⁷ Since the transition from socialism in Croatia began under conditions of political instability, the question raised by the model discussed here is whether this instability was the cause of the rise of crony capitalism in Croatia. And the next question is whether the development of Agrokor, from its early growth during the period of privatisation of state owned companies to its collapse, fits into this framework.

3.2.1 Political Instability

The initial position is political instability. To understand political instability it is useful to explain the meaning of terms in the context of political systems. A political system is a set of institutions that mediate conflicting social demands and organise the realisation of political interests. It provides for the division of labour between the public and private sector. A stable political system minimises uncertainty if faced with two types of problems. The first one is the replacement of government. The second is the problem of the changes in the fundamental rules that shape the political system. If these two conditions are fulfilled all subsequent changes are endogenous to the political system. Such a system is then self-enforcing and stable. Under conditions of political instability the replacement of the government or the change of internal rules are exogenous. A military coup is an example of an exogenous replacement of the government, but the lack of common knowledge about the political system is a cause of political instability as well. Under conditions of political instability political factions that come to power cannot make a credible commitment towards the protection of property rights. As a consequence the government is unable to protect or stimulate economic activity. According to the model, there are three exits from this state of affairs. The first one is a dictatorship, the second one is a democracy (limited government) and the third exit – in the modern world – is crony

⁷ This conclusion fits to analyses of the relationship between democracy and economy in Sokoloff (2002), Acemoglu and Robinson (2009; 2012), and North, Wallis and Weingast (2009). Sokoloff emphasises participation, Acemoglu and Robinson emphasise inclusive institutions, and North, Wallis and Weingast point to the depersonalisation of institutions and the reduction of privileges. However, an improvement of democracy and dismantling of crony capitalism does not guarantee economic growth, although the above authors believe it does. The relationship is not linear (see footnote 9).

capitalism.⁸ The problem with a dictatorship is its unrestrained political power. By definition a dictatorship is predatory and thus it cannot make a credible commitment that property rights will be protected. As a consequence a dictatorship cannot stimulate economic growth, which is necessary for the sustainability and legitimacy of the system. The alternative to a dictatorship is democracy, that is limited government. Under the condition of democracy, the government's predatory power is limited by the veto power from another faction, or another political institution. Usually this is referred to as a system of checks and balances. Democracy can make a credible commitment, therefore this is a political system favourable for economic growth.⁹

3.2.2 Crony Capitalism

The third exit is crony capitalism. The sequencing of steps is to some degree different than under dictatorship or democracy. The crony capitalism solution aims to consolidate political power by making a credible commitment on the protection of property rights of particular businesses and give a stimulus to economic activities. In order to consolidate the system credible commitments come first, not vice versa. This is why crony capitalism is so persistent: because cronyism is fundamental for the system; its stability is founded on the support of cronies.¹⁰ A political faction and a particular business (asset holder) make an informal agreement. At the time of the agreement this political faction usually holds formal power, although this is not necessary.

In crony capitalism there are two types of integration of political factions and businesses, which are not mutually exclusive. In the case of so-called *backward in-*

⁸ Under traditional nomenclature the third exit is oligarchy. For the purpose of our analysis we will put aside the analysis of relationship between traditional oligarchy and crony capitalism.

⁹ Economic growth depends on a number of factors. It comes as a consequence of fulfilled opportunities. Opportunities are probably wider under a regime of civilised and developed democracy and a well-ordered market economy, although growth is not guaranteed. There is a vast literature on the subject. Przeworski (2004) persuasively disproved a linear relationship between democracy and growth. In my opinion this does not undermine the model. Democracy, that is limited government, is valuable by itself.

¹⁰ Franičević (2001: 73) concludes: "Whatever the cause, *it is important to note that accumulation and growth, in principle, do not require markets, as is important to note that legitimization, in principle, does not need a democratic constitution.* Modern history is rich with examples of countries passing through long periods of high growth and political stability in spite of the fact that neither markets nor democracy were dominant attributes of the period... The social-institutional arrangements of the so-called 'Golden Age' period in the most developed countries of the world can hardly be described as purely liberal and/or democratic. Rather, corporatist arrangements and states were functional to such growth... Even socialist industrialisation (which can be viewed as a particular case of late modernisation) produced periods of high growth under highly non-democratic but hardly contested arrangements."

tegration the business side dictates to the political institutions the economic agenda, and in the case of *forward integration* members of the government turn their interest into business (Haber, Maurer and Razo, 2002). There are a number of forms of backward and forward integrations. The most suspect form is the exchange of financing of political activities (e.g. campaign) in return for market privilege. The next one is the employment of family members of politicians in a particular company, and vice versa, the employment of members of business families in the state administration. The so-called revolving doors relationship between business and administration is the third form. In all these cases, the key characteristic is that the relationship is basically personal. This is why the rule of law is of secondary importance, conflict of interest is pervasive and different forms of corruption are omnipresent.

According to the above analysis, crony capitalism is the second best solution for growth. The question is why there is no initiative from the political side for the universal protection of property rights which, according to the model, can provide a greater stimulus for the economy? In the circumstances of political instability the government cannot make a general commitment, because this is not, by definition, a democratic political setting. There is no political faction that holds veto power. Therefore the government can always turn and become predatory, or another faction can take the power. Crony capitalism is a method of strengthening political power through economic growth.

4. Agrokor and Croatian Transition

There is a lack of research into the relationship between political and economic aspects of the transition in Croatia. The subsequent brief analysis of political and economic transition in Croatia is based on the model of origins and characteristics of crony capitalism presented above (sections 2 and 3). Agrokor, the largest Croatian and regional conglomerate, is used here as a persuasive example. Its history is intertwined with the transformation of socialism to capitalism, above all with the process of privatisation of socially owned companies. The idea of the following analysis is to examine whether the transition and privatisation stimulated the emergence of cronyism in Croatia and to initiate further studies of the political economy of transitional countries. The analysis consists of three chronological parts: (i) political instability and privatisation; (ii) mature crony capitalism; (iii) why did the relationship between Agrokor and the government abruptly break?

4.1 Political Instability and Privatisation

It is not disputable that the 1990s in Croatia were a period of political instability. The Homeland War, which erupted after the declaration of independence of Croatia from the former Yugoslavia, lasted from 1991 to 1995. However, as a consequence

of the transition from a one-party to a multiparty political system, a lack of common understanding of the internal rules that regulate political and economic affairs fuelled political instability more than anything else. First president Franjo Tuđman emerged as an authoritarian leader who installed members of his political party, the Croatian Democratic Union (CDU), at the top of the state-owned infrastructural and other large companies. The question is why and how did he and his close political circle establish an informal cooperation with the segment of business people who participated in the privatisation process?

Privatisation was the challenge of the time. It was assumed and promised that the system of private property would enable and lead to economic growth. At the same time, from within Tuđman's party, companies were seen as prey and privatisation provided a method of taking them over. Privatisation was not only on the policy agenda of the CDU but a constituent part of the political programme of all parties. The opposition forced privatisation to lessen the control of the government over the society and decentralise economic power. This implies that the opposition also behaved towards companies to be privatised as potential prey. One of the most debatable questions (even today) was whether privatisation favoured the new ruling elite or the former political and economic elite which occupied top positions of the companies during socialism.¹¹ In the political battle several ideological assumptions were employed. It was claimed (i) that the decentralisation of economic ownership leads to the development of a market economy, economic growth, the decentralisation of political power and democratisation;¹² (ii) that any private property is economically more efficient than state-owned property. Yet, the second proposition was the argument used by the ruling party to distribute ownership to its members and clients.¹³ This intervention undermines the persuasiveness of the first argument as well: the decentralisation of economic ownership does not necessarily lead to democratisation. Therefore, the above two conclusions were abused to support crony capitalism (instead of democracy and market economy).

¹¹ Krištofić (1999) has noted: "Of 130 managers who were surveyed in 1996, 60 had also been directors under socialism, and 70 came to their management position after the change of the government".

¹² This is a variant of the modernisation theory that was formulated in the sixties and re-emerged in the nineties (Lipset, 1994).

¹³ The second proposition is, empirically, probably more often true than false. Private property is usually more profitable than state ownership (efficiency is another concept). This proposition belongs to the understanding of economy as an autocorrecting mechanism analysed in section 2 above. The fact that this understanding can support the political intervention in the economy discloses its ideological and contradictory nature. "Good intervention" (distribution of property to clients since *any* private property is better than state owned) is analogue to above mentioned "good lobbying".

4.1.1 Three Features of Privatisation

Three important characteristics of Croatian privatisation fit the description of an environment of political instability favourable for the emergence of crony capitalism. The first is asset stripping (tunnelling).¹⁴ Theory recognises asset stripping as a method for saving property in circumstances of political instability (Allen, 2002). An asset holder moves a resource under his/her control to another company or decreases its value for the purpose of deterring a possible competitor. The second is the lack of respect for the rule of law and formal institutions.¹⁵ This characteristic was at the same time a consequence of political instability and a cause of the development of crony capitalism (Hoff and Stiglitz, 2004). This circumstance stimulates the establishment of personal relationships between politicians and asset holders (business people). The role of politicians is to protect business ownership. The third characteristic was the preference for sole (single individual) ownership of companies, i.e. that they had a recognisable dominant shareholder. This arrangement was the openly preferred ownership structure by the political elite since it made the establishment of personal relationships easier and more efficient. All three characteristics are intertwined and, at the same time, a consequence of political instability and a cause of the development of crony capitalism.

4.1.2 Backward and Forward Integration

According to the theory of crony capitalism explained above, backward and forward integration between business and politics strengthens personal relationships. Two convincing examples illustrate this. The first is the case of Nevenka Tudman, daughter of the first Croatian president, who became a business partner of Agrokor in the 90s, as well as Nikica Valentić after he left his position of prime minister in 1995. These are examples of forward integration. In the nineties Agrokor was allowed to acquire, through the process of privatisation, its most important companies, Konzum, a retail chain, the largest in Croatia, ice-cream producer Ledo, mineral water producer Jamnica and butter and vegetable oil producer Zvijezda, all of them having a strong monopoly position in Croatia. Members of the family of the president attended opening ceremonies of new business facilities and this kind of business success in the private sector was celebrated as an argument for the pri-

¹⁴ Asset stripping is a general term. In the transitional environment asset stripping was called tunnelling (Johnson et al., 2000). For a detailed account of asset stripping in Croatia see Ivanković (2009) and SAOR Final 2004 – *The Final Report on Privatization*, The State Audit Office of the Republic of Croatia, Zagreb, available at www.revizija.hr.

¹⁵ Bićanić and Ivanković (2017) recognise that lack of respect for the rule of law existed already during the last decade of socialism. This created a favourable environment for the emergence of the crony characteristics of privatisation.

atisation policy being implemented. The theory of crony capitalism recognises that companies, in an exchange of favours, were supposed to deliver growth.¹⁶ As an example of backward integration, besides the privileged position in privatisation, Ivica Todorić, the owner of Agrokor, openly demanded the protection of his firm's privileged market position from foreign competition.¹⁷ As a conclusion, the key characteristics of crony capitalism in Asian countries presented above (Haber, 2002; Kang, 2002), political instability, personal relationship and credible commitment, formalised through backward and forward integration, are recognisable in Croatia. This makes cronyism a widespread pattern of the development of capitalism. The examples from the next phase support this insight.

4.2 Mature Crony Capitalism

The next phase of the development of crony capitalism in Croatia was characterised by the following well known patterns: (i) corruption; (ii) the revolving door method of strengthening personal relationships between business and politics, enabling an influence of particular business interests on legislation and securing a privileged market position; (iii) partnership between the government and privileged companies in a chosen policy of economic development through cooperation in the execution of a particular business project. As for (i), at the end of the first and the beginning of the second decade of the 21st century Ivo Sanader, prime minister, and several ministers were formally accused of corruption in several cases. This theme will not be further explored here.¹⁸

As for the revolving door method, when the centre-left coalition took power in 2000, several members of the previous political elite were employed in Agrokor and some executives from Agrokor moved to the government. The conglomerate played both sides. It is important to note that the governor of the Croatian National Bank was an employee of Agrokor, the minister of finance as well, and the head of the Croatian Police Forces. Although the form was changed, the personal relationship between Agrokor and the government survived. The adaptation of Agrokor's ideological position to the new political atmosphere is notable. At the end of the nineties Croatia suffered a recession and banking crisis which wiped out several private con-

¹⁶ According to Krueger (2002), it was supposed in South Korea that private conglomerates beside growth deliver also a public good, the same as state owned infrastructural companies. This is why, according to her analysis, these companies are not efficient enough and the growth based on them lags. Her conclusion is empirically questionable.

¹⁷ In the movie "Gazda" ("The Boss") Ivica Todorić, the owner of Agrokor, demands support from the government for the development of his business.

¹⁸ Still, it is important to note that Agrokor's secret financing of political parties became public after the collapse of the conglomerate. A politician from a small party confirmed it in the Sunday tv-show *Nedjeljom u dva* on 15 October 2017.

glomerates that were supported by one faction inside the ruling conservative party. Trying to solve a liquidity problem, Agrokor played a political game. The trade union organised a street protest to demand a state guarantee for an international loan which enabled the conglomerate to overcome the liquidity problem. From that time Agrokor established a good relationship with trade union leaders and in public communication emphasised its growing number of employees. The new government was more internationally oriented than the previous one, and open for cooperation with neighbouring countries in the region. The conglomerate followed this policy, supported it and exploited the opportunity to further develop its business. Financed by the EBRD, Agrokor was the first Croatian company to acquire a Serbian company.

The thesis that crony capitalism is the developmental state's solution for the problem of growth (second best) was further confirmed when the conservative government came back to power. From 2003 to 2011 Agrokor acquired several bankrupted state-owned agro-conglomerates, heavily invested in their recovery and secured its position as the best and most important business partner of the government. Certainly, the fact that Prime Minister Sanader behaved as a strong leader was favourable for this development. It was easier to make a contract with him. Agrokor was helpful for the next prime minister, Jadranka Kosor, who was a politically unstable leader. In addition to its own intensive investments across the country and in the region, Agrokor supported the family businesses of some ministers, private businesses of former politicians and influential members of the elite.

At the time of Prime Minister Sanader, in the first decade of the 21st century, Croatia was close to developing the mutual hostage relationship between business and politics. Sanader established a strong relationship with the largest companies. Later, while testifying to a parliamentary commission, Sanader confirmed that the postponement of the tax payment for the largest oil company INA was his informal decision. When Agrokor acquired bankrupted PIK Vrbovec, the largest Croatian meat producer, the Government decided to write down its tax debt. The same happened in several other Agrokor's acquisitions. Agrokor's privileges were obvious.

4.3 Larger than the State

Croatia's recession lasted for six years (2008-2014). Among the members of the EU, only Greece's recession was deeper. During the recession, in the middle of 2013, Croatia joined the European Union. While the national labour market contracted (the unemployment reached 17 percent), Agrokor reported profit, employed people and invested a lot. This was welcomed by the government. After Sanader resigned, Prime Minister Jadranka Kosor (2009-2011) was an unstable leader. The balance of power between politics and business shifted toward Agrokor; the conglomerate became larger than the state. It was by revenue more than two times larger than the second largest corporation INA, an oil producer and trader. Following

Kang's scheme, this was the period of *rent seeking*. From one side, Agrokor acquired enormous social and political power. From another, its corporate culture and business model greatly deteriorated due to lack of control.

As for social and political power, the conglomerate was the largest advertiser in the country. Therefore, all major media were under Agrokor's control. The conglomerate consolidated its relationship with the trade unions. A leader of the organization was awarded with an executive position in the corporation. Agrokor's representative in the Croatian Employers' Association was the president of the organization that officially negotiated laws with the government. In 2015 a minister of finance, who was earlier an executive of Agrokor, postponed some laws only to mitigate Agrokor's financial difficulties. These are examples of a strong forward integration.

Since the conglomerate was too strong economically, socially and politically, nobody controlled it. Neither the tax administration nor any other state agency supervised Agrokor. All major decisions were made by the owner without any formal procedure. There was no record of formal meetings of the board.¹⁹ The distinction between the company and the owner, between private and official, blurred. Banks and other financial institutions financed investments without a due analysis. They relied on the magnitude of Agrokor's business. When Croatia joined the EU, Agrokor encountered strong competition. Instead of consolidating its business, the conglomerate took over several bankrupted state-owned agricultural companies and finally, in 2014, it acquired the largest regional retailer, the Slovenian Mercator. The investment and acquisitions were financed by expensive bonds and loans provided by Western and Russian (from 2014) banks. Now this looks like a kind of Ponzi scheme.

Two years after Sanader's resignation, Agrokor's owner, faced with the prospect of the approaching parliamentary elections, decided to take part in the elections more directly and give financial support to an independent list in which National Bank governor Željko Rohatinski was the candidate for prime minister.²⁰ According to surveys, the list didn't have enough support so they gave up.

4.4 The Break of the Relationship with Politics

When Agrokor encountered a liquidity problem at the end of 2016 and eventually collapsed at the beginning of 2017, the government refused to help. From the framework presented above there are two explanations for such a development. The first is that Agrokor was not capable of delivering economic growth any more. The se-

¹⁹ According to the first report of the commissioner after the government took the management of the firm, which is available at www.agrokor.hr, Agrokor didn't record or didn't hold meetings of the board.

²⁰ My article about that endeavour was published in *Express*, a Croatian weekly. Rohatinski confirmed this to me personally.

cond is that the government was prevented from helping.²¹ The second thesis is more interesting and important, since it implies the end of the previous form of crony capitalism in Croatia. As for the first thesis, Croatian crony capitalism has never delivered exceptional economic growth. Immediately before the recession growth was very strong, but even at that period Croatia lagged behind Eastern members of the European Union.²² As for the second thesis, the question is what would prevent the government from supporting the largest and most important Croatian conglomerate?

It is a fact that EU membership restricts opportunities for intervention. The government took over the management of Agrokor for 15 months preventing its owner Ivica Todorić from having any role in the decision-making process. This implies two important changes that fit the above model: a break of the personal relationship between politicians and business – despite the fact that the current finance minister Zdravko Marić was a former executive in Agrokor – and that rule of law is respected more than before, which is surely a consequence of Croatia's EU membership. Finally, Most, a minor party in the ruling coalition, employed its veto power and openly demanded that Ivica Todorić leave the company if the government was to intervene. This veto was supported by an enormous aversion of the public against the hierarchy (the elite) that emerged during the development of Croatian crony capitalism. Most recognized its chance. Although this looks like progress towards democracy, a better conclusion would be to say that the collapse of Agrokor only created *opportunities* for the improvement of democratic standards in Croatia.

5. Conclusion

The development of Agrokor over the period of the Croatian transition and its collapse after the country joined the EU clearly bears some of the characteristics and patterns of cronyism described above. Croatian capitalism fits the framework of crony capitalism presented in sections 2 and 3. The objection that illustrative examples prove nothing misses the point. The idea was to recognise patterns, not to prove something. The fact that the relationship between politics and business in Croatia shares some features with the Philippines, South Korea and other countries does not imply that the evolution of capitalism eventually follows a predetermined path. The same is true with economic growth which does not necessarily follow from particular institutional settings. The model identifies the main components and analyses

²¹ The owner of Agrokor Ivica Todorić claims that members of the government joined a conspiracy against him and the conglomerate. The purpose of the conspiracy is to take over the conglomerate as cheap as possible. Todorić left the country before the Croatian police issued an international warrant against him.

²² The relevant statistics is provided here: [http://ec.europa.eu/eurostat/statistics-explained/index.php/File:Real_GDP_growth,_2006-2016_\(%25_change_compared_with_the_previous_year;%25_per_annum\)_YB17.png](http://ec.europa.eu/eurostat/statistics-explained/index.php/File:Real_GDP_growth,_2006-2016_(%25_change_compared_with_the_previous_year;%25_per_annum)_YB17.png).

their possible relationships. Unlike the Philippines, South Korea developed a mutual hostage relationship between business and politics. The military and economic cooperation with the United States contributed to that outcome.

According to the model, crony capitalism and cronyism are primarily political concepts. They are not reducible to economic analysis. However, crony capitalism is a solution for economic growth, but only because growth can be used to give an explanation for privileges and special relationships. When Agrokor collapsed, it failed to justify the system. Economic growth comes as a consequence of fulfilled opportunities for growth. Croatian crony capitalism never developed the mutual hostage relationship. During the nineties, when Agrokor acquired its largest companies through the process of privatisation, president Tudman was too powerful. Despite strong features of cronyism, crony capitalism in Croatia was at that time in an infant phase. It was not possible to show that Agrokor's business significantly contributed to economic growth. Politicians used Agrokor's business success more as an example of the validity of the process of privatisation. This does not undermine the analytical potential of the model. Croatia was closer to the mutual hostage model in the first decade of the 21st century when Prime Minister Sanader developed a strong informal relationship with the largest companies. Nevertheless, Croatia's growth lagged behind comparable countries. Therefore, it is time to try something different. If Croatia takes the chance for an improvement in its democracy after the collapse of Agrokor, it will not mean that growth will follow automatically. Democracy is important and valuable by itself.

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