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MAKING MONEY IN THE STATE: NORTH KOREA'S PSEUDO-STATE ENTERPRISES IN THE EARLY 2000s

Abstract

In the 1990s, a part of the North Korean economy underwent a process of marketization and de facto privatization. While largely spontaneous, this process was eerily reminiscent of developments in other post-Communist countries in Eastern Europe. One of the results was the emergence of a new entrepreneurial class, a nascent bourgeoisie. In order to overcome the obstacles that arose from the lack of any legal framework for their activities, they often chose to register their enterprises with state agencies, creating what we call Pseudo-state Enterprises (PSEs). Utilizing an agency theory approach, with particular emphasis on property rights and contracting problems, this article traces the origin of the PSE, their interaction with the state, how they are managed and the challenges they face. The article is based on refugee interviews with five North Koreans involved with the PSE-related activities in nine entities covering a range of different sectors.

Keywords

North Korea, marketization, postsocialism, postcommunism, transition, principal-agent problems, black market, Pseudo-state enterprises

INTRODUCTION

This article is about how entrepreneurs created new de jure state-owned enterprises in North Korea starting from the late 1990s. The major focus of the article is the 2000–2011 period, that is, a decade between the end of the Great Famine (euphemistically known as the ‘Arduous March’) of 1996–99 and the death of Kim Jong Il in 2011. The changes that happened under Kim Jong Un’s rule are beyond the scope of the present article—partly because of paucity of material, but also because the new situation remains somewhat uncertain.

The article seeks to offer some tentative answers to the questions around who these people were, the firms they created and how these firms interacted with the state. We call these firms ‘Pseudo-state Enterprises’ (PSE), for this is what they are: state-run and owned on paper, but in practice controlled by private interests to which much of the profits accrued. Following a detailed discussion of the paper’s framework, we focus on nine firm case studies based upon interviews with five individuals. Our purposes are in the first instance descriptive, and they center on two issues. The first issue is around the identity of the people who started PSEs—the entrepreneurs themselves. From what kind of social background did they come, and what kinds of sums did they invest?

The second issue regards state–business relations—how PSEs were set up and how they interacted with the state.

However, we nest our discussion in the context of property rights and agency problems in state-socialist systems. We conclude that the PSE is a form of transitional ownership structure created due to a lack of properly functioning, market-constituting legal institutions. The state sector faces agency problems vis-à-vis PSEs, with local, but particularly central, government officials facing difficulties in monitoring these entities. We show that the incentives of higher- and lower-level officials diverge (an agency problem for higher officials), with local-level officials more inclined to tolerate the PSEs than are those of the central government, who periodically seek to break them up.

The entrepreneurs themselves face the problem of how to assure at least some property rights over the venture and how to operate in a dangerous and highly uncertain environment. We consider they ways contracts are constituted to solve these problems, and the problems such contracts face. But these entities necessarily result in the corruption of existing state socialist legal norms and law enforcement mechanisms; corruption is a central theme in these entrepreneurs' stories. A peculiar form of corruption is the "prophylactic bribery," in which the entrepreneurs make advance payments to officials who have at least a theoretical ability to disrupt their operations—ostensibly with no demands, but on the assumption that the officials would keep turning blind eye to their activities.

The reason for these dynamics is rooted in the ongoing commitment to state socialism. Under North Korean law there remains no such thing as private property. Until the early 1990s, North Korea was a rather extreme example of a Soviet-type command economy in which the state controlled production and distribution. The North Korean state banned or severely restricted all kinds of private economic activities, including the seemingly innocuous private sale of cereals and the private sale of services (e.g. shoe repair).

The state economy was remarkably inefficient, and it began to fall apart when Soviet aid was suddenly discontinued in the early 1990s (Haggard and Noland 2007). Just as marketization took hold in post-socialist Eastern Europe, the USSR, and China, it also began in North Korea, in spite of the authorities' attempts to maintain the old order. In the new situation, as state industries largely collapsed and agricultural output declined severely, North Koreans had to adapt to survive. They began to farm privately, turning slopes of neighboring mountains into private plots (Lankov, Kim, and Kwak 2010). They started to steal factory equipment and use it in private workshops (Lankov et al. 2013). The products they manufactured were sold at market, as were the many goods smuggled from China. North Koreans (specifically North Korean women) became a "nation of small shopkeepers" (Jung and Dalton 2006). The North Korean market system, hitherto a small and marginal part of the nation's economy, has become increasingly developed and complex, with retail markets, wholesale markets, and specialized export markets springing up in or near all major urban areas (Joung 2010; Noland and Haggard 2009).

However, the state sector was not immune to the economic crisis, nor, as we discuss below, were its productive assets and personnel immune from the forces (and allure) of marketization. It is estimated that by the late 1990s North Korean state-owned enterprises operated on average at only 30–40 percent of normal capacity (Kim 1997, 37). State managers that did manage to keep their enterprises operational (partially at least) often had to utilize markets to procure raw material, spare parts, and other equipment because state

systems of allocation and distribution no longer functioned (Park 2011; Jung 2012; Jeong, Kim, and Lee 2012). Thus they also began to collaborate with market actors, with rights to profits and control over operations becoming blurred, as entrepreneurs began to infiltrate state institutions (Jeong, Kim and Lee 2012). It was this crisis of the state economy that generated the opening for the PSE to emerge; we conclude by considering its role in both the state socialist economy, if it continues, and the reform process.

SOURCES

Our analysis is based on interviews with five North Korean refugees residing in South Korea who were involved in nine separate business entities. The nine PSE operations we analyzed appear to be representative of North Korean private businesses. It has been noted that such private operations are especially common in fishing, construction, restaurant industry and inter-city transportation (for example, see Yang, Yi and Chong 2014, 31, 95, 125, 215–218). All these areas of operations are represented in our, admittedly rather small, group, permitting us to generate a stylized portrait of the PSE—an ideal type—which shares a number of features across the cases.

The use of interviews in the study of otherwise ‘closed societies’ has a long tradition. During the Cold War, there were two major interview projects targeting émigrés from the Soviet Union, including the Harvard Project on the Soviet Social System of 1950–51, and latterly, the Soviet Interview Project of the early 1980s (Engerman 2009, 65–70). It is important to note that much of what Soviet émigrés told their interviewers was never written down in official records because it was considered either too trivial or irrelevant to the state and its officialdom (for instance, Berliner 1957).

Fieldwork was conducted between April and September 2014. Semi-structured interviews were conducted usually over the course of two to three hours, and some informants were interviewed on multiple occasions. The names of places and institutions have been obscured, where necessary, to protect the identity of informants and their families; individuals are identified by what their business involved (for example, Mr. Antiques, etc.).

(1) THE PSE AND SUPERIOR STATE ORGANIZATION: PROPERTY RIGHTS AND AGENCY PROBLEMS

The PSE is a transitional institution. It emerged in circumstances where state economic power has fragmented and de facto control over nominally state-owned property has become fuzzy or privatized. This is a feature of post-socialism in other countries as well, for, as Stark (1996) put it, the post-socialist transformation is the process of “rebuilding organizations and institutions not on the ruins but with the ruins of communism” (see also Stoica 2004; King 2001).

These ruins are the formerly state-controlled command economy. As convincingly argued by Zaleski (1980), and latterly, by Gregory (2004), Soviet-type economies were not actually planned economies. Plans functioned as motivating tools and statements of broad political goals, but actual resource allocation and output were usually handled on an ad hoc basis and through a continual process of multi-lateral barter between superior government institutions and state-owned enterprises (SOEs), as well as between SOEs themselves. These processes occurred in North Korea as well, and

created the space where the PSEs can exist and flourish. PSEs allowed for the existence of profitable enterprises and contributed to the economic recovery, but they also exacerbated agency problems from the point of view of the state because state property has been effectively embezzled or otherwise substantively privatized in contravention of the existing legal order.

The first PSEs emerged in the 1990s, the earliest case among our informants was that of Mr. Oil, whose oil refinery became operational in the late 1990s. As a first approximation, according to their formal affiliations, PSEs can be divided into three groups. The first kind of PSE is embedded within a peculiar North Korean institution: the Foreign Trade Company (FTC). The FTCs are established by the North Korean state-owned enterprises or government agencies and have a right to conduct foreign trade operations with a great deal of autonomy (see Kim 2014; Kim 2006, 157–160). The second kind of PSE is more straightforward. Private enterprises are registered as regular state companies, and deal mainly with the domestic market. Finally, the third group consist of the PSEs which grew out of state-owned enterprises. These include cases when an investor makes a deal with the existent state enterprise and essentially takes it over. This is of course a simplified account, since the lines are often blurred.

In most cases, the larger a PSE is, the more likely it is to be embedded within the state FTC network. From the early 1990s, FTCs began to enter into agreements with private individuals and businesses. The latter would provide expertise and capital, and in return they were appointed as managers of divisions (*kiji*, literally “bases”) of these companies. Typically, an FTC would have several divisions, semi-autonomous, and all paying a portion of their declared profits to the central office of the company. In this regard, on paper at least, they partially mimic a multi-divisional form (MDF) corporation (Williamson 1985), with largely autonomous separate divisions being responsible for the day-to-day management of specific business operations, and incumbent assets and personnel.

In reality, however, it appears that some such divisions are actually PSEs in their own right, being run by a private investor. Thus the divisional managers effectively pay for the right to use the FTC name in the form of a portion of the profits, while keeping most residual income and control over day-to-day operations. At the same time, the central offices are, in most cases, headed by people with good political connections who are members of North Korea’s semi-hereditary party/state/military elite.

This was, for example, the case with Mr. Coal and Mr. Gold. Mr. Gold’s mine was officially established and managed by an FTC created by a Department of the KWP Central Committee while Mr. Coal’s three mines were technically subordinated to a branch of an FTC which was established by the military. Both Mr. Coal and Mr. Gold were officially considered the branch managers of a respective FTC.

Of the second type PSE, one should mention the restaurant once ran by Mr. Barbeque. The restaurant was opened as a result of an agreement Mr. Barbeque struck with the city administration. For a promise to pay a fixed amount of money to the local budget (and also some bribes to officials), he was allowed to use his money to open an eatery which in all official papers was considered to be a state-owned enterprise.

The third type is represented by Mr. Imitation Meat. “Imitation meat,” a soya-based food product first introduced from China in the 1990s, is hugely popular in North Korea. The imitation meat factory was created as a result of a deal between Mr. Imitation Meat and the manager of a partially functioning state-owned enterprise. The owner hired

personnel and used existing equipment (technically state owned). The investor paid 20 percent of monthly turnover to the manager of the factory for the right to use the factory and for access to electricity. In a manner of speaking, this situation bears a striking resemblance to a “management buy-in”: the PSE owner obtains the right to use state assets, such as buildings, land, and sometimes workers, and pays “dividends” to the supervisory state institution (a de facto “shareholder”), while obtaining control and income rights with respect to the firm.

As stated above, the PSE is a typical case of fuzzy property, so one has to be careful when applying the term “property rights” to a PSE and its owner/manager. As observed by Kornai (1992, 64–66), property rights can be subdivided into who has the rights to income generated (income rights), who exercises control rights over the firm (control rights), and who has rights of transfer with respect to the firm’s assets (transfer rights). PSEs are legally state-owned enterprises in which the entrepreneur(s) is legally defined as the state-appointed manager(s) of the enterprise. Thus, the entrepreneur does not possess income rights or transfer rights de jure, and control rights are also limited to lower tier decisions like shift-patterns. Hiring is formally the purview of supervisory state institutions, as is capital investment.

In fact, however, the entrepreneur is usually the main investor and also the manager who can hire and fire personnel more or less at will. In this way, the entrepreneur does possess substantial control rights, as well as income rights. The entrepreneur has transfer rights de facto only in part—land is owned by the state and cannot be disposed of, there is also no market for enterprises per se, which necessarily further weakens transfer rights.

The absence of a legal framework means that arrangements between superior state organizations and the entrepreneur take the form of informal contracts, and most of the transactions are unofficial, based on oral agreements, and done in cash with little or no paper trail. This situation, unavoidable in the case of the PSE, implies that the superior state organization—that is, the state institution that agrees to provide the PSE with legal cover—faces a set of agency problems (Kiser 1999; Shapiro 2005). The principal, the superior state organization (*sanggūp kukka kigwan*, as it is normally known), cannot realistically monitor all of the actions of the agent, the entrepreneur, especially when many of his/her actions are illegal in nature and thus done covertly—clearly the case with North Korean PSEs. The entrepreneur (agent) has many opportunities to behave opportunistically by cheating the state organization (principal). For example, the entrepreneur can (and often seemingly does) under-declare revenues or overstate costs, behavior that is actually similar to factory managers in command economies (Harrison 2011).

As will be shown in more detail below, there is a commonly accepted way around such problems: the state organization and the entrepreneur usually agree on a certain fixed amount that the organization shall receive from the entrepreneur on a monthly or annual basis. This is an example of outcome-based contract, in which the state organization surrenders managerial rights to the entrepreneur and in return receives a fixed share of the output—either in the form of hard currency or in kind (Lassar and Kerr 1996, 616).

Another tier of agency problems exists between different parts of the state. At the local level, state agents’ lack of interest in carrying out the edicts of the central bureaucracy has led to the rise of what we have termed “prophylactic bribery,” payments made to officials with the power to disrupt the operation of PSEs. Official willingness to engage in such

rent-seeking activities has thus allowed for the continued existence of PSEs when faced with a hostile local regulatory environment. At the same time, central state institutions are no longer able to fully control the activities of state agents at the local level, including actions that may be adverse for the contract between the superior state organization and the PSE manager.

(2) THE SOCIAL ORIGINS OF ENTREPRENEURS AND THEIR CAPITAL

Marketization wreaked havoc with North Korea's existing social system, once rigid and hierarchical. From the early 1960s until the early 1990s, chances of social advancement greatly depended upon family origins (*sŏngbun*). Origins were normally defined by what ancestors did in the 1940s and early 1950s. Descendants of revolutionaries, war heroes, and party/state officials all have good *sŏngbun*, while *sŏngbun* of descendants of priests, colonial officials, and businessman is bad. Only those with sufficiently good *sŏngbun* can make a career within the existing state bureaucracy and can achieve prominence within the managerial hierarchy of state-run economy (Hunter 1999; Collins 2012).

The collapse of the old system in the 1990s changed everything. Many of the PSE managers and other members of North Korea's emerging entrepreneurial class have good *sŏngbun* and are connected (at least loosely) to the established power elite. Nonetheless, the semi-spontaneous marketization of the 1990s and 2000s was a great social leveler, which much reduced the significance of hereditary family background. North Korea's new business elite includes a large number of people who would have had little or no chance of advancement under the old system. For example, the 1960s returnees from China (and, generally speaking, North Koreans with relatives overseas), hitherto discriminated against, suddenly found themselves in an advantageous situation, since they could rely on support from their overseas relations (Li 2009).

During our interviews, we encountered a widespread opinion that bad *sŏngbun* and/or dubious political credentials do not exercise much negative influence when officials decide whether they should enter a PSE-style arrangement with a particular individual. It is one of their features which make the PSEs different from state-owned enterprise management. Mr. Antiques summed up the new social situation when he said:

If you want to rise up the party-state ladder, you still have to have impeccable *sŏngbun* and good connections, but being a businessman is different. All you need is money, the more the better. When you want to start a business and are talking with officials they are not interested in your *sŏngbun*, all they want to know is whether you have money.

The case of Mr. Cement provides a perfect example of this trend. Once a successful industrial manager, he was arrested after he had illegally made a trip to China to meet a close relative from South Korea, and he spent some time in prison. This was a severe political crime so he would never be able to find any regular white-collar job in the "regular" state economy. His dubious past was not seen as any problem, though, for his eventual cooperation with an FTC as a PSE investor/owner, because he was capable of bringing in start-up capital as well as useful experience and connections.

Mr. Coal also had a problematic family background, due to direct family connections with China. Mr. Coal was one of those ethnic Koreans of China whose families moved

back to North Korea in the 1960s, during the turbulent times of Great Leap Forward and the Cultural Revolution. While accepted as refugees and as North Korean citizens, such people and their children faced much discrimination under the old North Korean system. However, in post-famine North Korea, when connections with China became an important source of monetary and social capital, these individuals flourished in private business.

Admittedly, other informants had less problematic backgrounds (*sŏngbun*): for example, prior to the collapse of the state economy in the 1990s, Mr. Gold was a police officer, while Mr. Oil was an officer in the navy (both used connections and opportunities provided by such jobs to build foundations for their eventual business success). Nonetheless, it is significant that people with politically dubious pasts, hitherto doomed to lifelong discrimination, can exist and flourish in the new economy. This represents a fundamental breakdown of state control over certain productive elements within the economy.

The major requirement for any aspiring PSE founder is access to start-up capital. The sums involved might be small by global standards, but they are vast for the average North Korean. While no official statistics exist, the refugee interviews indicate that around 2010 the average income of the North Korean family, largely derived from the unofficial economy, fluctuated around \$30–35 a month. Thus, \$5,000—the smallest amount of the start-up capital for establishing a PSE mentioned by our informants—is, therefore, roughly equivalent to 10–15 times the annual incomes of the average family. Although it is impossible to determine with any degree of accuracy the entry level for an aspiring PSE owners most informants switched from other informal market activities to PSE-type businesses when they had capital of more than \$10,000.

Normally, the investors themselves need large sums to have a chance of making good returns. There are exceptions, however: Mr. Flats, the head of a state construction company, took to doing contract work when the state ceased to be able to provide resources and gradually transformed a state-owned construction company into a de facto PSE without investing any capital at all. He was able to do this because he had a control over a state enterprise which could sell its product (flats) to the cash-paying customers with relative ease.

In nearly all the cases under review in this article, initial investment funds were acquired as a result of some prior activities in the private economy or through the de facto privatization of state assets. While some entrepreneurs were lucky to receive a large amount of money from their overseas relatives, the majority began small and grew as North Korea's spontaneous marketization advanced. Mr. Coal and Mr. Oil both acquired initial funds while working in the seafood industry, making use of their positions to de facto privatize what was technically a state resource: seafood. Mr. Oil, being a naval engineer, arranged profitable fishing expeditions to areas for the exclusive utilization of the navy (it also helped that he had access to scarce diesel fuel) while Mr. Coal used his family connections with China to start profitable trade in seafood. Ms. Coal (no relation to Mr. Coal, but his employee) made substantial sums in smuggling and selling pharmaceuticals manufactured in China—yet again, smuggling represented a theft of state resources, in that the state legally held the right to grant access to foreign markets. Mr. Barbeque also, in his capacity as a police officer in a borderland city, made good money through smuggling protected species (a state asset), and from

bribery (i.e. access to state power, rent-seeking). The case of Mr. Flats, a former manager of a state-owned construction company who gradually developed it into a PSE, has been just mentioned.

Mr. Cement was somewhat of an outlier among those interviewed. First, he was not all that rich. While by no means poor, he still only had start-up capital of approximately \$5,000—which he got from his relatives in South Korea via China, a rather unusual source. However, his major investment in a PSE largely took the form of network and social capital, since Mr. Cement had previously worked in his town as a successful state manager and then semi-private business operator. The fact that such activities could be overlooked by the state agents and enforcers of the legal order represents a breakdown of the state: the regime was simply not able to make effective use of its own agents within established organizational structures due to economic collapse.

(3) PSEUDO-STATE ENTERPRISES (PSE): ORIGINS AND *MODUS OPERANDI*

(3A) *THE ART OF THE DEAL: WHY AND HOW PSES ARE SET UP*

The need to expand while enjoying a modicum of security is a major reason North Korean businesspeople enter a PSE arrangement, or, to borrow a Chinese expression, “wear a red hat” (a modified version of the expression exists in North Korea: “to wear the [insert state agency’s name] hat”). Small businesses, so numerous in post-famine North Korea, have no need for a PSE-type arrangement: they operate independently of the state, avoiding its gaze whenever possible, being satisfied with merely tacit acceptance by the state.

However, once private enterprises expand and become larger than a food stall or cigarette workshop with three of four teenage employees, the owners discover that, in order to survive, they need access to legal and technical infrastructure, like many Chinese business people in the 1980s and 1990s (Chen 2007). This is the point when establishing a PSE appears to be the best or only option.

Indeed, scale creates demand for electricity, land, buildings, the requisite official permissions, and some access to industrial resources and equipment. Additionally, the entrepreneurs, whose day-to-day activities under the existing legal arrangements technically constitute a crime (often a capital crime), need a modicum of protection from law enforcement via direct connections to a state institution. As Mr. Flats put it, “if one goes it alone without state cover, the chances of being arrested and losing everything are much higher, even though the profits can often be larger.” Mr. Oil and Mr. Coal also chose a PSE because they needed to have some legal status for their large enterprises (an oil refinery or a small network of coal mines), which were way too big to operate below the screen of the authorities.

An FTC established by a military academy, which at the time was in a very bad state financially, technically controlled Mr. Cement’s operations. The military academy made sure that all required paperwork was done properly, but it was his task to use his own money, connections, and negotiating skills to make profits by buying and reselling cement, timber, and other construction materials. Given Mr. Cement’s problematic background (a former political prisoner, only recently released), the deal made sense for him: it allowed him to make large sums under the cover of the state.

As stated above, many of the resources and property the entrepreneur uses are legally state owned, hence the residual income derived thereof (as per Kornai 1992) is legally meant to accrue to the state. Allowing the excess output to be granted to the entrepreneur—that is, the granting of de facto income rights—and to a lesser extent his staff, can be considered a win-win outcome for both state and PSE managers (and personnel). But it also represents an agency cost for the state in general, and the superior state organization in particular; for the utilization of the services of the entrepreneur, the state surrenders some income and control rights.

At the same time, the superior state organization faces a monitoring problem. They seldom if ever can control the daily activities of the PSE and determine the income of the PSE operators with any certainty. Hence, in most cases the superior state organization arranges a fixed amount of money to be paid at regular intervals (monthly, in most cases).

For example, in the case of Mr. Bus's company, the oral agreement between the entrepreneur and a Pyongyang-based FTC envisioned that the bus company would have revenue of \$30,000 a year. Of this amount, \$10,000 was to be used for operational expenses and reinvestment, the other \$20,000 was to be paid to the foreign trade company headquarters in Pyongyang. In actual fact, the company made significantly more than expected initially, but Mr. Bus kept this secret from the superior state organization, and provided them with the agreed amount of money only.

Similar arrangements were made by Mr. Gold and Mr. Coal, both of whom made a deal with an FTC and used their money to re-open abandoned mines. Both were expected to pay a fixed amount of money to their superiors—a Party-controlled FTC in the case of Mr. Gold and a military-controlled FTC in the case of Mr. Coal.

Arrangements for Mr. Oil's oil refinery were essentially similar, but the fixed amount was to be paid in diesel oil (15 tons a month—or roughly 40 percent of the refinery's actual output). Mr. Cement also paid in kind, delivering 20 tons of cement monthly to the head office of the FTC that provided his business with legal cover.

There is always a threat that the "superior state organization" might unilaterally change conditions, increasing the amount of these obligatory payments. This is the reason why nearly all our informants admit that they under-reported their earnings and did what they could to create an impression that their PSEs were not doing well. Mr. Gold, for example, was expected to pay a fixed monthly amount (\$1,500) to his bosses/protectors at the FTC under the control of the Party Central Committee. But he not only under-reported the actual output of his mine, but also normally did not pay the exact amount required; instead, he cited ongoing difficulties and paid a couple of hundred dollars less. This was done out of fear that such regular payments would prompt his "protectors" to increase the size of the obligatory contribution.

Not only can terms be changed, it is widely understood that the superior state organization can shut the PSEs down at any moment or even, in more extreme cases, initiate an investigation of the PSE activities, and thus has efficient means to penalize the entrepreneur if s/he does not make agreed payments or otherwise misbehaves. None of our informants personally experienced such proceedings, but they assured us that the threat was real. Interestingly, a similar situation also existed in China among "Red Hat enterprises." In his study of China's economic development Yasheng Huang gives the example of Kelon Group, a very successful pseudo-state company in China that was eventually taken over by the local government of which it was legally the property (Huang 2008,

64–72). So, although it might appear that the superior state organization is in full control, this is not the case: closing a PSE would result in the interruption of the cash flow which benefits both organizations as a whole and top managers in particular. Thus, such extreme measures seemingly are taken only in extreme circumstances.

Apart from relations with superior state organizations, PSEs also entered into agreements with *bona fide* state-owned enterprises (SOEs) and engage in market (though not necessarily monetary) transactions. For example, Mr. Oil worked directly with an SOE. His refinery was located on a plot of land that was obtained from a non-operational state plant. As rent for the land, the entrepreneur provided the plant with one ton of diesel fuel a month. The location was convenient because it gave the refinery access to communications and the power grid. It seems that such horizontal connections are easier to manage because they are usually based purely on mutual self-interest of the parties involved, without the added complication of rights to particular property.

(3B) CORRUPTION AND DAY-TO-DAY INTERACTIONS WITH THE STATE

Within North Korea's existing legal and social environment, the PSE is essentially a mutually beneficial arrangement that makes sense for all its participants. Nonetheless, it should not be forgotten that every PSE-operating entrepreneur is technically guilty of large-scale embezzlement as well as a multitude of other "economic crimes," many punishable with death.

Additionally, officials create red tape for the entrepreneurs. The desire to minimize such complications is one of the reasons the interviewees chose to register as PSEs in the first place. However, even when bribes and kickbacks are ignored, a PSE faces restrictions which significantly increase production costs. For example, Mr. Oil visited China about ten times, and all of these trips were illegal. His official connections and access to funds would have meant that he could have had a passport issued, but the process was troublesome and time-consuming. Therefore, he decided to take a short cut and crossed the poorly guarded border illegally every time he needed to consult with Chinese partners who lived close to the border. They discussed shipping and other related issues, and the goods were then shipped quite legally while the goods' owner again had to walk back home crossing a shallow border river under the cover of the darkness. This demonstrates how different state institutions have very different incentives with respect to PSEs and their managers.

Such unaligned incentives lead to corruption. Indeed, it is corruption—the PSEs' owners' ability to corrupt officials (as rent-seekers)—that enables PSEs to exist. North Korea's state economy and the organizations thereof went through a rapid and ad hoc process of decentralization in the 1990s as the command economy collapsed. Unlike China, where the state began a process of managed, gradual decentralization in the 1980s, in North Korea this process was largely spontaneous and unrolled amid the panic and anarchy of economic collapse. Nonetheless, as in China, this process produced manifold opportunities for officials in local and regional institutions to engage in rent-seeking behavior (Wedeman 2003). Indeed, bribery and corruption is taken for granted by the people we interviewed. As Mr. Oil put it, "if you have power, you can get money. If you have money, you can get power."

Given the dubious nature of the PSE arrangement, opportunities for corruption were (and still are) seemingly plentiful. Indeed, our informants had much to hide from the North Korean state. In the case of coal mines and the oil refinery, for example, there was a large discrepancy between the actual amount of coal (or diesel oil) produced, and that reported to have been sold domestically or overseas, and this could be easily discovered by audit teams. There were other criminal transactions as well: for example, Mr. Cement's activity required constant purchase of cement from workers of the still-functioning cement plants, who acquired the product by stealing it in large quantities. Therefore, when subjected to regular audits, the entrepreneurs had to pay hefty bribes to audit officials—a few thousand dollars was a normal payoff for both Mr. Coal and Mr. Oil. Auditing teams can be seen as an effort by the central government (whence they usually are dispatched) to wrestle back income and control rights over the PSE from its manager.

Another expense is “prophylactic bribery”—paying off officials who had the power to disrupt operations of a PSE and, worse still, to arrest the entrepreneur. The key figures in local criminal and political police, party bureaucracy and city/county administration had to be paid off regularly. For example, Mr. Gold paid bribes to the mid-ranking Central Committee officials, to ensure that they would accept his doctored reports, while Mr. Flats gave away recently built apartments to influential officials.

(3C) THE CENTRAL AND LOCAL BUREAUCRACIES

PSEs reflect a fragmentation of state power, particularly the state's control over large parts of the economy and formerly productive assets. The interviewees suggest strongly that the interests of lower-level officials and the center generally do not coincide in the emergent North Korean market economy. On the one hand, there are local officials who interact with entrepreneurs on a day-to-day basis. These officials include local police (both criminal and political), party and government administrators, and other quasi-autonomous regulatory agencies responsible for specialist areas like hygiene, occupational safety, and the like. On the other hand, there are high-level officials, up to the Party Central Committee and National Defense Commission, as well as the Cabinet and other central state agencies. Such agencies and their powerful administrative personnel might indirectly get a slice of PSE earnings, but they normally do not interact with most PSEs directly on a regular basis. Instead, they occasionally dispatch audit teams and initiate investigations of PSE activities.

Our interviewees (Mr. Antiques, Mr. Oil) agree that the behavior of these two groups is in some regards distinct. This is not surprising since their respective interests also differ. On one hand, both local and high officials would like the economy to be seen to be doing well in order that they receive plaudits from more senior officials and institutions (including the Kim family itself, if you are high enough in the official hierarchy) on the basis of performance. Altruistic considerations may even come into play as well, since many (if not most) officials would like their country to be strong and their people to have affluent lives. Both high and low officials would also like to take bribes and personally benefit from corruption.

In some significant regards, though, these two groups have different and sometimes antagonistic interests. Local officials are interested first and foremost in a steady

income, which PSE owners provide as a price of doing business. Local officials also want their area to appear politically stable and the local economy to be in a healthy state. Ideological and macro-political concerns are often quite secondary. Thus, they would much prefer to have PSEs and associated entrepreneurs around. The PSE is an ideal arrangement for them: they are unable to start efficient productive units using the old (but officially prescribed) methods of the command economy. Hence the PSE that are masquerading as state enterprises in the official documents while also producing the useful output, not to mention steady payments to the local budgets and steady kickbacks to the officials, constitute the ideal arrangements from their point of view. The agency issues are mitigated through the system of fixed payments, which largely liberate the local bureaucrats from the nearly impossible task of monitoring the PSEs' daily activities.

By comparison, high-level officials, while still dependent to some extent on bribes, tend to have a more ambivalent attitude toward PSEs and private business in general. They see unofficial business activities as potentially destabilizing and threatening to the long-term stability of the state. Some of them might even have sincere ideological aversions to private commerce. This different set of incentives means that the central bureaucracy occasionally starts campaigns aimed at eradicating, or at least restricting, the activities of PSEs. Thus, from time to time the central agencies create pressure powerful enough for the audit team to ignore the prospects of a hefty payout and severely prosecute the PSE and its managers/owners for irregularities.

It seems that the ingrained hostility of the high officials of Kim Jong Il's era can be seen as the major reason driving the occasional crackdowns against the private businesses, including the PSEs. Such campaigns became particularly pronounced in the 2005–09 period when the government seemingly did what it could to roll the spontaneous marketization back largely, out of fear of political consequences (Lankov 2009). Indeed, until the last days of Kim Jong Il's rule, the PSE operators faced a small, but nonetheless real risk of getting into serious trouble because of their business activities. A Russian diplomatic source summarized it well when told one of the authors: "The new North Korean entrepreneurial class has a good life and is doing well, but pretty much any (or all) of them can be arrested and executed at any time in strict accordance with the North Korean law."

Our interviewees emphasized that arrest and even executions of PSEs' owners were usually provoked by an audit which could not be handled properly; such audits are commonly instigated by the central authorities. Mr. Antiques who was one of the pioneers of private business in North Korea once said that out of the nine private entrepreneurs especially prominent in Pyongyang around 1990 when the unofficial economy began to grow in earnest, only two have survived up until this day. All the others have been arrested and/or executed. Mr. Gold is significantly more optimistic—perhaps because his activities were somewhat less dubious from the point of view of the North Korean law, but also probably because his activity began much later, in the late 1990s, when the state became lax in its attitude to the private economy. Mr. Gold estimated that merely some 5–10 percent of the PSEs' owners and other large private entrepreneurs have ended up being executed or perished in prisons. Nevertheless, Mr. Gold still agrees that this type of activity is not only highly profitable, but also risky.

For Mr. Oil, this risk influenced his life strategy. He explained the reasons behind his decision to liquidate his manifold business activities and move to South Korea (via China) by the constant fear for the future of himself and that of his family. While in

South Korea his income and living standards are significantly below what they used to be in the North, he believes that he has made the correct decision since some people with whom he used to interact with in his 15 years of business have been imprisoned.

There is a near consensus that people who become too rich too quickly face bigger risks. Mr. Gold mentioned the case of a rich entrepreneur, a PSE owner, who was arrested and executed around 2006. It was rumored that the police found \$700,000 worth of foreign currency hoarded in his house so it was widely said that he took more than he should have.

These remarks hint at an interesting possibility, which, unfortunately, cannot be fully verified from the existent sources: it is possible that there are “glass ceilings” for PSEs. Entrepreneurs who cross this putative line are likely to be arrested or driven into exile. This might mean that within current social arrangements, the PSE is a limiting form, which does not allow for further growth. Put differently, this form might be suboptimal to regularizing property rights.

CONCLUSION

The PSE, as a de facto privatization of state assets and/or non-functioning SOEs, emerged as a result of the final collapse of a sclerotic economic system increasingly unable to perform, and suddenly deprived of external assistance. The reasons for a lack of performance are complex, but principal–agent problems—unrealistic targets from principals, agents shirking by exaggerating need for inputs, and the like—were a key element within it.

In economies transitioning from one form of economic relations—in this case a socialist command economy—to another, capitalism, private property rights, and formal legal institutions to protect them do not arise instantaneously. Transitions take years, sometimes decades, and during that time, the question of ownership is often a murky issue.

Spontaneous marketization with the absence of a formalized system of private property rights created manifold problems for North Korean entrepreneurs. Admittedly, similar problems were faced by some Chinese entrepreneurs until very recently (Tsai 2007, 53–60) while property relations that arose during the transition from socialism to capitalism in the former Soviet Union and Eastern Europe were often unclear as well. Factory managers and investors engaged in a number of hedging strategies dubbed by Daniel Stark (1996) as “recombinant property” in which transfer and control rights of asset, and especially of liabilities were (often intentionally) made obscure to maximize potential gains during economic transition. However, the situation in North Korea is in many regards extreme.

Post-famine North Korea is in many regards a transition economy, playing host to a largely hollowed out state socialist economy and a far more vibrant set of nascent market economic institutions. Yet, due to manifold political and ideological concerns, the government has been loath to recognize such changes (Kim and Yang 2012; Yang 2010; Yi 2005). The PSE is thus an adaptive institution borne of a highly repressive legal and economic order: it is public in form and private in content, and it essentially exists to mask the market nature of the enterprise, providing it with a politically acceptable facade.

So far, the PSE remains the only way for private economic activity to take place on a larger scale. Tentative economic reforms were proposed in 2002 in North Korea (Eberstadt, 2007), and as of 2016 there is renewed talk of such reforms being gradually implemented. Nonetheless, in most important regards the North Korean economy remains legally unchanged from its Stalinist origins. There has been no wholesale privatization of SOEs *à la* Russia (Aslund 2007). Nor was there a gradual process of sustained, if at first tentative, SOE reform, as seen in China—as described by Huang (2008) amongst many others. On paper, the North Korean state still remains formally committed to all the core economic tenets of economic Stalinism, and this commitment exercises significant adverse influence on the performance of the SOEs. This also means that PSEs have advantages, being flexible and efficient, and capable of delivering goods and services the SOEs cannot produce at the same cost and with the same level of quality.

What might happen to the PSEs in the future and how will this peculiar type of enterprise influence ongoing changes in the North Korean society? In one regard, there is little doubt that PSEs, together with other forms of the new private economies, are remarkably productive and thus have made a significant contribution to the improvement of the economic situation in North Korea in recent years. The existence of PSEs also creates a favorable environment for private capital accumulation on a rather large, if ultimately limited, scale: behind the “red hat” of a state enterprise, the North Korean entrepreneurs can amass capital and experience which would be unattainable otherwise.

The PSEs’ activity strengthens the unofficial connections between the state bureaucracy and private entrepreneurs. Bureaucrats, particularly junior local officials, get involved in networks of businesses and in many cases have begun to perceive private economy as a major source of income which should not and cannot possibly be replaced. This means that they are likely to connect their future with the growth of markets, and look at ongoing changes favorably. While the market in general has such social/political effects (entrepreneurs pay bribes to the officials, as a matter of routine), with the PSE their nature itself ensures that entrepreneurs’ connections with and influence over the state bureaucracy are especially strong. In some cases, the PSEs might be construed as an example of the proverbial “revolving door” providing officials with lucrative business opportunities; many of our informants began as officials and then switched to the PSE-style business. One can surmise that such changes are likely to make bureaucrats less hostile towards the market economy.

At the same time, the transitional nature of the PSE arrangements means that in the long run this form is not likely to last. If and when the North Korean government chooses to be more open about ongoing changes, the PSEs are likely to openly admit their actual market and private nature and be transformed into “regular” private enterprises. On the other hand, in the (admittedly, less likely) case of renewed massive crack-downs on the private businesses, many PSEs will be confiscated or liquidated, as was occasionally the case in the 1990s and 2005–09. So far, however, the PSEs, being the largest private enterprises in the country, seem to play a significant role in the ongoing transition of North Korea towards market economy.

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SUPPLEMENTARY MATERIAL

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