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Russia

Creating Private Enterprises and Efficient Markets

Edited by
Ira W. Lieberman and John Nellis
with Enna Karlova, Joyita Mukherjee, and Suhail Rahuja

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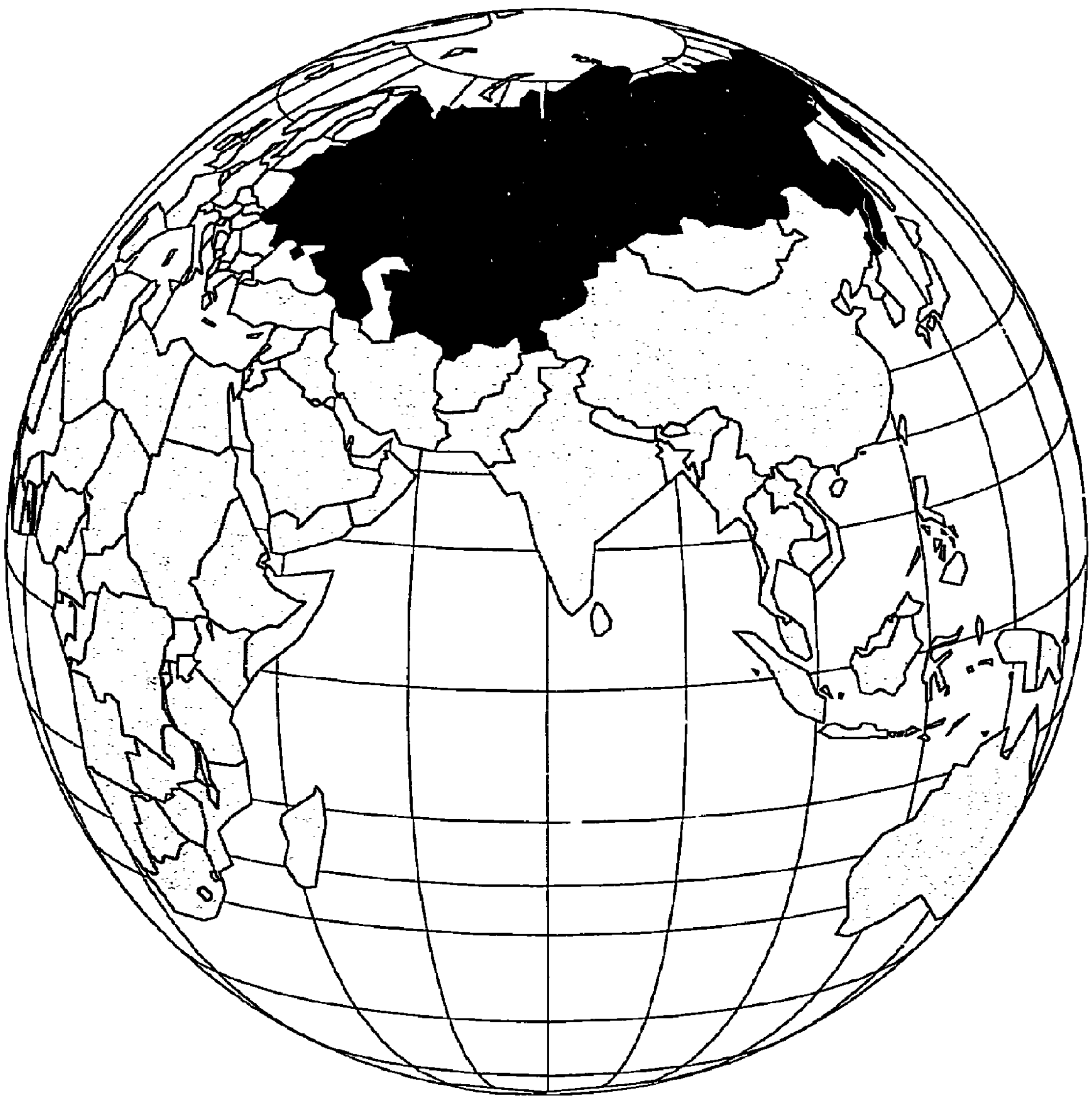

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Foreword

The role of private sector in the economic development of an economy is well-established. In Russia, the task of creating a private sector where none had existed for the better part of this century was a daunting one. The Russian privatization program initiated at the end of 1991 has been successful in transferring ownership to private hands and creating a critical core of private enterprises. By July 1994, between 12,000 to 14,000 enterprises large and medium-sized enterprises had been privatized, and 40 million Russian had become shareholders in private enterprises. This provided the basis for a rapidly emerging Russian capital market.

Moreover, roughly 85,000 small businesses, mostly service establishments, were also privatized. This achievement was critical to demonstrate to the Russian population that private ownership matters significantly, and that the quality of goods and services available to the ordinary consumer can be improved upon. It is also important because it begins to open the retail and service sectors to private sector entry. Moreover, it provides employment opportunities as the vast downsizing and restructuring of newly privatized enterprises takes shape over the next several years.

The World Bank held a conference on privatization and the private sector in Russia in June 1994 to acknowledge the extraordinary achievements by a small but talented and dedicated group of reformers who against difficult odds have managed to implement the Russian Privatization Program. It brought together leading decision-makers and advisors in the Russian privatization process to discuss issues related to privatization, capital market development, corporate governance and restructuring, and the constraints and regulations affecting the private sector. This publication is based upon papers presented at that conference.

This book was prepared by the World Bank's Private Sector Development Department with contributions from leading Russian reformers, and advisors to the Russian government from the World Bank Group, academia, and the private sector. It is intended for policymakers, development institutions, researchers, and academics. Non-governmental organizations may also find it useful to learn and understand the extent of reform in Russia, and the issues that it faces in the coming years.

Russell Cheetham
Director
Country Department III
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Abstract

This book contains a collection of papers prepared at a World Bank conference held in June 1994 on privatization and private sector development in Russia. It reviews the privatization achievements of Russian reformers over the past three years, discusses emerging second-tier privatization and post-privatization issues, and summarizes the key themes in the papers presented at the conference.

Between November 1991 and June 1994,

- between 12,000 and 14,000 medium-size and large enterprises had been transferred to private ownership;
- this set of firms employed more than fourteen million people, or about half of those employed in Russia's industrial sector;
- about forty million Russian citizens owned shares in privatized firms or investment funds.

Although the Russian privatization program has achieved impressive results, the transfer of ownership (mainly to insiders) is only a first step. This must be followed by equally essential second steps to facilitate ownership of privatized firms to external, core investors who will bring in much needed capital, managerial know-how, and access to global markets.

The sixteen chapters in this book are divided into four sections: Privatization, Capital Market Development, Corporate Governance and Restructuring, and the Emerging Private Sector: Constraints and Regulations. The articles concentrate not only on what has been done, and why, but also on what remains to be done, and how to address the critical issues that impede further reform.

Acknowledgments

The editors wish to acknowledge the support and assistance of the many officials—particularly from the Russian State Committee for the Management of State Property (GKI) and the World Bank's Eastern Europe and Central Asia Region, Country Department III. Thanks are due to Russell Cheetham, Yukon Huang, Michael Gould, and Constantine Michalopoulos for their support in the publication of this book. Magdi Iskander, Director of the World Bank's Private Sector Development Department, encouraged the idea of the conference and the production of the book. The editors are also grateful to Peter Fidler, Bruce Ross-Larson, and Vince McCullough for editorial assistance, and to Heather Imboden for desktopping. Gloria Orraca-Tetteh prepared the manuscripts, and Susan Marcus with Suzanne Smith provided advice on production.

Introduction

John Nellis

Stunning accomplishments

Privatization is the one bright spot in the generally bleak Russian economic landscape. Starting from less than zero[1] in November 1991, a small, determined, and often beleaguered group of Russian reformers—with some important external support[2]—has been able to:

- Devise and implement, in the face of strong resistance, a "corporatization" program that turned about half of Russian state-owned enterprises into joint stock companies;
- Persuade the most important "insider" stakeholders who might have opposed privatization—workers and managers—to take part in the process by offering them shares in the firms in which they work for free or at a low price;
- Conceive and implement a voucher program, giving 144 million participating Russians a chance to become, along with insiders, owners of enterprises;
- Create a national voucher auction system in more than 85 regions, with 750 bid reception centers; and
- Facilitate the creation of some 650 private investment funds that compete for vouchers and convert them to diversified shareholdings in newly privatized enterprises.

The result is that by the end of June 1994,

- Between 12,000 and 14,000 medium-size and large enterprises had been transferred to private ownership;
- These firms employed more than 14 million people, or about half of those employed in Russia's industrial sector; and
- About 40 million Russian citizens had become owners of shares in privatized firms.

These achievements border on the miraculous, having taken place in the absence of consensus on the desirability, scope, and pace of liberalizing reform in general, and privatization in particular, and in the absence of what would normally be considered the requisite administrative and financial resources to implement, monitor, and enforce a privatization program of this magnitude. Yet it was done. The only potentially comparable privatization experiences are those of the former East Germany and the former Czechoslovakia.

...by the end of June 1994, between 12,000 and 14,000 medium-size and large enterprises had been transferred to private ownership...

Comparisons to Germany and the former Czechoslovakia

In Germany the *Treuhandanstalt* succeeded in putting more than 10,000 enterprises in private hands between 1991 and 1994. This achievement cannot and should not be minimized. Nonetheless, German privatization was a case of integration of a formerly socialist economy into a functioning, indeed flourishing, market economy, an exercise that differs sharply from the total transition that Russia confronted. In Germany, an irreplicable combination of West German legal and administrative institutions, West German managers, and West German money eased many of the problems of the integration.

The mass privatization program of the former Czechoslovakia, which transferred 1,491 firms into private ownership in 1992 and 1993, with a "second wave" coming in both successor states that will touch an additional 1,300 firms, is the best and perhaps only comparator to the Russian

Transfer of ownership to insiders was a striking step.... External investors will complete the restructuring of firms begun by the transfer of ownership.

privatization program. The Czech and Slovak privatization programs are remarkable achievements. Indeed, a few Czechs have suggested that their privatization method is superior to Russia's since no special inducements have been given to insiders. Outsiders, in the form of external investors and investment funds, have played a major ownership and governance role from the outset, and some Czech practitioners and external observers now criticize Russia for not having followed the same course.

Without disputing the impressive Czechoslovakian achievements, it has to be stressed that Russia embarked on privatization in circumstances very different from those of the former Czechoslovakia. First, pre-communist Russia in 1917 was markedly different from pre-communist Czechoslovakia in 1948; it was less industrialized and less capitalist. Second, the length of the communist period in Russia was almost double that in Czechoslovakia, meaning that in Russia collectivist approaches and habits had more time to take root and become deeply ingrained. Third, and paradoxically, Czechoslovakia benefitted from an absence of reform communism. Unlike Hungary, Poland, and to some extent Russia, Czechoslovakia basically maintained the central planning system until the very end. The successor governments thus have not had to debate the scope and pace of liberalizing reform with entrenched, decentralized stakeholders such as the Solidarity movement in Poland, the workers' councils in Hungary, or the relatively empowered enterprise managers, members of cooperatives, and leaseholders created in perestroika Russia. The inheriting regime in Czechoslovakia in 1990 was less constrained by decentralizing forces than almost other successor regimes in Eastern and Central Europe—circumstances of which Vaclav Klaus and his reform team have made the most.[3]

All in all, the obstacles to Russian privatization were more numerous and more daunting than those encountered in Germany and Czechoslovakia, or indeed in any other country that has seriously embarked on the process. In Russia, because of these different initial conditions, the period of "extraordinary politics"[4] was both shorter lived and less intense than in other economies in transition. This point must be grasped, both to comprehend how truly impressive Russian privatization results have been, and to understand why the Russian process has unfolded as it has, with the defining characteristic being the provision of financial rewards or equity stakes to all the various actors and agencies involved—meaning that the approach was thoroughly decentralized.[5] Had the Russian reformers attempted to follow the Czechoslovak route of centralized administration of the process, and had they tried to treat enterprise insiders as one potential purchaser like any other, it is likely that little privatization would have occurred.

What happens next

The Russian privatization team thus opted for the method that they judged would yield results—and they got them. But as a consequence, the results were tentative and partial. Transfer of ownership to insiders was a striking step, but only a first step. It must now be followed by equally essential second steps opening ownership of privatized firms to external investors and owners. These, in turn, will bring needed capital, market access, managerial know-how, and a bottom-line mentality to privatized companies. External investors will complete the restructuring of firms begun by the transfer of ownership. A significant percentage of restructured firms will become profitable as well as nationally and internationally competitive, and Russia will be well launched on the process of growth and integration into the global economy. Such is the hope.

Issues to be resolved

To put it mildly, much stands in the way of the achievement of this grand aspiration. Ignoring the evident macroeconomic and macropolitical deficiencies of present-day Russia, and concentrating solely on the privatization process, one encounters a number of critical issues and questions:

- Insiders fear that the restructuring brought about by external investors will cost them their jobs, thus they do their best to prevent or minimize sales of large blocks of shares to external investors. *What are the mechanisms by which secondary trading, leading to restructuring, will be amplified and entrenched?*
- The voucher scheme expired on June 30, 1994. The current political configuration will apparently not tolerate a second voucher issue. However, 12,000–14,000 enterprises remain uncorporatized, unprivatized, and lacking the voucher mechanism to spur their divestiture. *What will happen to this important set of firms?*
- Small-scale privatization in Russia is impressive in absolute terms (with some 85,000 small business units divested), but lags relative to similar programs in, Poland, Hungary, Estonia, and the Czech Republic, where a much larger percentage of the entire small-scale base has been divested. Small-scale privatization schools both new owners and consumers in market economics, and has proven critical in job creation, essential to the absorption of surplus labor flowing out of the large enterprise sector. *Why has Russia exhibited this comparatively poor performance regarding small-scale privatization, and what does it mean for the economic future of the country?*
- Twelve to fourteen thousand medium and large firms are now in private hands. But there are few who believe that their future operations will be left entirely to determination by pure market forces, since the current Russian variant of the market deviates so sharply from the textbook model. Privatized firms urgently require technical assistance (to help in the preparation of business plans and in restructuring), credit to finance working capital, trade, and investments, and equity injections to provide both long-term money and active governance. *How can these needs be met in a manner that does not reintroduce the heavy hand of the state into businesses? Who will fund and provide these resources? And what parallel reforms are required in the financial sector and capital market development to support these actions?*
- Important as privatization is, it is only a part of the transition process, alongside new entrants and greenfields investments. *What does the nonprivatized private sector look like, and how, if at all, do its activities differ from the privatized sector?*

Approach of the study

These are the many complex themes addressed in detail in the chapters of this book. The authors are, without exception, actors in the privatization process, either as officials of the Russian Government, advisors to the Russian privatization body (the State Committee on Property Management or GKI, as it is known from its Russian initials), officials of international financial institutions working with the GKI (half of the authors in this volume are staff of the World Bank or the International Finance Corporation), university professors on contract to the GKI, or staff of private sector consulting firms employed by the GKI. One author—who heads an investment fund in Moscow—comes directly from the emerging Russian private sector.

Given the active roles of the authors, the volume is as prescriptive as it is analytical; that is, chapters concentrate not simply on what was done and why, but on what remains to be done, on the questions listed above that have not been answered, and on how they may be resolved. In addition, the volume contains a detailed summation of the proceedings of a conference held in Washington, D.C., on June 21–22, 1994, in which the draft versions of the chapters were presented and discussed and in which presentations on the accomplishments and remaining problems of the Russian privatization program were made by Anatoly Chubais, Russian Deputy Prime Minister, by Maxim Boycko, President of the Russian Privatization Center, and several resident advisers to the GKI.

Small-scale privatization schools both new owners and consumers in market economics, and has proven critical in job creation...

Privatized firms urgently require technical assistance..., credit, ...and equity injections...

The thrust of these presentations by the direct practitioners was threefold:

- Russia's voucher-led mass privatization program, without precedent in terms of size and speed, is a major success. Why? Because the links between the enterprises and the state have been severely frayed, if not yet totally cut, and a mass of property owners—who, presumably, will support further reform—has been created. The first and overarching goal of the process, to make reform irreversible, seems to have been achieved. Initial inquiries into the behavior of firms after sale reveal that restructuring is under way, as evidenced by product diversification, labor shedding, and changes in top management.
- The next stage of privatization will entail selling the remaining shares and the remaining thousands of enterprises for cash, through auctions and tenders. The government proposes that a substantial amount of the generated cash remain in the firm to finance needed restructuring. To increase the attractiveness of firms to investors, the real estate on which the company sits must be clearly tradable and clearly included in the deal. This approach will address essential needs of newly privatized firms, but will necessarily be a slower process than transfer through voucher auctions. And it has already provoked vehement opposition from regional governments and municipalities, who see the new approach as a threat to their lucrative control over local real estate. In mid-July, 1994, the Russian Parliament rejected the proposed second phase program, but it was promptly promulgated by a presidential decree.
- A fundamental contribution of the mass privatization program has been its capacity to reveal the need for and spur reform in other aspects of the economy. Legal reforms, land privatization, protection of shareholder and creditor rights, social safety net reforms, and the closely related issue of how to dispose of ancillary or social assets of firms—the need for reform in all these areas is acute, and considerable activity is under way. However, a recurring theme in the conference, on which there was universal agreement, was that the priority matter was the development of capital and securities markets. This is seen as critical to assist investors in acquiring property and protecting savings and to address the problem of improved corporate governance in the privatized firms.

Notes

1. Less than zero in the sense that the reformers were not faced simply with the privatization of a mass of state-owned enterprises, but also had to deal with the quasi-private entities that had been created during the late perestroika period. See John Nellis, 1991, "Improving the Performance of Soviet Enterprises", World Bank Discussion Papers 118, Washington, D.C.

2. From the G-7 countries through bilateral programs and from the European Bank for Reconstruction and Development, the World Bank Group, and the European Community. Equally important, the Russian privatization team knew how to put these external resources to effective use.

3. One potentially massive set of decentralizing factors that existed in 1990—the federal nature of the state and the tensions between the Czech and Slovak territories—has, of course, been resolved by the dissolution of the federation.

4. The phrase is from Leszek Balcerowicz and Alan Gelb, "Macropolicies in Transition to a Market Economy: A Three Year Perspective," paper presented to the World Bank's Annual Bank Conference on Development Economics, Washington, D.C., April 1994. The authors argue that a period of "extraordinary politics" occurred in a number of Eastern and Central European countries when the old communist elites were discredited, but developed interest groups were few, fragmented, and disorganized. This allowed reforming technocrats to take command, greatly raising the "probability that difficult, normally controversial, economic policy measures will be accepted" (p. 11). The period lasts, say the authors, for one or two years, and then "politics as usual" tend to regain their supremacy.

5. Given the complexity of the program and the lack of political consensus, it was imperative that the process be decentralized; privatization could not have been accomplished without the active involvement of the regional and local authorities and the regional voucher auctions.

Part One

PRIVATIZATION

An Overview of Privatization in Russia

Ira W. Lieberman and Suhail Rahuja

Russia's size makes its privatization program probably the largest sale of assets ever conducted. From December 1992 to February 1994, nearly 9,500 large-scale enterprises, employing 11 million people, were privatized, creating 40 million new shareholders. The speed with which the program has been enacted is impressive given Russia's recent political turbulence and its dire macroeconomic performance. Indeed, these numbers will rise even higher by the end of the voucher auction program in June 1994.

This chapter describes the design, implementation, and progress of the Russian large-scale privatization program. The program is the centerpiece of Russia's formal privatization process. In contrast to other formerly communist countries, which have used a variety of methods to achieve their privatization goals, Russia's reliance on a large-scale mass privatization program has imposed a high degree of conformity on the privatization process. In Russia, large-scale enterprises have been privatized essentially by a closed subscription to the employees followed by an open voucher auction. In this respect, it differs from the Czech and Slovak Republics and Poland, where a menu of privatization techniques (such as IPOs, trade sales, mutual fund schemes) was part of the overall privatization program. The uniformity in the method of privatization not only captures most of the ways that large enterprises in Russia have been privatized, but also explains the speed of privatization.

Not all Russian enterprises, however, have followed the prescribed privatization route. Russia's significant defense industry, for example, has been excluded from the privatization program. The privatization of enterprises in this industry has proceeded slowly and informally, away from the public glare. An analysis of the privatization of these enterprises—which, in any event, has been limited—is not within the scope of this paper.

As the first country to embrace communism, Russia has an industrial and commercial base that is more heavily distorted by communist planning than most. This section of the chapter begins by highlighting some of the most salient points of the environment in which the Russian privatization program has been carried out. It discusses the degree of state ownership and industrial concentration that existed in the Soviet Union (and by proxy in Russia) prior to the collapse of communism.

Privatization is always an intensely political process and nowhere was this more true than in Russia. To understand why managers and workers were able to influence the privatization program in Russia to the degree that they did, it is necessary to understand the political forces unleashed by the Gorbachev reforms. Thus, this section includes a brief introduction to Gorbachev's economic reforms.[1] It also provides a highly abbreviated chronology of the major Russian privatization laws, as well as a description of the major institutions responsible for enacting privatization.

The second section covers the basic aim, scope, and structure of the privatization program and compares and contrasts the Russian program with the Czech, Slovak, and Polish schemes. It then describes each of the program's major elements: corporatization, vouchers, open subscription, voucher funds, voucher auctions, and the public information campaign. The next section provides the latest data on the progress of

In Russia, large-scale enterprises have been privatized essentially by a closed subscription to the employees followed by an open voucher auction.

the program, as well as recent evidence on the low values currently being placed on shares sold through voucher auctions. It also summarizes preliminary research on initial trends in share ownership after voucher auctions. The last sections highlight developments in Russia's capital markets and provide brief remarks on foreign investment in Russia.

The industrial legacy

Privatization is always an intensely political process and nowhere was this more true than in Russia.

Until the Gorbachev reforms of 1985, the USSR followed a classic central-planning system. The state played an overwhelming role in the economy. In all Eastern bloc countries, the state was the dominant economic player, but there was a notable variation between the USSR and Eastern bloc countries. In the Soviet Union it has been estimated that in 1985, 96 percent of the net material product (NMP) was produced by the state sector (Milanovic 1989). In 1984 in China, the figure was 82 percent and in Hungary, 74 percent. Only the former Czechoslovakia and East Germany had higher figures—97 percent (1986) and 96.5 percent (1982) respectively. It has been estimated that there were 47,000 state enterprises in the USSR industrial sector.[2] If energy and large service firms are included, the total rises to 55,000.

Soviet state enterprises were large and monopolistic. Of the 7,664 product groups distributed by the former Soviet Gossnab (Committee of Deliveries and Supplies), 77 percent were produced by just one firm. The high degree of industrial concentration and the size of the Soviet market meant that the average Soviet enterprise was far larger than its counterpart in either the Western or Eastern bloc.[3] The average number of employees for the largest 952 firms in manufacturing and energy was over 8,500; the average for all 25,000 enterprises in these sectors was 821, ten times the equivalent figure for a range of Western countries. The largest enterprises in the former USSR (AVTOVAZ, which produced cars, and KAMAZ, which made trucks and tractors) each employed 100,000 employees. This industrial legacy of a high degree of both state ownership and industrial concentration dramatically increased the scope and complexity of the privatization program, as well as the need for an effective post-privatization corporate governance system.

Gorbachev's reforms

Gorbachev's reforms of 1985–90 were the first systematic attempt to dismantle the central planning apparatus. The reforms had considerable impact on the privatization program. The broad aims of the reforms were to transfer decisionmaking power from the branch ministries and the central agencies to enterprise managers, and to allow (and encourage the formation of) nonstate forms of enterprises.

Enterprise managers' new rights were laid out in the 1988 Law on State Enterprises. Managers were given leeway to retain and allocate internally generated funds (particularly for wages and bonuses), change product design, expand into foreign markets, seek foreign joint venture partners, and borrow from outside the official funding sources. Most important, mandatory production targets were replaced with "state orders." Enterprises were now free, after fulfilling state orders, to produce and sell as much output as they could. Initially, this meant little, since state orders covered 90 percent of industrial output. State orders, however, were progressively curtailed and managers were given real power over output decisions. And from 1989 on, branch ministries were reduced and reorganized, considerably restricting their power over state enterprises. These ministries have since sought to reassert themselves (as holding companies, joint stock companies, trade associations, and so on), forcing the privatization program to require corporatization at the lowest institutional level.

Cooperatives and leaseholds were permitted from 1988, and small private companies, limited-liability companies, and joint stock companies were permitted from 1990. Cooperatives were frequently subcontractors or spin-offs from state enterprises and were often set up to exploit privileged access to scarce goods. Likewise, leaseholdings were usually subunits of large state enterprises. Groups of workers would lease space and equipment from their state enterprise. Leaseholders were free to accumulate new assets through retained earnings or bank loans, with these assets becoming the property of the leaseholders. Agreements to buy out the leased assets were also common. A recent survey of private sector manufacturing activity in St. Petersburg shows how a cooperative or leasehold functions in practice.[4]

As intended, Gorbachev's reforms transferred power from planners to workers, managers, and regional authorities. What was not anticipated was the manner in which these groups began to exploit their new-found freedoms. State enterprises began rapidly increasing workers' wages, bonuses, and welfare expenditures. This led to a sharp decline in after-tax profits remitted to the state and a federal budget crisis.

Spontaneous privatization became prevalent as managers began to divert profits and assets both legally (through cooperatives and leaseholds) and illegally. The demise of the Communist Party and its associated organs of control made this possible. This process accelerated in 1991 as employees used the purchase option in lease agreements with a new right to set up joint stock companies, often buying leased assets at book values—a fraction of their true value. Similarly, local authorities took control of infrastructure in their area (water, electricity, and so on) and demanded control over enterprises within their jurisdiction. Governments at all levels lost many of their ownership rights to enterprises, which had been ceded to workers, managers, and local authorities. Russia's mass privatization program, by necessity, had to recognize and incorporate these new and competing ownership claims.

Legislative and institutional framework

The first steps toward privatization were taken by the Gorbachev government in July 1991, when the former Soviet Union Supreme Soviet passed a law on "The Basic Foundations of Denationalization and Privatization of Enterprises." An equivalent law was passed by the Russian Supreme Soviet a few days later. Previous reform packages, such as the "500 days" program put forward by Grigory Yavlinsky and Stanislav Shatalin in mid-1990, had mentioned privatization but had never contained a detailed program. These packages were ultimately abandoned. Although the 1991 law has since been amended, it remains a blueprint for privatization. It lays down procedures, outlines the organizational infrastructure for implementation, and mandates a detailed annual privatization program. Even at this early stage, the law foresaw workers receiving discounted shares in the enterprise in which they worked, state enterprises converting into joint stock companies, and vouchers being distributed. But given the political turbulence and uncertainty generated by the coup in August 1991, the breakup of the Soviet federation, and Yeltsin's initial focus on macroeconomic stability, little was done to establish the necessary legal and institutional framework required for privatization. Not surprisingly, by January 1992 the number of enterprises transferred to private and collective ownership had reached only 70 and 922, respectively (Chubais and Vishevskaya 1993).

The first steps toward privatization were taken by the Gorbachev government in July 1991...

The privatization program as it unfolded in 1992 and 1993 was heavily influenced by the differences between the Yeltsin presidency and the Russian parliament. The parliament acted as a remnant of the communist past and an obstacle to smooth passage of the program. Quarrels over the form and speed of the 1992 privatization program erupted throughout the first half of the year. Significant compromises were made to the anti-reform camp in the passage of privatization legislation through Parliament. The 1992 annual privatization program itself was not passed until mid-1992.[5] A large number of other enabling decrees and laws covering details were issued from 1991 onward. Topics covered delineation of ownership between federal and local authorities, the corporatization process, vouchers, investment funds, auctions, tenders, and other sales procedures.

Along with progress on the legislative front, an institutional infrastructure was also established. The State Committee for the Management of State Property (known as the GKI) was reoriented to drive forward the privatization program. The GKI

The privatization program as it unfolded in 1992 and 1993 was heavily influenced by the differences between the Yeltsin presidency and the Russian parliament.

is responsible for formulating and implementing privatization policy. It has also been responsible for preparing annual privatization programs, drafting privatization laws and decrees, distributing vouchers, licensing investment funds, and enforcing privatization legislation. The GKI is supported by regional (oblast) and municipal subsidiaries (KIs) attached to local or municipal administrations. The head of each oblast is nominated by the governor of the oblast for approval by the central GKI. The head of each municipal KI is appointed by the local mayor. Regional and municipal property committees ensure that each state enterprise sets up a privatization commission, produces a privatization plan, and is later corporatized.

The Russian Parliament, in an effort to exercise greater control over the privatization program, created a rival agency to the GKI, the Federal Property Fund, which reported directly to the Parliament. In addition to the Federal Property Fund, property funds were created at the local and municipal level. The heads of oblast property funds were appointed by and reported to oblast soviets until the latter were abolished in October 1993, following the failed coup. These property funds assume the state's stake in an enterprise from the GKI or KI (as relevant) after corporatization of the enterprise. The local property fund exercises ownership rights on behalf of the state and is responsible for the management and dispersal of the state's remaining stake, such as publishing the legal notice announcing an auction and distributing property titles. Tension has arisen between the GKI and the Federal Property Fund, compounded by the overlap in administrative roles. Infighting, however, generally has not filtered down to the local or municipal level. Indeed, cooperation between the local and municipal property committees and property funds is the norm, and this has ensured a measure of continuity in the privatization process.

Mass privatization program

Russia's privatization program is extremely ambitious. It entails privatizing some 5,000 large state enterprises and gives 16,000 to 20,000 medium-sized enterprises the option of joining the program. These figures underestimate the true numbers. Data on the number of large and medium-size enterprises prior to privatization are sketchy, and during the course of the privatization program some enterprises split into smaller independent units. Russia's privatization programs dwarfs those in the Czech and Slovak republics and in Poland. In the first wave of the Czech and Slovak mass privatizations, 2,776 enterprises were sold, of which 1,492 were privatized in voucher auctions. In the second wave, 900 enterprises are to be privatized in the Czech Republic. In Poland, 600 enterprises are to be privatized in the mass privatization scheme.[6] Only the privatization of more than 10,000 firms by Germany's *Treuhandanstalt* comes near to Russian totals. The administrative complexity of the Russian program was further compounded by the inability of the center to control, for both technological and political reasons, the oblasts (property committees and property funds). With eighty-eight oblasts, the program had to be decentralized, as opposed to the Czech, Polish, and German schemes, which were tightly administered on a national level. In comparison with the Czech or Polish programs, the Russian mass privatization program has been a much more complex political and logistical operation.

Principles

In drafting the Russian program, reformers focused on a few key principles:

- *Speed.* As the power of the center receded, managers and workers found themselves in a governance vacuum. On the one hand, the best assets were being systematically looted by spontaneous privatizations. On the other, the state was bailing out loss-making enterprises (either directly through subsidies or indirectly through financing by the state-owned banks) on such a scale that macroeconomic stability was threatened. It was therefore essential to establish a privatization program by which many firms could be quickly privatized.

- *Transparency and fairness.* Proper regulation and procedures were required to ensure that each privatization was adequately reviewed, that a transparent environment was created, and that bidding was as fair and competitive as possible.
- *Political feasibility.* There had to be enough incentives to ensure the support of all directly-affected stakeholders (workers and managers) and of those who implemented the process (oblast authorities).
- *Political popularity and equity.* Market reforms have led to a marked decline in living standards for most Russians. It was important to offer incentives to the general public. If privatization were successful, it would be the first reform that would bring benefits to the general public through short-term financial rewards and access to goods and services. Reformers had to create a large and powerful constituency that would have a vested interest in ensuring the continuance of economic reforms.
- *Demand.* The program had to stimulate demand for assets as public savings are too low and foreign investment too uncertain to ensure that more than a small fraction of the assets on offer can be sold, even at book values unadjusted for inflation.
- *Decentralization.* The program had to be "bottom-up" in approach—that is, enterprises had to carry most responsibility for developing their privatization plans. Moreover, implementation and supervision of privatization had to be at the local level.
- *Governance.* Privatization had to transfer state assets to economic agents with both the incentives and the expertise to undertake the restructuring required to build a healthy and profitable economy.

Framework

To reconcile these objectives, the large-scale privatization program was built on:

- A mass privatization program;
- The distribution of privatization vouchers;
- The creation of financial intermediaries and institutions; and
- Voucher auctions.

Like the Czech and Slovak scheme, the Russian scheme was "bottom-up." The state's privatization role is limited to providing enterprises with a conceptual framework and common privatization documents and to reviewing and approving the plans submitted to them. Moreover, as with the Czechs and Slovaks, Russian individuals and firms are free to start up voucher funds that can accumulate vouchers and bid for enterprises, subject to minimal criteria.

There were, however, substantial differences between the Russian and Czech and Slovak programs. Russian managers and workers won substantial privileges not available to their Czech and Slovak counterparts. They secured big (often majority) shareholdings in a "closed subscription" before equity was put up for general sale. They were also able to ensure that outsiders played a far smaller role in Russian mass privatization than they did in the Czech and Slovak Republics. There was no scope in Russia for outsiders to submit alternative privatization plans to the authorities as there was in the former Czechoslovakia. Many different and competing privatization alternatives emerged out of the Czech and Slovak mass privatization scheme, such as voucher auctions, direct sales, competitive auctions and tenders, and combinations thereof. In Russia, the most common way for outsiders to participate in privatization has been through a voucher auction, an effective way of dispersing outside share ownership and, as a consequence, of limiting and diluting their influence. Finally, in Russia there was no single grand Czech-style auction in which the shares of a thousand or more enterprises were allocated at once and in which all voucherholders were free to bid. Russia's size, the number of enterprises up for sale, and the lack of a communications network made such an auction technically difficult. Further, the autonomy each enterprise and oblast had over the speed of the privatization process meant that a single grand auction was also politically difficult. An attempt to hold such an

Russia's privatization program... entails privatizing some 5,000 large state enterprises and gives 16,000 to 20,000 medium-sized enterprises the option of joining the program.

auction would have led to lengthy delays in the privatization process. In Russia, most enterprises are auctioned a few at a time by the local property fund to voucherholders who live in the region over a period of time determined by local players. In 1993, a voucher depository network and a national auction center were established that helped mitigate the parochial nature of auctions.

Russian policymakers rejected the "top-down" approach of the Polish voucher scheme because of three main concerns. First, the Polish scheme emphasizes allocating a selected group of enterprises to twenty or so government-sponsored investment funds. The funds in Russia could easily evolve into a powerful constituency arguing for subsidies and cheap credits for the companies they managed, effectively hindering the efficient and speedy restructuring of these enterprises. Second, in the Polish scheme, enterprises essentially play a passive role in the privatization process. In Russia, the influence managers and workers have made such an approach unfeasible, and the privatization process has to directly incorporate their interests. Finally, the Polish scheme requires a delay of eighteen months or so before voucherholders can convert their vouchers into the shares of mutual funds, and an unspecified time will elapse before citizens can directly hold equity in the privatized enterprises. Thus, the political benefits of involving the general public in the mass privatization scheme at the earliest opportunity would be lost.

A series of laws passed by Parliament in 1991–92 categorized state property as federal, local (oblast), or municipal and allocated responsibility for privatization to property committees and property funds at the appropriate level.

First steps

A series of laws passed by Parliament in 1991–92 categorized state property as federal, local (oblast), or municipal and allocated responsibility for privatization to property committees and property funds at the appropriate level. State enterprises were also characterized as small or large for the purposes of the privatization program. A large state enterprise was defined as an enterprise with more than 1,000 employees or assets over 50 million rubles as of January 1, 1992.[7] A small enterprise was defined as an enterprise with fewer than 200 employees or assets less than 1 million rubles as of January 1, 1992. Medium-size enterprises were defined by exclusion. Small enterprises follow a different privatization procedure than large enterprises. Most small-scale enterprises are owned by municipal authorities who are responsible for their privatization, whereas most large-scale properties are owned by the federal or oblast authorities. Further, although federal authorities are responsible for the privatization of federal properties, oblast property committees and funds carry out the tasks of privatizing federal properties, getting the approval of the GKI or the Federal Property Fund before proceeding with the privatization. All enterprises, whether federal, local or municipal, large or small, were allocated to one of five broad categories in the 1992 state program.

Mandatory privatization. This includes firms in wholesale and retail trade, construction and construction supply, food processing, light industry, textiles, furniture, agricultural produce, road transport, and all loss-making enterprises (except those that fall into one of the other categories). Most small-scale enterprises fell into this category, together with some 5,000 large enterprises. By having a mandatory category, the Russians created a pipeline of firms to be privatized.[8] This put pressure on oblast authorities to begin privatization as quickly as possible.

Privatization with the approval of the federal GKI (after consultation with sectoral ministries). This includes large firms that either dominate the market they operate in, employ over 10,000 people, or have assets worth over 150 million rubles on January 1, 1992 (such as railroads, airlines, shipping lines, alcohol, tobacco, pharmaceuticals, and medical equipment). When these enterprises are privatized, the state can retain a controlling stake for up to three years.

Privatization permitted with government approval. These are firms in industries of strategic importance (natural resources, steel, defense, information and wireless agencies, grain storage, and so on). Given the opposition of anti-reformers in government, privatization of these industries has been slow.

Privatization forbidden in 1992. This category included entities such as major natural resource industries, the Central Bank, social infrastructure, television and radio stations, ports, and nuclear production facilities.

Local privatization programs. This category includes most social infrastructure under the auspices of local authorities (such as mass transit systems, health, education, and cultural and sports facilities).

Corporatization

Corporatization is the process by which a state enterprise becomes a joint stock company with a legal identity. It is no longer an adjunct to a branch ministry. It has its own charter (rights and obligations of shareholders), a board of directors that has the right to appoint and dismiss management and operates under the same commercial law as the private sector. All large-scale enterprises, except those for which privatization is forbidden, must be corporatized. Subdivisions of large enterprises can also corporatize as a first step toward independence. Medium-size enterprises can be privatized through either the small (which does not require corporatization) or large privatization program.

To be corporatized, an enterprise had to submit a privatization plan, a valuation of its assets (as of July 1, 1992), and a joint stock charter to the local property committee by October 1, 1992.[9] Tight deadlines were set for the corporatization process, as well as for particular stages. In practice the timetable was untenable. Many enterprises filed late, and even a year after the original deadline the process was still far from complete. Insofar as the intention was to create a pipeline of firms ready for privatization, however, the tight deadlines had the desired effect.

Power over the privatization process was in the hands of enterprise insiders, with the balance of power usually lying with managers. Thus, the composition of the privatization commission (which carries out the practical tasks of the corporatization procedure) was determined by the chief executive of the enterprise. The only requirements were that the commission have between three and five members, one of whom had to be from the workers' collective. The original 1991 Privatization Law envisaged a much larger privatization commission, with representatives from local state property committees, local citizens, officials of financial agencies, managers, and workers. To accelerate privatization and strengthen the role of managers, the composition of commissions was curtailed in a presidential decree of July 1992 (President's decree 721).

The KIs can do little to hinder the enterprise's proposals on privatization. For example, the KIs had to approve asset valuations prepared by the privatization commission, but they had little information on which to assess or contest the validity of management's valuation. Management had a big incentive to underestimate the valuation since the valuation was taken as the founding capital of the privatized firm and, hence, the basis on which managers and workers bid for shares in the closed subscription. Indeed, this methodology was modified by the July decree to favor speed (and, thus, insiders). The original 1991 Privatization Law envisaged that the valuation would be calculated on a market or discounted cash flow basis. Given the understandable difficulties of making projections under Russian conditions, the methodology was changed to one based on book values (as of July 1, 1992).[10] With inflation running at over 1,000 percent in 1992, this was a huge transfer of wealth from the state to insiders.

Corporatization is the process by which a state enterprise becomes a joint stock company with a legal identity.

Closed subscription

One of the major decisions managers and workers make as part of corporatization is over the closed equity subscription. Employees have three choices:

Option 1. Managers and workers are given 25 percent of the enterprise's equity in preferred, nonvoting shares.[11] They also have the option to subscribe for another 10 percent of ordinary (voting) equity on favorable terms. These include:

- A 30 percent discount from the book value (taken on July 1, 1992),
- Payments are in equal quarterly installments over three years (considerably reducing the real value of the payment, given inflation),
- An initial down payment (payable within 90 days) of not less than 15 percent of the book value, and
- Up to 100 percent of the amount owed can be paid for in vouchers.

Acquisition of both the 25 percent nonvoting stock and the 10 percent voting stock are subject to ruble limits to prevent excessive giveaways in enterprises that have high asset values relative to total employment.[12]

In addition, enterprise managers (director, deputy director, chief engineer, and chief accountant) have the option of acquiring up to 5 percent of voting equity at book value (for which they can pay with vouchers and cash). Managers and workers can sell their stock to whomever they choose, but sale of the nonvoting preferred stock does not change its status.

Option 2. Employees can buy 51 percent of the ordinary shares of the enterprise for 1.7 times the book value (as of July 1, 1992). There are no discounts or deferred payment terms and no sales of nonvoting shares. Vouchers and cash can be used to pay for the shares (no less than 50 percent must be in vouchers). The entire payment must be made in 90 days. The 70 percent markup on the book value was an inadequate attempt by the GKI to compensate for inflation.

Option 3. This is open only to enterprises with more than 200 employees and assets of between 1 million and 50 million rubles as of January 1, 1992. Managers assume responsibility for running the enterprise under a contract with the local property committee. They agree to maintain both the competitiveness of the enterprise and a certain number of jobs for at least two years. If the terms of the contract are fulfilled, managers can acquire 20 percent of the voting capital at book value with payment over three years. All enterprise employees (including managers) are also given the right to acquire a further 20 percent of the voting capital at a 30 percent discount to book value. Option 3 has rarely been used.

A vote on which option to choose is made at a general meeting of the workers' collective. A two-thirds majority is required to choose option 2 or 3. If there is no such majority, option 1 applies.[13]

Employees also had two other important subscription privileges—Personal Privatization Accounts and the Share Fund for Employees of the Enterprise (FARP). Privatization accounts are part of an enterprise's social fund. This is composed of such items as a housing fund, wage fund, bonus payments, and, more recently, privatization accounts. Each year part of the enterprise's net income is allocated to the social fund. Employees can use these privatization accounts to finance their share purchases in the closed subscription (though inflation has reduced their value in real terms). FARPs allow certain groups of employees to subscribe for up to 5 percent of the enterprise's capital after the closed subscription and the voucher auction. FARPs apply to those who could not participate in the closed subscription, such as former or retired employees.

Significant restrictions were placed on the use of shares in the hands of the local property fund after the closed subscription. The fund may not vote more than 20 percent of the equity. Any stock held by the fund in excess of this (40 percent in the case of option 1 or 29 percent in the case of option 2) has the status of nonvoting, preferred shares with a minimum dividend equal to the bank discount rate. Only on sale to a private investor will these shares become common stock. These restrictions were imposed to thwart local property funds from trying to maintain direct control over enterprises. Because substantial equity ended up in the hands of insiders, however, these restrictions had unintended consequences. Under option 1, for example, insiders who took up their full subscription received 15 percent of the equity, but because of the restriction on property funds' voting rights, had 47 percent of the voting rights; they do not need to buy many more shares in open subscription to gain voting control. Under option 2 insiders can subscribe for majority control, but even when they fail to subscribe for their full allotment or subscribe for their full allotment and then sell their shares, the 20 percent voting limit on the funds provides insiders with considerable leeway before they lose voting control.[14]

The scale of equity transfer offered through closed subscription is enormous—a reflection of the strength of implicit ownership claims spawned by the Gorbachev enterprise reforms. Managers and workers, through their de facto control of enterprises and their vocal representation in Parliament, were able to mold privatization legislation. Enterprise workers have received more generous concessions than in any other privatization program in the world (Boycko, Shleifer, and Vishny 1993). Not only did they receive 35 percent of the equity on generous terms under option 1 or 51 percent under option 2 (with an opportunity to increase their shares in open subscription), they also had a voice, through the workers' council, on the choice of option. More importantly, they were able to prevent the immediate dominance of strong powerful outside shareholders. In acquiring stakes, managers and workers invested little of their own money, but were usually able to subscribe for the full amount open to them. After taking into account the effects of inflation (1,000 percent) and the use of discounts, vouchers, payback periods, and privatization accounts, the actual contribution made by workers and managers has been negligible. Closed subscription has represented a significant transfer of wealth from the state to workers and managers.

The original privatization plan envisaged only option 1, which did not offer immediate majority control, inhibited outsider involvement, and represented a de facto veto on future restructuring. Option 2 offered both substantial equity and immediate control. Not surprisingly, more than 70 percent of corporatized state enterprises chose option 2. The rest chose option 1 and only a handful of enterprises chose option 3.

Vouchers

Vouchers were put on sale a month ahead of schedule (from October 1, 1992) at Sberbank, the state savings bank, to demonstrate that privatization had started in a meaningful way and to build support for the program. The main characteristics of the voucher scheme were:

- For a fee of 25 rubles, each Russian would receive one voucher with a denomination of 10,000 rubles. All citizens would receive a voucher regardless of age, residence, workplace, or income.
- Vouchers could be accepted by a privatization agency anywhere in the Russian Federation for the sale of state assets. Once received by the agency, the voucher would expire.
- Vouchers were bearer documents and could be used to buy shares of the enterprise in which the voucher holder works or to purchase shares at the auction of any other enterprise in the Russian Federation, traded in a commercial or investment tender, exchanged for shares of a voucher investment fund, sold for cash, or used to pay for housing and small-scale property.
- Vouchers were originally to be valid from December 1, 1992, to December 31, 1993, but the deadline was extended to July 1, 1994 because of delays in the privatization program.
- Only the Russian Federation could issue vouchers and only federation vouchers could be accepted by privatization agencies. No local vouchers were permitted.

The Russian privatization voucher differed in important aspects from the Czech and Slovak voucher. It was less expensive. The Czech and Slovak voucher cost about $35 (roughly the average weekly wage) and the program was self-financing. The Russian voucher first went on sale at around 5 cents. This led to both a higher take-up rate and rapid disbursement. The GKI estimates that by the end of January 1993, four months after the first sale, 95 percent of Russians had collected their vouchers (some 146 million). Four months into the Czech and Slovak sale, only 2 mil-

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lion of an eligible 10.5 million participants had bought voucher booklets.[15] The Russian voucher had a nominal denomination of 10,000 rubles (unlike the Czech and Slovak vouchers, which were denominated in points, not currency units), and Russians could sell their vouchers for cash, unlike the Czechs and Slovaks.

Russian reformers had several reasons for allowing voucher trading (Boycko 1993). First, any restrictions on trading would limit an individual's portfolio choices. Second, some people, especially the poor, could sell their vouchers to increase their consumption. Third, given that many people would want to sell their vouchers even if it were illegal to do so, a black market was bound to emerge—an official market could be somewhat regulated. Fourth, tradability would allow large and powerful shareholders to emerge. It would permit individuals, firms, and voucher funds to acquire as many vouchers as they wished, which is precisely what happened.

One argument against voucher tradability is its possible effect on inflation—vouchers, functioning as high-denomination bills, would add to the money stock. In addition, distributing vouchers leads to an increase in the wealth of all citizens which, in turn, would increase their consumption and thus inflationary pressure; borrowing against vouchers for current consumption would only result in an increase in the relative price of goods consumed by the poor (food, clothes, and so on). Restricting the use of vouchers so that they are not redeemable for goods and services mitigated their inflationary consequences, but the most potent method was to ensure that there was a rapid supply of enterprise shares, thereby reinforcing the equity-linked basis of vouchers.[16]

A related issue was allowing vouchers and cash to be used as alternate forms of payment. The decision on payment depended on satisfying a number of policy objectives and constraints. First, it was important to ensure that local authorities received cash from share sales and thus had the incentive to sell the shares in the first place. Second, it was important that a direct link was made between vouchers and assets on sale, thereby ensuring that vouchers were backed by valuable assets. Third, in the event of an illiquid voucher market, an insistence on using only vouchers would delay the privatization process until investors and employees had bought the required vouchers. Finally, assigning a nominal value to vouchers had ramifications for the payment decision. If the voucher's market value falls below its nominal value and if there are no limitations on how many vouchers can be subscribed, then no investor (either in the closed or open subscription) will use cash to pay for privatized assets.

Open subscription

The privatization commission has to lay out a proposal for the sale of the equity remaining after the closed subscription. The three choices for the enterprise are a voucher auction, a voucher auction combined with commercial tender, or a voucher auction combined with investment tender. Each of these options could also be followed by a sale of shares for cash. A minimum of 29 percent of the total equity had to be sold in a voucher auction.[17]

Under a commercial tender, the enterprise is sold (in an auction room or by sealed bid) to the highest bidder accepting specific conditions. An investment tender is a much longer process, suitable for large enterprises. The evaluation criteria are not restricted solely to price, but may also include investment, employment guarantees, and so on. Commercial and investment tenders are rare. In February 1994 a presidential decree was issued in anticipation of the increase in tenders likely to occur after the end of voucher auctions in July 1994. The decree simplified the procedures required for investment and commercial tenders.

Given the absence of control from the center, the nature and speed of the sale of the remaining equity has been negotiated between the enterprise, local politicians, the KI, and the local property fund. This has left a large amount of discretion over the form of the open subscription in the hands of the insiders. Insiders may try to delay the sale either to keep equity in the hands of the property fund, which is likely to be more responsive to their interests and to share their concern over outsider control, or to allow time to accumulate enough capital to buy some or all of the remaining equity. In voucher auctions, local property funds and enterprises have often tried to evade the 29 percent minimum by selling a smaller percentage through a series of auctions in which small stakes are sold. The situation deteriorated so much that another decree was issued after the April 1993 presidential referendum reiterating the 29 percent target and threatening disciplinary measures for failure to comply with the target (presidential decree of May 8, 1993). Compliance has improved considerably since this decree.

During 1993 it was common to find local property funds retaining 20 percent of the equity in privatized enterprises, believing that once 80 percent of the equity had been sold (most commonly in an enterprise choosing option 2, with 51 percent sold to the employees and a minimum of 29 percent sold through a voucher auction) they were under no obligation to sell more. The "80 percent" rule, however, required that 80 percent of enterprise equity had to be sold for vouchers. If the proceeds of the closed subscription were not entirely in the form of vouchers, then the property fund (having sold 29 percent through the voucher auction) has to sell from the remaining 20 percent to comply with federal legislation. The GKI has used this rule to push the property funds to sell more equity for vouchers before the voucher expiration date.

Local property funds have also reduced their stakes by using the option of selling up to 5 percent of the share capital offered in the voucher auction for cash (that is, up to 5 percent of the minimum 29 percent). Property funds are reluctant to sell further shares for vouchers, and most are waiting for the expiration of vouchers at the end of June 1994, when they hope to sell shares for cash. In contrast to the 5 percent cash sales, the proceeds from these cash sales will not accrue solely to the local property fund. They will be split with the federal property fund, the local KI, the central GKI, and the federal and oblast authorities. Local property funds will retain the option of selling shares through an investment or commercial tender beyond the June voucher deadline.

Voucher funds

Russian investment funds are all privately sponsored. The state is limited to providing and ensuring compliance with a prudential regulatory framework. Legislation, including a presidential decree issued in October 1992, followed by an Investment Company Law in 1993, allowed for the creation of both voucher and nonvoucher investment funds. The voucher funds are licensed and regulated by the GKI and the nonvoucher funds by the Ministry of Finance.

Investment funds were slow to emerge. The first investment fund licenses were not issued until December 1992, three months after vouchers first went on sale. There were logistical hurdles to the formation of funds, such as raising finance, registering, and so on. There was also a lack of public [illegible]standing of investment funds, due in [illegible] poor marketing. Even so, the number of funds has grown rapidly. It is estimated that by May 1994, there were 624 licensed investment funds (mostly voucher funds), with 550 investment fund managers and 21 million shareholders controlling 45 million vouchers—about 30 percent of the total number issued (Price Waterhouse 1994). By May 1994 voucher funds had invested 27.6 million vouchers. Moscow city has the highest concentration of funds with more than 120 (the Moscow oblast has about 150), while the St. Petersburg oblast has about 35. The largest fund has more than two million shareholders and four million vouchers. Voucher and nonvoucher funds can subscribe for cash, though this has not yet been a priority and little cash has been raised. This will change after the expiration of vouchers in mid-1994.

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Investment funds and managers are regulated in a number of ways, such as the form and nature of investment funds, licensing requirements, the relationship between funds and fund managers, portfolio investment restrictions, valuation procedures, reporting requirements, the rights of shareholders, and so on. Legislation saw voucher funds acting as passive portfolio investors, playing much the same sort of role as their Western mutual fund counterparts. (The Investment Company Law was based on the 1940 U.S.

Investment Company Act.) In particular, various restrictions were placed on voucher funds' portfolios. Funds were not allowed to invest more than 5 percent of their assets in one enterprise, to own more than 15 percent of the debt instruments of an enterprise, or to invest outside of Russia. One important restriction was that a fund could not own more than 10 percent of the stock of an enterprise. This rule (later changed) initially placed voucher funds at a disadvantage not only to insiders, but also to other private investors who faced no such restrictions, and severely limited the corporate governance role they could play. In comparison, in the Czech Republic, the limit is set at 20 percent. Thus in the Czech Republic it would require three voucher funds voting together to control an enterprise, whereas in Russia it initially required six.

The licensing conditions that funds and fund managers have to comply with have been kept to a minimum both to encourage the formation of funds and to leave little discretionary power in the hands of oblast KIs...

The funds' behavior has been quite different from that originally envisaged. There seem to have been two stages of development. At first the funds were active participants in the voucher market. In addition to trading vouchers for capital gains, funds were selling vouchers to raise cash to meet their current expenses, since they found themselves in a position with little or no interest or dividend income and an illiquid share portfolio. Their only cash reserves were their founders' capital. The voucher market was the only avenue by which funds could be obtained for current expenses. To the extent that cash proceeds from voucher sales did not come out of trading gains, the fund was paying expenses out of principal. The government took the view that the resulting sell-off of vouchers by the funds was undermining voucher prices and, in a May 1993 presidential decree, forbade funds from trading in vouchers. This belief seems unfounded—fluctuations in the voucher market are more a reflection of the vagaries of Russian politics on the prospects for privatization—though concern about funds eating into their capital bases seems reasonable. It appears that some funds are evading this rule by exploiting ambiguities in the legislation. They purchase vouchers for cash in the market but keep them separate from vouchers they receive in exchange for their shares. The latter are used in voucher auctions, the former for speculation.

As the pace of voucher auctions increased, funds focused on acquiring blocks of equity in specific enterprises and industries. There seem to be two broad explanations for this behavior. The first is that, like Czech funds, Russian funds see more profit in acting as proactive restructurers of corporate assets rather than as portfolio investors. Singly or in concert, Russian funds have challenged management at shareholders meetings and have sought to remove them or otherwise promote restructuring. To gain control, many funds have ignored the 10 percent restriction. Because of the widespread disregard for the rule and because it was felt that funds were being unfairly penalized, the limit was raised to 25 percent in the 1994 privatization program. The second reason for acquiring blocks of equity is the exact opposite of the first. Many managers have sought to expand their shareholdings beyond the level granted to them in the closed subscription. Funds often acquire shares in voucher auctions or in the secondary market with the intention of selling them back to management at a markup. This practice has proven to be a lucrative source of profits with which to pay dividends, though in doing so funds are forsaking a long-term investment role and instead fulfilling the role of a broker.

The licensing conditions that funds and fund managers have to comply with have been kept to a minimum both to encourage the formation of funds and to leave little discretionary power in the hands of oblast KIs, on whom most of the regulatory burden falls. Two points are worth noting: foreign fund managers are treated no differently from domestic and state enterprises are forbidden from setting up voucher funds. The latter condition was imposed because it was feared that state enterprises might create funds to buy stakes in privatized companies, thus defeating the purpose of privatization.[18]

By decree, Russian voucher funds have to be closed-ended—that is, they have a fixed number of shares in issue. An investor subscribes capital during specific offer periods, and once the fund is set up, the investor recoups investment by selling voucher fund shares on the secondary market. Unlike investors in open-ended funds, investors in a closed-ended fund cannot subscribe more capital or ask the fund to redeem shares.

Though voucher funds are closed-ended, many have developed a lopsided nature in that they have semi-continuous subscription periods (in contrast to the limited offer period of a Western closed-ended fund). These funds fall halfway between a closed-ended fund and an open-ended fund in that they subscribe for vouchers on a semicontinuous basis without being obligated to redeem their shares. This has caused a number of problems, including the rate at which funds are exchanging their shares for vouchers. Most funds are issuing their own shares for a fixed number of vouchers (normally ten shares for each voucher), with little or no attempt to update the price of their shares on any net asset valuation basis. Thus, one group of shareholders is being short-changed at the expense of another. If a fund's assets are worth more than the price at which that fund's shares are being sold, shareholders' investments are being continuously diluted, whereas if the fund's assets are worth less than the price at which fund shares are being sold, then future shareholders are being short-changed. Funds have claimed that they are prevented from changing their prices because of a Ministry of Finance regulation that prevents shares of the same issue being sold for different prices. If they did not engage in these semicontinuous subscriptions, this problem would not occur. The situation is further complicated by the fact that no attempt is made to recalculate share prices (the ratio at which fund shares are exchanged for vouchers) with the voucher market price. Thus there is little relationship between fund share prices (to the extent that they exist) on the primary or secondary market and net asset values. Indeed, so long as funds engage in semi-continuous subscriptions, they have little interest in seeing a secondary market in their shares emerge.

Like their Czech and Slovak counterparts, funds have been aggressive advertisers, particularly on television. Many have made exaggerated claims about future dividends, causing concern among policy-makers. Thus there is a regulation forbidding Russian voucher funds from making guarantees on future performance. This rule was instituted because of the experience of the Czech and Slovak authorities. In the former Czechoslovakia, several investment funds guaranteed tenfold returns or more on a citizen's coupon book a year after shares began trading. Authorities feared that if enough people cashed in their fund shares at the same time, these funds might have to liquidate a substantial portion of their portfolios to make good on their promises, leading to a steep fall in the stock market and seriously undermining the credibility of the nascent capital markets in the eyes of the general population. To prevent this kind of scenario in Russia, Russian voucher funds were forbidden from making guarantees.

Still, there are many examples of misleading claims. Indeed, a large number of unlicensed funds are operating. There have been a number of scandals in which fund shareholders have been defrauded. Recently the GKI has made strides in improving good practice in the industry. A Funds Monitoring Unit was set up in Moscow to collect information on developments in the industry from oblast KIs, analyze funds' financial statements, and initiate action against unlicensed funds and other illegal behavior. Two trade associations have been formed, the Association of Investment Funds and the League of Investment Managers. The latter has self-regulatory status with the GKI and the Ministry of Finance and was modeled after the ASD in the U.S. and the CIDA in Canada.

The connections between banks and the voucher funds are looser in Russia than in the Czech Republic. In the Czech Republic, a small number of privatized former state banks dominate the banking sector. All major investment management companies are owned by the big banks. Thus, through their direct credit relationships and their influence over investment funds, Czech banks have emerged with a large amount of control over enterprises. In Russia the banking sector is fragmented. There are over 2,000 banks, most of which are privately established. Although Russian banks have established funds, they do not dominate the fund industry.

Voucher auctions

Most state enterprises are sold locally, though a national and inter-oblast auction scheme has been created. In a typical regional auction, the shares of between five and twenty enterprises are sold. Bidders must report to the voucher auction center or to a satellite bid center within a specified period—normally two to six weeks. In the voucher auction, voucherholders have two choices. They can submit any number of vouchers, not specify the number of shares they expect, and accept the strike price that clears the auction (type 1 bid). Or they can submit any number of vouchers with a specific maximum price, that is, the maximum number of shares per voucher (type 2 bid). Those who bid at or above the strike price are then allocated shares. Those who bid below the strike price do not receive any shares and have their vouchers returned for use in a future auction.

Russian interest groups or stakeholders (workers, managers, bureaucrats, politicians, or investors) have a keen interest in privatization, given the possible rewards.

There is a large variation in the speed at which regions hold auctions. Determined opponents can stall privatization, prevent shares from being sold to voucherholders from outside the region, or both. By March 1994, some regions had sold shares in over 370 state enterprises, while others had sold shares in less than 20.

As auctions took place, the government became concerned that the intra-oblast nature of the auctions was helping those forces seeking to fragment the Russian Federation. It was thought that if inter-oblast holdings could be encouraged, the unity of the Federation would be strengthened. Thus a voucher depository scheme and a national auction network were introduced during 1993 to facilitate inter-oblast holdings. The voucher depository scheme consists of 30 centers around the country; it allows voucher holders to deposit vouchers at one of the centers in exchange for a receipt. The receipt is used to bid at a voucher auction held in other oblasts. At that auction, authorities verify the receipt and confirm it has not been used in another auction. On verification, the voucherholder's account is debited. This depository system relieved the voucherholder of the need to carry large numbers of vouchers around the country.

In addition, an "All Russia Auction Center" has been in place since March 1993. Although the center is based in Moscow, auctioned enterprises can come from anywhere in Russia and can be sold concurrently through a large number of oblasts. Twelve regions participated in the first auction of Zil, the car manufacturer, and the national auction scheme has grown since to include 72 regions. The center is reserved almost exclusively for the largest enterprises, almost all of which are federally-owned properties. Initially, the choice of whether to go through the national auction center was voluntary, but since October 1993 it has been mandatory for enterprises with capital over 250 million rubles as of January 1, 1992. Almost all of these enterprises are outside the mandatory privatization category because of their size, and instead fall in the category requiring federal GKI approval. Because of the political clout the sheer size of the enterprise gives them, managers of these enterprises have considerable discretion over their passage through the privatization and national auction process. In many cases they are able to negotiate special terms not available to firms privatized on a local basis. In addition to the national auction center, a more limited inter-oblast voucher auction has been created in which the shares of an enterprise in one oblast are offered to voucherholders in at least three regions. There are no requirements regarding whether a property has to go through this limited inter-oblast auction, but it appears that most have capital of about 100 million rubles.

Public information campaign

Privatization is an intensely political process everywhere, including in Russia. Russian interest groups or stakeholders (workers, managers, bureaucrats, politicians, or investors) have a keen interest in privatization, given the possible rewards. Policymakers felt that there was a need for an information campaign to mold the public into a constituency with a clear interest in pushing forward the program.

The campaign had to overcome indifference and hostility to both economic reform and privatization. Various media were used in the campaign—advertising on national television, on the radio, in print, and in prime-time weekly programming devoted specifically to privatization issues. Regional information offices were set up and regional training seminars held. An educational brochure, "Privatization in Your Pocket," was produced, and mass publicity "privatization days" were organized. The campaign was split into phases. The first was an aggressive promotion of the voucher-distribution program. The second distinguished privatization from hyperinflation (which many thought stemmed from privatization) by portraying privatization as the principal means for economic change. The next phase dealt with the irreversibility of privatization. In this phase, the campaign moved beyond discussing vouchers by highlighting the national voucher auctions and identifying privatization success stories.

Another use of public information was to increase transparency in privatization. The privatization law required advertising for enterprises that were to be sold in national or local media. Additionally, at bid centers, information on companies to be auctioned was provided (such as sales and export figures, number of employees, major products, and so on). While this requirement increased the cost of the public information program, it was critical to keeping privatization transparent. The provision of public information also signified a break from the communist past.

Progress of mass privatization

Corporatization

By March 1994, over 8,700 medium-size enterprises had been privatized through the large-scale privatization process (table 2.1). This was mainly because insiders perceived privatization as a defensive measure; it served to ensure that outsiders did not gain control. The fact that many medium-scale enterprises chose the large privatization scheme is indicative of the certainty that it provides against outsiders gaining control of the enterprise. Of the closed-subscriptions options, option 2, which gives insiders immediate majority control, is the most popular; 78 percent of medium-sized enterprises took this route. Option 1 was chosen by 18 percent of medium-size enterprises. This option was usually chosen when the company was too capital-intensive to buy outright (which is presumably why the percentage is higher for large enterprises) or when managers feared giving workers voting shares.

By March 1994, over 8,700 medium-size enterprises had been privatized through the large-scale privatization process.

Voucher auctions

By October 1992, even though vouchers were being distributed a month ahead of schedule, little progress had been made on bringing enterprises to the market. So at the end of October the federal GKI asked local KIs for enterprises that had already been corporatized, transformed into joint stock status, and were ready, at short notice, to take part in voucher auctions. Bolshevik Biscuit Company, a cake and confectionery baker based in Moscow, was chosen, after hurried negotiations with its management, to be the first company to go through the auction. It was done at breakneck speed in December 1992, amid a blaze of publicity and considerable Western technical assistance. In that month, eighteen enterprises from eight oblasts or cities (including Moscow, Vladimir, Yaroslavl, and Perm) representing a variety of industries (including trucking, cement, and microchip produc-

Table 2.1 Overview of corporatization in Russia, March 1994

	Large enterprises		*Medium-size enterprises*		*Total*	
Method chosen	*Number of firms*	*Percent*	*Number of firms*	*Percent*	*Number of firms*	*Percent*
Option 1	758	33	1,551	18	2,309	21
Option 2	1,377	60	6,748	77	8,125	74
Option 3	22	1	83	1	105	1
Lease	2	0	4	0	6	0
Unknown	125	5	348	4	473	4
Total number of firms	2,284		8,734		11,018	

Source: GKI/RPC Performance Center.

Bolshevik Biscuit Company... was [auctioned] at breakneck speed in December 1992, amid a blaze of publicity and considerable Western technical assistance.

tion) went through the process. By March 1994 some 9,500 enterprises in 81 regions, accounting for 10.8 million workers, had sold shares through voucher auctions (table 2.2). It is estimated that of the vouchers submitted by April 1994, 80 million have been used in closed subscriptions and voucher auctions and 5–10 million have been used in small-scale privatizations, leases, FARP housing, and so on. By May 1994 some 45 million vouchers had been collected by voucher funds, of which 27.6 million have been invested.

Asset values

Calculations based on voucher auctions and the voucher market price show asset valuations to be uniformly low. This suggests either a worthless capital stock or (more plausibly) that most wealth is retained by insiders.

Russian assets should be valued based on an aggregate and on an individual basis. Assume that the assets sold at auctions are representative of Russian industry as a whole. By June 1993, 15 percent of Russian industry had gone through voucher auctions, selling an average of 20 percent of the equity (about 3 percent of all Russian equity) for $150 million. This implies that the whole of Russian industry is worth just $5 billion—the value of one U.S. Fortune 500 company (Boycko, Shleifer, and Vishny 1993).

The figures become more dramatic among individual enterprises (Boycko, Schleifer, and Vishny 1993). Zil, the automaker, with more than 100,000 employees, a ready market for its goods, and substantial real estate holdings, is, according to the voucher auction, worth only $16 million. The second most valuable company that was auctioned by June 1993 was a Moscow hotel with 154 employees. Uralmash and Permsky Motors, each with over 30,000 employees, are valued at $7 million and $4 million, respectively. Boycko, Shleifer, and Vishny argue strongly that these low valuations are a result of the position of outsiders in relation to insiders and the government. They point out that much of the value of an outsider's stake in a company is expropriated by insiders, either through workers' demands for high wages, managers making asset sales to their own companies, illegally changing shareholder charters, and rigging shareholder meetings, and government regulations, taxes, restrictions on layoffs, and so on. Paying dividends to outsiders is a low priority. With so few shareholders' rights, it is not surprising that the worth of minority stakes is seriously devalued.

Share ownership

Managers and workers have been aggressive in consolidating their shareholdings, us-

Table 2.2 Voucher auctions in Russia, December 1992 to February 1994

	Number of enterprises sold	*Number of regions*	*Number of employees (thousands)*	*Charter capital sold (millions of rubles)*	*Weighted average charter capital sold (percent)*	*Vouchers accepted (thousands)*	*Weighted average auction rate*[a]
December 1992	18	8	44	513	17	158	3.2
January 1993	107	21	189	706	12	229	3.1
February 1993	197	30	206	1,629	19	612	2.7
March 1993	436	51	536	5,160	25	2,202	2.3
April 1993	612	61	829	6,528	23	4,158	1.6
May 1993	581	53	609	5,306	21	4,305	1.2
June 1993	897	74	812	7,209	18	4,360	1.7
July 1993	907	62	754	8,170	23	6,641	1.2
August 1993	894	66	924	6,903	21	4,255	1.6
September 1993	786	66	838	7,123	20	4,745	1.5
October 1993	963	74	906	8,289	19	4,557	1.8
November 1993	883	64	1,021	8,461	19	2,832	3.0
December 1993	1,047	65	1,101	9,635	19	4,002	2.4
January 1994[b]	643	66	746	11,552	23	3,925	2.9
February 1994[b]	475	53	1,333	14,636	24	3,920	3.7
Total	9,446	82	10,848	101,551	21	50,091	2.0

a. Thousands of rubles share per voucher.
b. Figures for January and February of 1994 are preliminary.
Source: GKI/RPC Performance Center.

ing voucher auctions and the secondary market to pick up further shares. The effect of this activity is clear from two recent surveys (table 2.3).[19] The Blasi survey shows that, on average, 70 percent of a privatized enterprise's equity ends up in the hands of insiders, and of that, 17 percent is owned by management. Of the remaining 30 percent, 16 percent is held by local property funds.

Even so, outsiders have been active in the voucher auction process. Outsiders hold about 14 percent of enterprise shares, of which 9.5 percent is with large shareholders—investment funds, wealthy individuals, and private firms and, to a limited extent, foreigners.

An interesting feature has been the extent to which managers have increased their stakes. In the closed subscription, managers would have received somewhere between 5 and 10 percent of an enterprise's equity. After bidding in voucher auctions and buying shares from workers, their holdings rose considerably. Their influence is not limited to equity ownership alone. Often workers' collectives have thrown in their lot with managers, pledging their shares to managers either informally or formally (through trust arrangements). Insider ownership, with managers in the driving seat, will be an inescapable feature of the corporate governance landscape for some time to come.

Small-scale privatization

Control over the small-scale privatization program is concentrated in the hands of municipal authorities. This was a result of a December 1991 presidential resolution on the division of state property (and hence responsibility for privatization) between the federal, oblast, and municipal authorities. Essentially all small-scale enterprises (such as retail shops, catering facilities, and consumer services) were transferred to municipalities. Given the sheer number of small enterprises and the time scale envisaged, it was technically and politically unfeasible for the federal authorities to carry out the small-scale program.

Scope. The 1992 annual state privatization program placed heavy emphasis on small-scale privatization. Wholesale and retail networks in the marketing of industrial goods, catering facilities (restaurants and cafes), and consumer services, along with wholesale and retail networks from other industries that had a significant number of small enterprises, were placed in the mandatory privatization category.

Table 2.3 Distribution of shareholders, Blasi survey
(percent)

	Insiders			*Property*	*Outsiders*			
Type of firm	*Workers*	*Managers*	*Total*	*Fund*	*Small*	*Large*	*Total*	*Option*
Food	20	60	80	0	15	5	20	2
Zil (auto manufacturer)	35	5	40	25	15	20	35	1
Machine tools	—	—	60	30	10	0	10	2
Radio	55	10	60	20	20	0	20	1
Trucking	90	3	93	0	3	4	7	1
Chalk	55	5	60	31	0	9	9	1
Trucking	—	—	80	20	0	0	0	1
Steel	89	11	100	0	0	0	0	Lease
Steel	29	35	64	10	3	23	26	2
Metal	66	18	84	0	15	1	16	2
Furniture	46	5	51	49	No voucher auction yet			2
Textile	92	5	97	0	3	0	3	—
Women's wear	90	—	90	10	0	0	0	1
Machine tool	33	18	51	30	1.5	17.5	19	2
Pasta	57	4	61	20	—	—	18	2
Wheat	28	45	73	18	8	1	9	2
Department store	10	30	40	20	12	28	40	1
Trucking	45	30	75	22	2	1	3	1
Trucking	58	5	63	30	6	1	7	2
Mean	53	17	69	16	—	—	13	

— Indicates data not available or not meaningful.
a. The average number of employees of the firms surveyed was 6,897.
Source: Boycko, Shleifer, and Vishny (1993).

Russia's small-scale privatization is larger than in other Eastern European countries. The GKI estimated the number of retail and service outlets at the beginning of 1992 was about 270,000, of which a third were in the mandatory privatization category. Given the exclusion of many enterprises from the mandatory category, measuring the extent of the program is difficult.

Framework. The 1991 privatization law and the 1992 annual state privatization program outline the main features of the small-scale program, leaving municipalities to fill in the details. The legislation stipulated that small enterprises were not to be corporatized (unlike large-scale enterprises) and were to be sold for cash through either an auction or commercial tender. In auction, the enterprise is sold to the highest bidder, with no special conditions attached. All potential bidders have to preregister, deposit 10 percent of the price as a sign of good faith, and bid in person.

The tender process gives municipalities greater discretion, which they have been quick to use. They can impose post-privatization conditions on potential bidders, with the highest bidder satisfying these conditions acquiring the enterprise. Restrictions can cover employment, investment, change of business profile, the financing of social programs, and the preservation of historical buildings. Bidding can be open or closed. Commercial tenders have been used for most sales. The two most common restrictions are a moratorium on layoffs and on changing the line of business. There was a failed attempt at the federal level to impose a three-year limit on post-privatization restrictions. Such restrictions can be in force from between one and fifteen years.

Because of the limited liquidity of the Russian real estate market and the low value of the enterprise's other assets, usually access to real estate is the only asset of real value that ownership of a privatized small enterprise brings. Federal legislation has stopped short of giving entrepreneurs the right to buy the premises on which an enterprise stands. For residential or multiunit buildings, a successful bidder acquires the right to lease the premises for fifteen years, with the option to buy after a year. Federal authorities, however, have not indicated the valuation methodology and legal procedures by which the premises can be sold. This gap has effectively stalled the follow-on sale of enterprise premises, even though there are thousands of bidders who (in theory) can exercise their option. This has led to a reluctance by entrepreneurs to take part in auctions and tenders.

Privatization legislation also provides for liquidation of small enterprises. In this case, a business is halted, its bank accounts closed, employees dismissed, and all assets sold. All liabilities are transferred to the municipal authorities and paid off with the proceeds raised from the sale of the assets. Apart from a few progressive municipalities, liquidation has rarely been used.

Bidding is open to all interested domestic parties, such as workers' collectives, Russian firms, or individuals. Foreign participation is allowed only at the discretion of the municipal Soviet, which effectively excludes foreigners. Federal legislation gives workers and managers substantial privileges. If they bid successfully, they receive a discount on the purchase price; if they are unsuccessful or do not bid, they receive part of the cash from the sale. To qualify for the bidder's discount, at least a third of the employees must form into a partnership or joint stock company.

If the employees' bids are successful, they get a 30 percent discount and can pay over three years, with a down payment of not less than 25 percent of the purchase price. Given that there is no adjustment for inflation, the three-year payment period dramatically reduces the real value of the purchase price. If the employee partnership or company does not win the bid (or does not bid) in an auction, they receive 30 percent of the cash proceeds, up to an individual limit of twenty times the national minimum monthly salary. If a competitive tender was held, employees receive 20 percent of the purchase price, up to an individual limit of fifteen times the national minimum wage.

Progress report. Small-scale privatization started in the city of Nizhny Novgorod (with considerable assistance from the International Finance Corporation) in April 1992, nine months before the large-scale program began. Nizhny Novgorod was chosen as a pilot city because of the political commitment of the oblast and city authorities (both executive and legislative) to privatization. In April 1992 alone, some 6,700 small-scale enterprises were sold throughout Russia.

Since then, Russia has made progress, though it is apparent that small-scale privatization has not catalyzed the growth of the small-scale sector. The GKI estimated that by March 1994, 75 percent of the 94,300 wholesale and retail networks in the 1992 mandatory privatization category had been privatized. Another 30,000 nonretail enterprises can be added to those estimates, making a total of about 100,000.

The mixed success of the program can be attributed to several causes. First, the number of small enterprises per capita and per unit area in Russia was low to begin with. This has been compounded by excluding a large number of enterprises from the program. Second, even for those included in the program, the nature of their privatization has been uneven. It was originally hoped that many of the practices adopted in Nizhny Novgorod (such as transparent procedures, the exclusive use of auctions, lack of restrictions, and the liquidation of enterprises prior to the sale of assets) would serve as a model for other municipalities. But with few exceptions, this has not happened. GKI figures illustrate this (table 2.4).

Table 2.4

Method of privatization	*Percentage*
Auctions	20
Commercial tender	50
Lease with rights to buy	30

Commercial tenders have clearly been the favored technique. More than two-thirds of auctions and tenders have been won by workers' collectives. There are numerous instances of post-privatization restrictions on changes of business profile and employment. It is estimated that more than 90 percent of auctions and tenders have been of enterprises as going concerns, rather than liquidation prior to sale.

The International Finance Corporation estimates that 14 percent of all municipal objects have been removed from the privatization process. It has also identified many abuses:

- *Yakutsk (Sakha Republic).* No auctions or tenders have ever been held and small enterprises were sold exclusively to workers' collectives.
- *Taganrog (South Central region).* Almost all of the small enterprises slated for privatization were leased under Gorbachev's leasing policy. One lease enterprise was an eighty-seven store monopoly. The municipality patently failed to break-up a torg.
- *Vladivostock (Far East region).* The torgs were not liquidated, but reorganized and leased to the workers' collectives. This has left few enterprises that can be sold through auction or commercial tender. The IFC is exploring ways of dismantling the torgs. Municipal officials have introduced an additional eighty enterprises into the privatization pipeline and are looking at ways of introducing another 500 previously excluded enterprises.
- *Petropavlovsk-Kamchatski (Far East region).* The authorities sold only unprofitable enterprises and held profitable ones. The mayor has also recently transferred responsibility for privatization from the KI to a department reporting directly to himself, stalling privatization.
- *Nakhodka (Far East region).* The city KI, department of trade, and the municipal Soviet excluded forty of the city's largest enterprises from privatization "to demonstrate the city's ability to manage property and trade enterprises."
- *Ptomaine (Western Siberia region).* The municipal Soviet removed sixty small enterprises from the program. Moreover, the municipal KI is interested in establishing "mixed enterprises," in which it retains an equity stake. Those enterprises that have been sold have been placed under particularly onerous conditions. In the case of one cafe, the KI went so far as to insist that each serving of dumplings be limited to 200 grams per customer.
- *Voronezh (Central region).* Eighty percent of the municipality's enterprises have been leased with right-to-buy provisions by the workers' collectives. Some of these enterprises, on privatization, have tried to resurrect the old torgs.

- *Vologda (North region).* The municipal Soviet flouted federal legislation by selling all enterprises to workers' collectives for book value without using auctions or commercial tenders.

Conclusion. The problem of the small number of retail outlets has been compounded by a failure to privatize what there is and to privatize it efficiently. To rectify the situation, privatization procedures should be modified, the connection between privatization and a commercial real estate market strengthened, and the business environment for small scale entrepreneurs improved.

The problem of the small number of retail outlets has been compounded by a failure to privatize what there is and to privatize it efficiently.

To increase the privatization pipeline torgs should be liquidated, enterprises excluded in the 1992 privatization program should be brought in, and the scope of the 1992 program must be widened.

But privatization is only one input into the development of the small-scale private sector. Another is a liquid commercial property market. Because of a lack of supporting legislation, privatization has become a surrogate for such a market. But given the restrictions placed on changes in business line and the bias toward workers' collectives, it is a poor one. Federal authorities should quickly lay down the methodology by which owners of privatized enterprises can buy premises and allow these owners to sell or lease their property. This will lay the basis for the emergence of new businesses (though restrictions on changes in business profile will continue to slow down reallocation of resources). Allowing owners to buy their premises would underscore the federal authority's commitment to not changing the "rules of the game." In contrast to Western retailers, who rarely own their premises, but who have well-defined and legally enforceable property rights, Russian entrepreneurs are likely to have hostile municipalities as landlords.

The way in which municipalities have conducted the privatization process does not bode well for the future. It is not just a question of post-privatization restrictions; entrepreneurs also usually face excessive municipal taxes as well. For example, businessmen in Oriol, a city in the Central region, face city taxes of up to 48 percent of profits, with federal levies on top of that. Access to credit is poor and wholesale supply and transportation conditions are unreliable. It will be critical for municipalities to drastically reduce both their involvement in the running of small enterprises and the tax burden, and take up the supervisory roles more traditionally associated with municipal authorities in the West, such as trade promotion, encouragement of investment, and so on. Only if progress is made on all these fronts will Russian consumers benefit from the flourishing small-scale private sectors that are a feature of other Eastern European countries.

1994 program

The 1993 privatization program was never enacted because of political opposition. Instead the 1992 program remained in force. The 1994 program retains the same structure of the 1992 program, in part clarifying the 1992 program, in part incorporating the presidential decrees issued in 1993 in lieu of the 1993 program, and in part adding new components. New components include bringing new industries within the scope of the program (such as agro-industries) and giving a mandate to develop privatization programs in others (such as health care). Further, the 1994 program clarified and strengthened shareholders' rights. Changes to a joint stock company's charter now require the approval of holders of three-quarters of the company's equity. The same is true for a change in the company's capital. All limitations on the sale of shares in an open joint stock company are now forbidden, and companies with more than 10,000 shareholders must have a board with at least nine members, of which no more than a third can be employees of the company.

In addition, new rules were included for specific types of investors. Thus, the limit on the stake a voucher fund could hold in any one enterprise was increased to 25 percent, a recognition of the widespread flouting of the previous 10 percent limit on voucher funds. Restrictions were placed on banks, currently one of the most profitable and cash-rich sectors in Russia. There was significant anecdotal evidence that banks were using their cash resources to buy up large amounts of equity. Banks are now forbidden to own more than 10 percent of an enterprise's equity and cannot have more than 5 percent of their assets in the shares of any one enterprise.

Capital market development

In contrast to the privatization program, in which both the rules and impetus were generated by the center (and the implementation left to local agents), the development of much of Russia's capital markets over the last three years has been initiated and implemented by private sector interests. To a large degree this should be welcome, but this development has taken place against a backdrop of little effective government or self-regulation. The lack of central direction can be partially blamed on the division of regulatory responsibilities between various bodies, such as the GKI, the Central Bank, and the Ministry of Finance. Thus the GKI is responsible for licensing voucher investment funds, the Ministry of Finance for brokers and all other types of investment funds, and the Central Bank for banks. But a Russian Securities and Exchange has recently been established on which all the relevant central bodies have representation and work has begun on building both an institutional and regulatory framework.

Russia's numerous regional exchanges, some of which appeared as early as 1990, were all privately sponsored. These exchanges initially focused on trading commodities, ranging from grain and metals to auto parts and computers. With the distribution of vouchers in 1992, most of these exchanges moved into voucher trading, and with the acceleration of the privatization program in 1993, most now make markets in the shares of privatized enterprises. Along with the creation of these exchanges, numerous brokerages have been established. It is estimated that by the end of 1993, there were 200 to 300 brokers in Russia, with many established by banks.

Though exchanges have proliferated, best practices on the exchanges have not. There is little real liquidity and transparency on the exchanges. There is anecdotal evidence of considerable price manipulation and false trades. Little or no self-regulation has emerged, and mistrust of exchanges is widespread. As a consequence, the exchanges are becoming less relevant, at least for the equity market. The Moscow Central Exchange, the oldest and one of the largest Russian exchanges, had a 1993 turnover of just 780 million rubles—less than $1 million. Most trades (up to 85 percent) are conducted through the over-the-counter market. Most of the activity on this market has consisted of brokers accumulating blocks of equity for enterprise managers wishing to increase their shareholdings in their own companies.

...the development of much of Russia's capital markets over the last three years has been initiated and implemented by private sector interests.

In addition to managers and investment funds, banks have also been particularly active in acquiring equity in privatized enterprises. The most liquid stocks in Russia (or those that have the appearance of being the most liquid) are bank shares. These banks are not privatized state banks, but instead have been privately established. In many cases they have built their capital bases through primary issues. Indeed, many have had more than one issue. In a sense, many appear to be in a continuous subscription mode. A large number of these banks (through their brokerage operations) make markets in their own shares, and given the extent to which these banks are issuing primary stock, they have a prima facie conflict of interest between their position as a primary issuer and their position as a dealer in their own shares. Given that nascent equity markets (both primary and secondary) are driven by players who have little interest in seeing truly liquid and transparent markets appearing, it is not surprising that they have not appeared. Efforts have begun to rectify this situation by bypassing the privately sponsored exchanges. The Russian Securities and Exchange will sponsor the creation of NASDAQ-type exchanges in Moscow and St. Petersburg.

Along with growth in trading, development in the capital market infrastructure has occurred, such as registrars, depositories, clearing agents, and settlement centers. But it has been haphazard on both an institutional and regulatory front. For example, most enterprises will maintain their own share registry, a source of obvious abuse. Or brokers, with management's

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support, combine the role of registrar and the main market-maker in an enterprise's stock. Further, few companies have issued share certificates, entry in the share register being the main form of ownership confirmation. This has lead to lengthy delays as investors (or their brokers) check share registers before clearing trades. Steps are now being taken to improve practices within the registrar industry. An enterprise with more than 1,000 shareholders must now have an outside registrar (though there are few resources currently devoted to ensuring enforcement). Twenty-five to thirty best practice third-party registrars are to be created across Russia and a Registrar Support Center, which is to form the nucleus of a self-regulatory organization, is to be established in Moscow. It is also envisaged that a registrar specializing in companies with more than one million shareholders (of which there are around sixty to eighty companies) will be created. For clearing and settlement, a best practice system is to be established in Moscow and St. Petersburg, the intention being to replicate the system in two other cities.

Foreign investment

Legally, the Russian privatization program does not discriminate against foreign investors. In reality, there is a built-in bias against outsider ownership, be it domestic or foreign. The 1992 privatization program broadly treats foreign investors as it does domestic investors. There are restrictions related to foreign ownership in strategic industries such as fuels, energy, minerals, defense, or certain small-scale industries (wholesale and retail trade, public catering, consumer services, auto transportation, and construction). Approval is needed from the Russian government, the republican government, or the municipal authority for strategic industries.

There are no restrictions on foreigners purchasing vouchers per se, but there are other hurdles. To acquire vouchers, a Western investor has to have access to rubles, and the only practical way to acquire them is through ongoing operations. Progress has been made in this area. In August 1993, the Central Bank announced that non-Russian entities would be allowed, for the first time, to buy rubles on the foreign exchange markets and open ruble accounts in Russia for investment.

Foreign investors could buy shares in the secondary market from workers and managers. The problem is that the embryonic secondary markets (and insiders' reluctance to part with shares) make it likely that this approach will take a considerable amount of time. A foreign investor could conceivably begin negotiations with an enterprise before it goes through corporatization and try to secure an equity stake ahead of privatization or bid in a commercial or investment tender. The success of any of these approaches depends on the circumstances of each enterprise and the enthusiasm of managers and local authorities.

Despite the hurdles faced by foreign investors, a number of venture capital funds have been established in Russia. In addition, the Russian Privatization Center and the Group of Seven are coordinating efforts to set up other equity funds under the auspices of bilateral donors. The U.S. government, for example, has established the Russian-American Enterprise Fund, similar to those established earlier in Hungary, Poland, and the Czech Republic. It has also established a series of funds through the Overseas Private Investment Corporation (OPIC) for capital-intensive industries and a fund for defense conversion. The European Bank for Reconstruction and Development and the International Finance Corporation have created a number of venture funds throughout Russia.

The establishment of a liquid secondary market is vital to the success of such funds because it provides an exit vehicle for the sale of equity holding in a given company. Moreover, without a liquid capital market, emerging market funds—a source of capital—will be unable to invest in Russia.

Conclusion

"At present, many people do not seem to understand that real privatization is not over as soon as a mechanical transfer of title has been made, even if politically this is considered to be the primary task. Transfer of title is only the initial and largely superficial stage of privatization: the new entities must be restructured to run more efficiently, and enjoy the benefits of corporate governance."(Federov 1993)

So wrote Boris Federov, the former Deputy Prime Minister for Finance and Economy and a key reformer in the Yeltsin government. With a lack of progress on other fronts, privatization stands as one of the few reforms to be carried out in Russia. Indeed, the sheer volume of "mechanical transfers of titles" that have been carried out indicates how successful the program has been. Clarifying the line of causation between the program's design and the rapidity of its implementation is a valuable part of understanding what lessons can be learned from the Russian program. But, as Federov states, the volume of transfer of titles is only one criterion by which the Russian privatization program should be judged. More important is whether, after the transfer of title takes place, the privatization program has truly created a framework within which economic agents have the incentives and the means to carry out the restructuring of Russian enterprises.

The most striking feature of the Russian privatization program is its speed. A large part of this is explained by the privileges granted to insiders. With so much equity available for so little cost, this is not surprising. But other facets of the program's design also helped expedite the process. First and foremost, like the Czech Republic and Slovakia, Russia adopted a mass privatization program. Thus, they immediately sidestepped the problems of Hungary and Poland, which laid primary emphasis on a mixture of trade sales and IPOs. The case-by-case nature of these methods has meant that in both countries privatization has been extremely slow, with considerable loss of political capital and momentum. Unlike the Czechs and the Slovaks, however, Russian reformers restricted the menu of privatization options available and made no provision for competing privatization plans. Russian policymakers thereby eliminated the need for extensive central oversight of the process in general, and the need for extensive central review of privatization plans in particular, which the Czech and Slovak programs required. Indeed, decentralization was central to the program's speed. The GKI laid down the ground rules for local oblasts to follow, using moral suasion, incentives (sale of shares for cash), and presidential decree to ensure implementation. It never attempted to carry out implementation itself. Had it done so, the process would probably have ground to a halt. Decentralization also emasculated the power of many central branch ministries. With implementation carried out on a local level, there was little formal role for many branch ministries to play and little they could do to hinder the process. Thus a potential source of delay was mostly eliminated.

Decentralization did bring its own problems. With so many oblasts to monitor, whether local privatization programs followed central ground rules depended heavily on local attitudes. Abuses were common, and there are wide discrepancies among oblasts in the speed and scope of privatization. In the more progressive oblasts, most of the enterprises in the mandatory category have been sold, while in others, privatization has not yet reached the halfway mark. In yet others, privatization rates fall well below even halfway. Likewise, though decentralization considerably reduced the influence of many ministries, it did not eliminate it. Key strategic ministries such as oil, gas, defense, and so on were able to exempt certain large enterprises within their range of control from the mandatory section of the mass privatization program. In these industries, the ministry, in conjunction with managers and to a lesser extent workers, has been able to dictate the nature and speed of privatization with little outside scrutiny. There are no publicly available figures on the number of enterprises that have been excluded from the large privatization program, though it is not unreasonable to assume that they number in the thousands. In addition, numerous enterprises were "grandfathered" into privatization under the leasing law established during the Gorbachev reforms.

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The manner in which vouchers were distributed also contributed to the speed of the program. Setting the price at which vouchers were sold to the public so low clearly led to a rapid distribution. Further, the distribution of vouchers at the earliest possible opportunity not only jumpstarted the program, but helped ensure its irreversibility. Once vouchers were in the hands of the general population and the expectation had been created that the vouchers would be converted into shares, it was much harder for opponents of privatization to reverse the program. Indeed, once vouchers had been distributed, the pressure was on the GKI to move quickly on voucher auctions.

Privatization, though a necessary step toward restructuring, is clearly insufficient. As Boycko, Shleifer, and Vishny (1993) write, state enterprises must be depoliticized "to make them respond to the pressures of the market rather than politicians." Privatization alone will not raise sufficiently the costs to politicians of interfering in the running of enterprises. To avert interference, an effective corporate governance system and an economically rational mechanism for the allocation of capital must follow privatization. Only then will commercial decisionmaking be out of the reach of Russian politicians. Of course, the corporate governance and capital allocation mechanisms that evolve are not independent of the privatization program, as might be the case say in a Western European privatization program. The nature of the Russian privatization program will critically affect the development of Russia's corporate governance and capital market systems; or, to use Earle, Frydman, and Rapaczynski's (1993) more encompassing term, Russia's mass privatization program will substantially affect its "private property regime."

Giving equity to managers and workers has been a feature of most privatization programs, both in and beyond Eastern Europe. Insider equity holdings will obviously, to some extent, align insider objectives with those of shareholders. As such, insiders will have a much greater interest in resisting the costly interventions of politicians. However, the amount of equity insiders (particularly managers) have emerged with, both in the closed and open subscription and through secondary-market acquisitions, has meant that insiders have emerged from the privatization program in Russia in a far more dominant position than elsewhere. This will have serious consequences. First, there is the conflict of interest between insiders' role as employees and their role as shareholders. Any internally generated restructuring that threatens managers or involves large-scale layoffs will be muted. But the consequences of insider giveaways are much larger than simply the blunting of insider incentives to restructure, because the extent of the insider giveaways has circumscribed the scope outside shareholders have to influence and replace insiders. There has been no direct replacement of insiders as an immediate consequence of the Russian privatization program, unlike the Czech program (which made explicit provision for it). Thus the main channel for outside influence in Russia will not be voucher auctions, but the development of liquid capital markets.

Of course, outsiders emerged through the voucher auction process. There are substantial numbers of Russian voucher funds and cash-rich private individuals and firms. Potentially profitable firms have quickly attracted their interest. In this context, allowing voucher trading has clearly proved beneficial in fostering the growth of large blockholders and is, as such, a useful antidote to the power of insiders. In this regard, it made a lot of economic sense to raise the 10 percent ownership limit on voucher funds to 25 percent in the 1994 program.

Given the limits placed on outsiders in the privatization program, if outsiders are ever to influence and overturn insiders, a liquid, transparent, and vibrant equity market combined with a vigorous market for corporate control will be necessary. Progress toward these goals has so far been patchy. Though there are numerous privately sponsored exchanges throughout Russia, there is little liquidity or transparency. As a consequence most trading now takes place on the over-the-counter market. (The development of the market in vouchers provides some comfort that the obstacles to a liquid market in shares are not insuperable.)

With respect to the market for corporate control, when outsiders have threatened takeovers, insiders have employed a variety of extralegal methods to repel them. One common source of abuse is the control many enterprises have over their own share registries, allowing the registries to ignore or misrepresent inconvenient trades. Discipline so far has actually been provided by outside majority shareholders (or the discipline provided by the potential for a majority shareholder to emerge from a group of minority shareholders).

Further, and perhaps more important, the influence outsiders gain from their position as minority shareholders is less than would be expected. Aside from the problems that one might expect from a lack of minority investor protection rights and the risks of investing in an employee-dominated shareholding structure, the availability of cheap credits from the Central Bank has undercut the power of outside minority investors. Lacking the power of a majority investor, the major influence a minority investor has is based on an enterprise's need to return to the market to raise capital. So long as the Central Bank provides cheap credits, "insiders have every reason to distribute the profits of the enterprise in the form of wages, bonuses, and other compensations to themselves rather than pay dividends to shareholders" (Earle, Frydman, and Rapaczynski 1993). Likewise, with little need to go to minority investors for financing, enterprises have little need to restructure.

In the absence of hard budget constraints on enterprises, the impact of the whole privatization process will be seriously undermined. The weak position of Russian minority shareholders is borne out by the low values that have been placed on stakes sold through voucher auctions. Without greater control on the part of the Central Bank of its credit policy, Russia's capital markets will remain moribund. Indeed, considering the market for corporate control, if outsiders were to gain control of an enterprise, the degree to which they would deviate from insiders in lobbying for access to Central Bank credits is a moot point. A management team's most valuable asset may turn out to be its lobbying connections and power.

The Russian mass privatization program must be seen as the first phase of reform. It represents a transfer to new, private owners, who now have the responsibility to restructure and modernize their companies or to sell ownership on the secondary market to agents who can restructure. To compete in world markets, these companies (now largely decapitalized and obsolescent by Western standards) need access to capital markets. Russian managers must recognize that it is in their interests to raise capital in secondary markets or to seek foreign investors.

Over time, workers and managers of firms that survive transition will sell their shares to outsiders when they realize that they can get a high price, and capital structures will gradually change. It is unrealistic to expect all of this to emerge from mass privatization alone. The ultimate success of the privatization program is closely linked to a tighter credit policy and the development of capital markets, the latter in part a function of the former. Much has already been accomplished in a short time, but because of the nature of the Russian privatization program, much remains to be done.

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Notes

1. A more detailed analysis is provided in *Gorbachev's Struggle for Economic Reform* by A. Aslund.

2. Nellis (1991) points out that these numbers are likely to be underestimates, since a significant number of enterprises are made up of subunits that in the West would be considered independent firms. Indeed, as privatization has got under way, a significant minority of enterprises has splintered into smaller units.

3. For a contrary view on industrial concentration in Russia, see Annette Brown, Barry Ickes, and Randi S. Ryterman, "The Myth of Monopoly: A New View of Industrial Structure in Russia," October 1993, World Bank.

4. See chapter 10.

5. The 1992 state privatization program, entitled "State Program of Privatization of State and Municipal Enterprises in the Russian Federation for 1992," was issued in conjunction with the "Amendments and Additions to the Law of RSFSR on Privatization of State and Municipal Enterprises in the RSFSR."

6. For a more detailed comparison of these mass privatization programs, see Ira W. Lieberman, Andrew Ewing, Michal Mejstrik, Joyita Mukherjee, and Suhail Rahuja, "Mass Privatization in Central and Eastern Europe: A Comparative Analysis." World Bank, forthcoming.

7. The privatization laws and decrees sometimes define large enterprises as those with over 1,000 employees *and* book value of over 50 million rubles, and sometimes as those with over 1,000 employees *or* book value of over 50 million rubles. There is a similar inconsistency in the definition of small enterprise.

8. See section on small-scale privatizations herein.

9. The privatization plan included information such as the firm's name, its location, the type of property it was (federal or oblast), its legal form, the number of workers it employed, basic financial information on the firm, its shareholdings in other firms, its business activities, the products it manufactures or services it offers, the outcome of the

vote on the closed subscription, and an outline of how equity remaining after the closed subscription is to be disposed.

10. "Interim Methodological Guidelines for the Valuation of Properties Targeted for Privatization," issued as Supplement 2 to the "Acceleration Decree."

11. Holders of preferred shares receive fixed dividends of 10 percent of the previous year's profits. If the holders of the common stock receive higher dividends on a per share basis than preferred share holders, then dividends on preferred shares have to be increased to match those on common shares.

12. Referring to the 25 percent nonvoting stock, each employee cannot receive shares with a book value greater than twenty times the minimum monthly salary guaranteed by law. Referring to the 10 percent voting stock, each employee can not receive shares with a book value more than six times the minimum monthly salary guaranteed by law. The minimum monthly salary guaranteed by law as of July 1, 1992 was 800 rubles. This has since been adjusted.

13. Options 2 and 3 were included in the privatization program because of the considerable lobbying power of enterprise managers and workers. The original program had only option 1.

14. Employees may fail to subscribe for the full allotment if the enterprise is particularly capital-intensive.

15. It was only after vigorous marketing by one particular investment fund that participation grew dramatically. In the end, almost three-quarters of those eligible collected their coupon books.

16. In reality, the potential inflationary impact of vouchers was a nonissue given that, because of other causes, inflation was in excess of 1,000 percent during 1993.

17. GKI regulation of February 12, 1993. Note this regulation refers to the percentage of each enterprise's equity that has to be sold specifically in the voucher auction. The 80 percent rule refers to the total percentage of each enterprise's equity that has to be sold for vouchers, including vouchers collected in the closed subscription, the voucher auction, and so on.

18. A state company is defined as one that was more than 25 percent state-owned.

19. Surveys have been carried out by Joseph Blasi and Katarina Pistor of the GKI. Quoted in Boycko, Shleifer and Vishny (1993) and in Webster (1993).

CHAPTER 3

Privatization in the Regions: Primorsky Krai

Alexandra Vacroux

The distance between Vladivostok, the capital of Primorsky krai (region), and Moscow spans seven time zones and 5,778 miles. Under communist rule, this geographical separation did not prevent Primorsky and nine other far eastern regions from being fully integrated into the economic and political life of the former Soviet Union. Since the dissipation of the USSR, the highly centralized bureaucracy and Communist Party structures that linked the regions to the center have been all but eliminated. As a result, Russian regions have had to adapt to a lower level of economic support and a higher degree of political autonomy than before.

Primorsky krai has adapted to post-Soviet Russia in much the same way as less-distant regions. As before, regional officials still rely on personal contacts in federal-level state offices to obtain financial and political support for residents and enterprises. As elsewhere, Primorsky officials have developed new strategies to demonstrate and augment local autonomy. Designed to extract the maximum amount of resources from the federal government while ceding as little control as possible over regional assets, these strategies are being applied across all policy areas, and have contributed to growing antagonism between regions and the central government. In Primorsky krai, the power struggle between region and center has been particularly acute in the area of privatization.

A study of privatization in Primorsky krai reveals more than the difficult and evolving relationship between the center and the regions in post-communist Russia. It illustrates the conflict between the executive and legislative branches of government (both of which were assigned privatization responsibilities) and affords a glimpse into the tensions between municipal and krai-level governments within regions. In addition, because the privatization of bigger Soviet enterprises has stimulated more political lobbying and maneuvering than the sale of smaller establishments, a discussion of large-scale privatization in Primorsky krai provides insights into how the interactions between political actors (such as officials) and economic actors (enterprise managers and entrepreneurs) are shaping Russia's future.

Primorsky krai is an interesting venue for a case study because it is both far from and important to Moscow. The krai's strategic location near key Asian markets, coupled with its three major ice-free ports and valuable natural and industrial endowments, provide both Moscow and the region with an interest in maintaining control over local resources. While it is impossible to test any hypotheses or theories with a single case, a study in this pivotal region should yield suggestive conclusions about how privatization is being implemented in the Russian regions.

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The economy of Primorsky krai

The Primorye area of Asian Russia forms the western banks of the Sea of Japan. It shares borders with the Khabarovsky krai in the north, China in the west, and North Korea in the southwest. Population estimates for the region converge at 2.3 million but probably do not take into account the significant military presence.[1] Just over three-quarters of the population lives in urban areas of the krai.

The region has abundant natural resources, including ore and mineral deposits, diverse chemical and timber reserves, and marine products. The regional economy

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depends primarily on fisheries, forestry, the nonferrous metal industry, sea transport, and the ship repair industry. Though it occupies only 2.7 percent of the far eastern land mass, Primorsky krai accounts for 80 percent of the area's marine transport capacity. As a result, the region's three large seaports serve as the departure point for much of Russia's raw material and consumer goods exports.[2]

Krai administration sources claim that 5 percent of regional enterprises (sixteen in all) were part of the military-industrial complex.[3] Other official statistics indicate that in late 1993 the defense industry employed 20,300 (8.3 percent) fewer workers than it did in 1992. (If accurate, this suggests that the distressed military complex may actually play a much more important role in the local economy than is suggested by administration figures.) The downturn in the local defense industry can be attributed to a reduction in federal government orders combined with its failure to pay for 250 billion rubles worth of orders it placed. Enterprises in other economic sectors are also having trouble adapting to the current transition period.[4]

Despite current economic difficulties, many of which are afflicting enterprises all over Russia, Primorsky has the potential to develop rapidly. The region, and Vladivostok in particular, is a transportation hub for Russia with easy access to foreign markets. In addition, it has a generous supply of raw materials, a strong industrial base, and a highly-qualified labor force common in defense-related enterprises.

Small-scale privatization

Primorsky CKI data for April 1, 1993, indicates that the region had 1,835 small-scale businesses eligible for privatization. Of these, 929 (51 percent) had been privatized by the end of the first quarter of 1993. The krai's Statistics Department reported that 65 percent of all enterprises were privatized through competitive tenders, while 31 percent were privatized through auctions. More than half of the small privatizations may have been completed with some restrictions on their future activity.[5]

Municipal governments have responded well to the cash incentive built into the small-scale privatization process. In Nakhodka, for example, city soviet Deputy Chairman Oleg Oksuzian emphasized that the city deliberately pursued an aggressive, small-scale privatization strategy in order to cover the municipal deficit.[6] The monetary incentive to sell small businesses has also created problems. In Vladivostok, the delineation of krai and city property led to conflict between the different levels of government. Sergei Soloviev, Chairman of the Vladivostok city soviet, complained that the Primorsky krai administration successfully designated a few hairdressers, movie theaters, and other "clearly municipal" businesses as krai property to earn income from their privatization.[7] Since small-scale privatization began, there have been complaints that privatized stores fail to meet the needs of the population. Some interviewed public officials claim that the reprofiling of small shops after privatization has made it difficult for the population to get basic necessities such as bread and milk, but this author has not come across any surveys or privatized stores in Primorsky krai that would confirm or deny this claim.

To overcome some of the perceived shortcomings of small-scale privatization, some municipal officials in Primorsky krai have turned to local legislation. Oksuzian provided examples of this behavior when he explained that the Nakhoda soviet passed a regulation that allows the local property fund to withdraw an enterprise from auction without specifying a reason if the offered price is perceived to be too low; another regulation reduces the payment period granted to winning labor collectives from 3 years to 6 months if "someone else is standing behind the collective" (as some investors might take advantage of the 30 percent discount to collectives). More study is needed to determine whether the use of supplementary local privatization regulations is widespread. If so, it could be distorting small-scale privatization by giving local authorities more discretion than was intended and by discouraging the restructuring of small businesses.

The restructuring and reorganization of small businesses is also hampered by a shortage of credit. Both privatized and new small enterprises report that they have difficulty obtaining affordable financing. Unlike large enterprises, small businesses do not receive government assistance and must find their own sources of financial support. In principle, both state and commercial banks are willing to lend money to smaller operations, but given the high inflation, they are, naturally, mostly interested in providing short-term, high-interest loans. One reason given to explain this phenomenon is that banks apparently fear that small businesses are disguised mafia operations created to get cash and vanish. Moreover, banks may be attracted to large enterprises that are unlikely to close and that have access to alternative sources of financing to bail them out. To begin to rectify this problem, the krai's Anti-Monopoly Committee and Japan's Ministry of International Trade and Industry have jointly created a center to support small and medium-size businesses. The Japanese have contributed $30 million to this program and are expected to agree shortly to set up four "adapting centers" for businesses in the near future.[8]

Large-scale privatization

The privatization of a large enterprise is an incremental process. First the enterprise is corporatized. Then, up to 51 percent of the joint stock company's shares are distributed among workers and managers in a closed subscription. The amount of stock distributed within the enterprise depends on which benefits option was selected by the labor collective. Once the workers have voted on an option, the property fund prepares a voucher auction for the sale of no less than 29 percent of the company's shares for privatization vouchers. After the voucher auction, some shares remain with the regional property fund. These shares, usually amounting to 20 percent or more of the stock, are earmarked for the auction or tender (for vouchers or cash) at a later date.

The voucher auction is a critical stage in an enterprise's privatization, for it transfers a third or more of an enterprise from state to private hands. It is also the first opportunity for outside investors to participate in privatization. However, an enterprise that has completed voucher auction should not be considered private so long as the property fund continues to hold shares. Moreover, privatizing an enterprise does not necessarily create a more efficient and productive business, but it may instead serve to betray the inherent unprofitability of an operation. Merely distributing shares to private investors does not necessarily stimulate an enterprise to behave differently in the short-run.[9] Thus one should not assume that the pace of voucher auctions is synonymous with the pace of plenary privatization, nor can it serve as a proxy for the rate of genuine industrial or corporate transformation. A region's ability to successfully organize many voucher auctions can serve, however, as an indicator of how committed local privatization officials are to completing privatization, and of how quickly the state's stake in the large enterprises is being diminished.

The voucher auction is a critical stage in an enterprise's privatization, for it transfers a third or more of an enterprise from state to private hands.

The Primorsky GKI and property fund moved quickly to design and set up a voucher auction system in late 1992 and early 1993. The fund, responsible for organizing the distribution and sale of shares, used an unconventional approach and put large enterprises up for auction in two-month "waves" of 40 to 50. By the third quarter of 1993, the fund had completed voucher auctions for almost 100 enterprises, and was among the top 15 regions in the number of enterprises sold. This brisk pace of voucher auctions suggests that Primorsky officials were reform-oriented and responsive to policies formulated in Moscow. This impression was consistent with the results of the April 1992 referendum, in which more Primorsky voters supported Yeltsin and his reforms than in Russia on average. Regional officials appeared to be committed to implementing federal privatization policy. Given this apparent support for voucher auctions and large-scale privatization, many observers were taken by surprise by the joint krai administration and the Council of Peoples' Deputies announcement that, as of August 1993, privatization would be curbed ostensibly to save local enterprises and voucherholders from the impact of bankruptcies.

Primorsky's (ultimately unsuccessful) bid to stop the privatization of large enterprises was not the only one of its kind—similar attempts were made in Novosibirsk and Cheliabinsk in April 1993. Nevertheless, because it happened in a region perceived to be successful, the stoppage led many journalists, officials, and business people to ask what had gone wrong with large-scale privatization in Primorsky. The conflict mobilized and exposed the institutions and individuals involved in the Primorsky privatization process, allowing one to clearly identify the leading political and economic actors. An analysis of the interaction among these actors illuminates the dynamic underlying the large-scale privatization process in Primorsky krai; at the same time, it illustrates how privatization is affecting the regions, and how the regions are influencing the overall process of privatization in Russia.

Federal GKI relied on a strategy of carrots... and sticks... to encourage local officials to follow privatization legislation.

Local government institutions

The main players in Primorsky's privatization process are, first and foremost, those that wield significant economic and political influence. Regional governmental institutions responsible for privatization (that is, the local GKI and property fund) have the authority to determine what will be privatized and when. While they can be successfully countered by recalcitrant directors who manage to sway federal officials against their enterprise's privatization, local privatization institutions have administrative powers that give them leverage over local enterprises.

Local executive branch players (the regional administration and GKI) are distinct from legislative branch players (local soviets, deputies, and the regional property fund). In addition, while the local GKI is often closely aligned with the regional administration (the head of an oblast or krai GKI serving, by law, as a Deputy Governor of the oblast or krai), the regional property fund tends to operate fairly independently of the regional soviet. Thus the local administration, local GKI, local legislature, and local property fund should all be considered separate actors, each with their own incentives and powers.

Federal government players

Government officials hierarchically superior to local players may also get involved in regional privatization. As institutions competing for jurisdiction over the process, the federal GKI and property fund will compete at the local level if necessary and will, on occasion, join a local contest between fund and committee. In some cases, the federal level organizations create tensions between local privatization organs that had been effectively cooperating. The Federal Property Fund, for instance, tried on a number of occasions to deny local property funds the right to sell 29 percent of federal enterprises at voucher auctions. This intervention, which frequently took place after the local fund and local GKI had finalized auction preparations, appeared to be motivated by the Federal Property Fund's desire to delay auctions until they had put in place a more lucrative mechanism for privatization

Federal GKI relied on a strategy of carrots (promises of technical and financial assistance) and sticks (such as threats of annulled auctions) to encourage local officials to follow privatization legislation. Meanwhile, the Federal Property Fund —which was brought under control of the government following the dissolution of the Supreme Soviet in October—generally acted as a brake on privatization. One of the Fund's Deputy Chairmen even lobbied aggressively for a new variant of privatization that would have sold large enterprises to employees. The fundamental philosophical gap between the Federal Property Fund and Federal GKI, a reflection of the diverging views on privatization held by the government and Parliament, intensified the jurisdictional struggle between funds and GKIs at all levels of government. It did not, however, prevent local fund officials, assigned personal responsibility for the sale of enterprises, from having closer relationships with the more supportive Central GKI than with the Federal Property Fund.

Enterprises

As in Soviet times, large enterprises continue to play an important role in regional economics and politics, though this role has changed as factories and firms become more independent. The centrally-planned economic system meant that regional political officials existed in large part to secure compliance with industrial plans. Correspondingly, enterprise production volume was a major determinant of regional (and personal) success. As part of the transition from communism, the state has been gradually ceding its control over the economy and enterprises have begun concentrating on obtaining private contracts. But despite a reduction in enterprise dependence on government, enterprise performance remains critical to the growth of local economies and local officials. Big enterprises are still the largest taxpayers, employers, and suppliers in most, if not all, regions.[10] In many cases, they also continue to be the primary providers of housing and social services.

Entrepreneurs

The potentially high rewards of privatization have also stimulated the involvement of actors who did not inherit political or economic power from the Soviet regime. Many of them can be considered entrepreneurs. These include both investors (such as wealthy individuals and voucher investment funds) and organizations that have sprung up to support and profit from the voucher system and large-scale privatization (for example, stock exchanges and brokerage firms). All these have made or expanded their fortunes through privatization, and are interested in seeing the process continue. They have expressed this interest more than once by launching public relations campaigns to counter the more virulent attacks against the privatization program. The strategy used by entrepreneurs to exert influence on the politics of privatization has gradually shifted from unilateral to collective action over the course of 1993.[11]

Political players

Only actors with official political power or economic assets appear to play a meaningful role in Primorsky's privatization process. Representatives from Primorsky's political parties and movements independently testified that their organizations have had no influence on the design or implementation of large-scale privatization. This is partly because privatization legislation is drafted at the federal level, and therefore falls under the jurisdiction of national rather than local party structures. Nonetheless, given the importance of privatization in redistributing regional assets, the passivity of local parties and movements would seem to reflect either ineffectiveness or a marked lack of ambition—or both.

Labor movements have also been inert. Though workers received great benefits in the 1992 Privatization Program, the organizations that claim to represent them have failed to translate this victory (and their Soviet legacy of newspapers, offices, and personnel) into political power. Most unions have been marginalized by the separation of industry and state. Deprived of official authority within factories, and lacking grass roots legitimacy among workers, they usually cannot affect the course of privatization within any given enterprise. The Primorsky Krai Federation of Trade Unions has tried to transform itself into a consulting operation for workers in privatizing enterprises. But the complexity and specificity of each large-scale privatization, often coupled with friction among workers, makes it difficult for them to have an impact on the labor collective, let alone on management.[12]

The strategy used by entrepreneurs to exert influence on the politics of privatization has gradually shifted from unilateral to collective action over the course of 1993.

Primorsky's privatization crisis

Privatization in Primorsky started in much the same way as in other parts of the country. The regional State Property Committee and property fund were created, staffed, and assigned responsibilities that included the privatization of large enterprises. A municipal level administrator, Gennady Tokulenko, was appointed Chairman of the GKI; in contrast, Valerii Lutsenko, a former general director of an association of local enterprises, was selected to chair the local property fund.

When the first privatization program was being debated in the spring and summer of

...many enterprises developed close relationships with privatization agencies, since an informal alliance with the fund or GKI was a means to ensure that one's interests would be taken into account as much as possible.

1992, enterprise managers in Primorsky and across Russia opposed corporatization and privatization. Primorsky's privatization institutions began to work with resistant directors and slowly convinced them that privatization was necessary and advantageous. Directors came to understand that privatization could make them personally wealthy, that they would not necessarily lose their dominions, and that foreign (and domestic) investors would be more attracted to private companies. According to Lutsenko, by the fourth quarter of 1992 skeptical directors had been persuaded to prepare their enterprises for transformation into open joint stock companies. Along the way, many enterprises developed close relationships with privatization agencies, since an informal alliance with the fund or GKI was a means to ensure that one's interests would be taken into account as much as possible. These close relationships were cited by GKI and fund officials as being one of the main reasons that Primorsky became one of the fastest corporatizing and privatizing regions in Russia.

Primorsky GKI data on corporatization by January 1993 reveal two interesting facts. First, labor collectives chose to buy out 51 percent of their enterprise in nearly 90 percent of large enterprises. This is significantly higher than the corresponding national statistic of 77.8 percent.[13] Second, the amount of charter capital being privatized (through voluntary corporatization and sale of shares) exceeds the amount subject to compulsory corporatization and privatization. These facts imply that by 1993, directors of medium and large companies in Primorsky had become aware of the potential gains from corporatization and privatization. They do not explain, however, why Primorsky's labor collectives are so often in favor (and able) to buy up over half of enterprise stock.

Besides working closely with fund and committee officials, some enterprises joined forces and created a financial-industrial structure called PAKT—the Primorsky Manufacturers Shareholders Corporation. Initiated by local enterprise directors (without pressure from Moscow), but allegedly approved by Prime Minister Chernomyrdin in the middle of last year, PAKT is a holding company whose founders include 31 large enterprises. A publicity brochure prepared by Anatoly Pavlov, President of PAKT, listed the organization's goals: to expedite the structural reorganization of the Primorsky krai economy; to further regional interests in the Pacific Basin; to facilitate the development of competitive technologies and services, with foreign participation if possible; to preserve and increase the effectiveness of krai industry by means of inter-regional cooperation and by encouraging development of small and medium enterprises; to create an economically efficient financial investment system that can provide insurance against seasonal and structural fluctuations in markets; to transfer capital from nonprofitable to profitable branches of industry; and to create a socially stable and economically protected structure for voucher investment by krai citizens and Russian voucher funds during the period of economic instability and bankruptcy.

Though there are many financial-industrial groups forming in Russia, PAKT is one of the most controversial. Uniting krai enterprises across a wide spectrum of industries (from ship repair to meat processing), PAKT aspires to replace the old branch monopolies that dominated the local economy. (The regional anti-monopoly committee has apparently ruled that PAKT is not a monopoly.) The PAKT leadership is currently working with member enterprises to develop a unified restructuring plan. Where two members compete in the same market, PAKT will determine which is most cost-effective and reprofile the other for production in areas in which it is has a comparative advantage. The stated goal of the organization is for associated enterprises to provide all the inputs and finished products required by other PAKT enterprises.[14]

Privatization has served as both a catalyst and instrument in the development of PAKT. Boris Fadeev, PAKT General Director, stated at a public roundtable that "the central principle in the earliest stage [of PAKT] was to protect future member-companies' independence during privatization. That is, we made sure that as the enterprises were converted to joint stock companies, local majority interest was maintained against the capital pouring into Primorye from all over Russia."[15] PAKT has pursued this objective by participating in the voucher auctions of member enterprises. The corporation either buys shares for the holding company or it gives money or credits to the enterprise so that it (presumably management) can obtain a majority of shares.[16] This approach has alarmed observers who have denounced the use of privatization as a means of reconsolidating regional economies (and politics) in the hands of directors.

PAKT's economic strength is difficult to assess. Members claim that they represent the best of far eastern enterprises, while opponents deride them as moribund defense factories. As a group, the PAKT enterprises employ 90,000 people (9 percent of the local workforce) and had a combined charter capital estimated at 2.5 billion–10 billion rubles ($2.5 million–$10 million) as of August 1993, according to figures from the Pavlov PAKT handout. Regardless of their actual economic puissance, PAKT members have amassed a great deal of political power. On May 19, 1993, Evgenii Nazdratenko, General Director of the far eastern mining company "Vostok"—a PAKT member—became Governor of Primorsky krai. By the end of the summer he had appointed three more PAKT industrialists to serve as Deputy Governors in his administration.

The new administration has aggressively tried to help local enterprises find state or private investment. As in other regions, krai officials have also sought to increase the authority of the regional administration in relation to the federal government. In a departure from more conventional regional strategies, the new administration tried to increase its power by openly challenging the center's right to implement reform in Primorsky krai. This challenge came in the form of a local regulation that fundamentally altered the large-scale privatization process.

In early August, Vladimir Kolesnichenko wrote a letter to the Chairman of the Krai Soviet and Krai Governor Nazdratenko. The letter stated that the Russian government's austerity policy and the absence of economic control were pushing krai enterprises toward bankruptcy and risking massive layoffs, strikes, and "social-political dissatisfaction with current economic reform among krai residents." The administration and legislature acted upon the letter's recommendations and issued a joint regulation that allowed the local government to temporarily hold on to its shares in "crucial and socially significant" enterprises (a category which encompassed 64 krai enterprises and 108 federal enterprises); create a regional governmental commission charged with deciding which enterprises were bankrupt and formulating a plan for restructuring the local economy; and halt all Primorsky voucher auctions.

The announcement of this regulation created a stir across Russia. Local and national investors began dumping their shares in privatized Vladivostok companies. Primorsky krai traders boycotted the securities market and the Vladivostok International Stock Exchange canceled trading in protest. The head of the stock exchange, Viktor Sakharov, launched a publicity campaign opposing the move. He was joined by investment funds who had purchased shares of local enterprises, and who threatened to take the local administration to court. In addition, Anatoly Chubais, Chairman of the federal GKI and a Deputy Prime Minister of the Russian Government, called the local administration to warn that stopping voucher auctions was tantamount to violating presidential decrees. Coming on top of pressure from entrepreneurs, the duress applied by a top-level federal government official precipitated a cancellation of the krai decision.

Given the extent to which the directors' lobby has captured the Primorsky krai administration, it is unlikely that Nazdratenko acted against the wishes of local enterprises and PAKT. But why would the krai's industrialists want to stop large-scale privatization if they had become convinced that both they and their enterprises would benefit from the process?

A credible answer lies in the rapid development and integration of Russian financial markets. When voucher auctions started in late 1992, investors who wanted

...some enterprises joined forces and created a financial-industrial structure called PAKT—the Primorsky Manufacturers Shareholders Corporation.

to participate in auctions outside their region were obliged to travel to the local auction centers and place bids in person. Quickly, brokerage firms emerged and began to take orders from nonlocal bidders across Russia. Primorsky and the distant Far East were not initially protected from this outside investment by their remoteness. Though nonlocal bidders tried to obtain controlling shares in local enterprises, they rarely succeeded.

By mid 1993, however, the Vladivostok International Stock Exchange had become one of the most active in Russia. GKI had put into place a depository system that allowed bidders to deposit their checks in a local depository and bid in remote voucher auctions with a receipt. In addition, many Russian regions had set up voucher auction centers that allowed them to run nationwide auctions, and Primorsky krai was under pressure to put its enterprises up for sale in national auctions.[17] In short, it appeared as if the voucher auctions for local enterprises would soon be opened to participation by powerful national investors.

In short, the central government has not been cut out of regional politics, though it does not appear to exert direct, daily control over local politics and economics.

Russian industrialists, not surprisingly, favored privatization when they realized it meant transferring property rights from the state to themselves. When there was even a risk that they would lose control over their enterprises, or receive no direct benefit, managers resisted the process. Managerial opposition would be even more likely in cases where continued state ownership is perceived to be less intrusive than diffused shareholder ownership. In Primorsky, the composition of the regional administration ensures that the state would be highly sympathetic to enterprise concerns. Together, these factors, coupled with the administration's obvious desire to increase its control over the local economy and the growing threat posed by outside investors, explain why large-scale privatization was essentially canceled in August 1993. Simply put, the krai government's decision to halt voucher auctions and manage the economy more closely was consistent with the self-interests of local enterprises and the regional government. The center's ability to overrule these concurrent interests demonstrates that, although Moscow may have ceded its right to define regional interests, it seems to have retained enough power to enforce its important economic policies.

Conclusions

This case study of privatization suggests a number of conclusions about politics in Primorsky krai. It is important to keep in mind that a single case study cannot yield information about whether a region is typical or atypical. For example, from the above analysis, one cannot assume that pro-privatization forces are strong enough to defeat gradualists and anti-privatizers across Russia. Nor is it possible to identify which factors most influence the privatization process in Russia as a whole. A regional case study can, however, act as a map for future research: conclusions drawn from the analysis of one region can serve as hypotheses to be tested in other case studies. Similarly, the factors (variables) isolated in one case study can serve as the starting point for additional studies which compare the importance of these and other variables in other regions.

Center-periphery relations

The relationship between the central government and the Russian regions has continued to evolve since the collapse of the Soviet Union. By their actions, it seems clear that Primorsky krai authorities would like to be responsible for regional issues, though the privatization crisis revealed that the region is neither wholly autonomous nor forgotten. When its jurisdiction was threatened by local actors, the Russian State Property Committee responded assertively to correct the region's deviation from federal privatization legislation. Prime Minister Victor Chernomydrin's tour of the Far East in August provided additional evidence that the center still supervises regional activities. In short, the central government has not been cut out of regional politics, though it does not appear to exert direct, daily control over local politics and economics.

It is difficult to assess the extent to which the relationship between Primorsky krai and the center is a function of regional specificities. Primorsky's rich natural resources, proximity to Asia, and access to international transportation networks have contributed to a regional sentiment that the krai could survive without the assistance (and demands) of the central government. This is not the case in many of the other Russian regions.

The regional politics of privatization

Economic actors have eclipsed political parties and movements in the regional politics of privatization, and perhaps in political life as a whole. Even the trade unions, endowed with a legacy of potentially fungible resources, have been outmaneuvered by more motivated and dynamic enterprise managers. Research completed in the summer of 1993 indicated that these aggressive entrepreneurs and savvy bureaucrats are playing the biggest role in shaping Russian capitalism, for they seem to best appreciate the potential gains.

The elections for the national legislature in December of 1993 and for local legislatures in the spring of 1994 may mobilize sluggish political actors into campaigning and lobbying. By that time, it will probably be too late to influence the voucher auction phase of large-scale privatization. Parties and movements may then try to influence the post-privatization process (that is, private and public investment policies) or they may select some other issue areas in which to act.

Interaction of politics and economics

The large-scale privatization process in Primorsky krai is allowing managers to consolidate control over enterprises and, to some extent, over the local economy. In the latter regard, Primorsky's industrialists have gone further than those in other regions. Enterprises of Novgorod have also united in a corporation, and "financial-industrial groups" have become popular across Russia, though none of these organizations seem to have succeeded in amassing PAKT's level of open political influence. In April 1993, a PAKT director stated in an interview that the organization "had no political program thus far."[18] By August, the PAKT Vice President would say that "it is no secret that the new [local] government is from PAKT."[19] PAKT's ability to compete in regional elections will provide an ongoing indicator of its political power. One could hypothesize that, while employees of PAKT enterprises would be more likely to support "their" candidates, the rest of the population may be indifferent (or perhaps even hostile) to structure devoted to advancing the future of certain large enterprises. A PAKT candidate's defeat of other candidates would provide evidence that there is popular support for PAKT's mission.

The Primorsky krai experience demonstrates that, while privatization reduces state control over enterprises, it does not guarantee that the regional economy will become more competitive and diversified.[20] Widespread voucher privatization may actually inhibit progress toward a competitive, decentralized Russian market by empowering large enterprises to recentralize the economy along geographical rather than industrial lines. Instead of striving for greater independence, some enterprises in Primorsky are pursuing new dependencies that will ally them with other (possibly struggling) enterprises. PAKT does not include all large krai enterprises, and its membership does not appear to be increasing dramatically, despite the high profile of PAKT leaders in local politics. In the long term, therefore, it seems unlikely that PAKT will succeed in monopolizing the krai economy. In the short term, however, PAKT's political and economic influence may slow the development of an open and competitive regional economy.

Notes

1. Primorsky Krai Statistics Department, *Third Quarter Report for 1993*, as extracted in *Utro Rossii*, October 26, 1993.

2. From an "Economic Map" of Primorsky krai produced by the Cartography Laboratory of the Russian Academy of Sciences' Far Eastern Institute for Economic Research, 1992. Far Eastern Aerogeodesingsky Enterprise. Note that "ship repair" is usually a euphemism for military maintenance.

3. According to a brochure distributed by the Primorsky krai administration (*Primorsky Region*,

1993, Ussuri Publishers, p.8), these enterprises allegedly produced 13 percent of the krai's industrial output.

4. In an August 1993 letter to the Governor, V. Kolesnichenko, Deputy Governor for Economic Reform, and V. Ignatenko, a representative of the Primorsky krai property fund, estimated that a one-third of Primorsky krai's industrial enterprises and one-sixth of construction-related enterprises were bankrupt. The perception that the economy is in trouble is widespread in the local administration (though it is difficult to evaluate the data used to calculate the ratios mentioned in the letter).

5. These restrictions may include obliging the new owner to finance social services affiliated with the enterprise, retain a certain number of workers, or invest a specified amount in the enterprise. The tender may also specify that the buyer cannot change the business' primary activity. These conditions are permitted by section 5.6 of the 1992 Privatization Program.

6. Interview in Nakhodka, April 28, 1993.

7. Interview in Vladivostok, April 22, 1993.

8. Interview with Yuri Uskov, Deputy Head of Primorsky krai GKAP and President of the Far Eastern International Center for Small and Medium Businesses, August 19, 1993, Vladivostok.

9. Directors and privatization officials alike have mentioned in interviews that large enterprises do not institute significant changes immediately following privatization, in part because a shareholders' meeting is required before major restructuring can take place. (This comment was made, for example, by Georgii Pikus, Senior Vice President of the Far Eastern Shipping Company, and by Valerii Lutsenko, Chairman of the Primorsky krai property fund on April 22, 1993.) Boycko, Shleifer, and Vishny (1993) emphasize the difference between the "largely formal transfer of ownership of cash flow and control" and "real changes in operations."

10. The 1993 third-quarter report on the Primorsky krai economy stated that only 35 percent of the workforce is employed in the "nongovernmental sector." Primorsky Krai Statistics Department, *Third Quarter Report for 1993*, as excerpted in *Utro Rossii*, October 26, 1993.

11. The Russian press frequently covers stories of entrepreneurs trying to influence politics and economic reform. For an example of support for privatization, see "Investment Funds support Chubais," in *Kommersant-Daily*, July 20, 1993, no. 135, p.3. For examples of attempted influence in other areas of reform, see "Entrepreneurs do not agree with the firing of Glaziev," in *Kommersant-Daily*, August 25, 1993, no. 161, p.3; "Entrepreneurs discussed the initiators of monetary reform," in *Kommersant-Daily*, July 28, 1993, p.1; "Young capitalists aspire to power in a Russian province [Vologda]," in *Izvestia*, September 10, 1993, p.2; and "Volsky and Skokov fight for influence on industrialists," in *Kommersant-Daily*, August 28, 1993, no. 141. For an illustration of politicians' efforts to mobilize entrepreneurial support, see articles discussing Gaidar's Association of Privatizing and Private Enterprises (such as "Chubais decided to strengthen his position from the 'top down' to "bottom up,'" *Kommersant-Daily*, September 4, 1993, no. 169.)

12. Interview in Vladivostok, April 22, 1993, with Anatoly Shalamanov, Deputy Chairman of the Primorsky Krai Federation of Trade Unions (PKFTU), and Yuri Kinash, Head of the Social-Economic Department, PKFTU. A draft regulation signed by V.P.Chubai, the Chairman of the PKFTU, notes that "the influence of trade unions on privatization has been practically limited, and a large part of the collective's social achievements have been liquidated" (unnumbered draft dated December 16 1992).

13. Boycko, Shleifer, Vishny (1993), p.19.

14. Tepliuk (August 19, 1992 meeting) and Boris Fadeev, PAKT General Director, quoted in "PAKT: United We Stand," *Vladivostok News*, 9 July 1993 (no. 13), pp.1,3.

15. Fadeev, "PAKT: United We Stand," p.1. The desire to keep out nonregional investors is not unique to Primorsky krai. Primorsky has apparently been fairly successful in keeping national investment funds and other non-Primorsky investors from taking a large number of shares at voucher auctions. ("East is Faster Than West," *Delovoi Mir*, 9 June 1993, no. 107-675.)

16. Tepliuk asserted that PAKT has managed to buy 20 to 25 percent of member enterprises through voucher auctions.

17. Interview with Lutsenko, April 22, 1993.

18. Leonov interview, April 23, 1993.

19. Tepliuk meeting, August 19, 1993.

20. Boycko, Shleifer, and Vishny (1993, especially sections 2, 5, and 7) emphasize that privatization must be supplemented with measures designed to increase the competitiveness of the Russian market after privatization.

CHAPTER 4

Investment Funds and Privatization

Mark St. Giles and Sally Buxton

If Russia's fledgling financial services industry is to achieve greater efficiency and legitimacy, there will have to be considerable revision of the present set of regulations and the way the business is supervised. Given the extraordinary pace of change in Russia and the demands created by the privatization program, it is remarkable that the financial services industry has developed as rapidly and as well as it has. Relentless political pressure to transform the Russian economy has left little time for the consultation and debate that would normally accompany major policy changes in established free-market economies. There was no existing infrastructure for an investment funds industry, nor did it have the financial expertise around which to construct the management and ancillary services for new businesses. Even basic financial vocabulary had to be invented for Russia.

Early in the planning of Russia's Mass Privatization Program (MPP) it was decided that investment funds should play a significant role. Funds were to provide an outlet for the vouchers of citizens who did not work for enterprises being privatized, and for those who did but wished to diversify their investments into a professionally managed fund. Moreover, the Ministry of Social Protection wanted to create funds for disadvantaged citizens (orphans, disabled, chronically sick, pensioners, and so on). The resulting "special" funds are structurally the same as voucher investment funds.

Drafting the necessary law began in July 1992. Deadlines were tight, but the State Committee of the Russian Federation for the Management of State Property (known as Goskomimushchestvo, or GKI), together with the Ministry of Finance and members of an international consortium advising on all aspects of the Mass Privatization Program, presented a completed law that took the form of an Ukaz signed by President Yeltsin. Three "schedules" were also issued covering model prospectus, fund charter, and contractual agreements.

Observers and foreign firms advising on investment funds have been, in turn, excited, challenged, worried, frustrated, and delighted by the progress of events. The enthusiasm and intelligence of many people in the government and the private sector have prevented the hectic pace of development from creating greater disasters than those that have already come to light. Even the accounting and management problems that investment funds face now seem solvable, despite some gloomy predictions following the scandal of the Moscow-based "Technical Progress" operation and, more recently, problems at the licensed fund Nefte-Almaz. Nevertheless, action is needed to stabilize the financial services industry in Russia to forestall future problems.

Voucher investment funds

In Russia, voucher investment funds face a more competitive environment than do those in other privatization processes in Eastern Europe. The issue of vouchers in bearer form (that is, tradable for cash) offered an option not available to citizens of other countries, such as the former Czechoslovakia. Vouchers can also be used as a form of currency to bid directly for state-owned enterprises (SOEs) at auction, as opposed to purely for funds, as in the proposed Kazakh and Polish programs. Sponsors of funds therefore face strong competition for customers and have, in

In Russia, voucher investment funds face a more competitive environment than do those in other privatization processes in Eastern Europe.

some cases, made exaggerated claims as to the returns investors could expect.

By March 1993, these factors, and the fact that approval for the first investment funds was not granted until early December (three months after the first issue of vouchers), gave rise to concern that the industry's development would be slower than hoped. This was compounded by worries about political uncertainties.

To make matters worse, there was a major fraud in St. Petersburg in February 1993. The sponsors of a fund, which had gathered at least 300,000 vouchers, disappeared—with all the vouchers. This was widely publicized and led many to believe that fund sponsors were criminals. The "Technical Progress" scandal in Moscow sharpened the perceptions of politicians, regulators, and the public of potential dangers in the system.

By the end of July 1994... there may be some 45 million shareholders in the 600 funds.

Some of these fears proved groundless. Major marketing campaigns by legitimate operators and a campaign of public information (including the regular publication of lists of licensed funds in leading newspapers) have counterbalanced some earlier worries. In hindsight, many concerns arose from delays—in putting groups of founders together and raising finance, issuing shares, getting licenses, planning and implementing marketing campaigns, implementing campaigns, and coping with shareholder registration and securities custody in an undeveloped market.

At the end of 1993, there were an estimated 600 funds nationwide with perhaps 15–20 million shareholders. By the end of July 1994, when vouchers expire and the first wave of mass corporate privatization will be completed, there may be some 45 million shareholders in the 600 funds.

Investment fund regulations

The law on investment funds took the form of a Presidential Ukaz (no. 1186). It created a regulatory framework for both nonvoucher and voucher investment funds. Voucher investment funds were permitted only as open (not open-ended) joint stock companies. These would be called investment trust companies in the United Kingdom or closed-ended investment companies in the United States. Provision for open-ended funds is made in the regulations, but given the problems of valuation and liquidity, such funds will probably remain inappropriate for the foreseeable future.

The main provisions of the legislation for investment funds are:

Form and nature of funds. This covers funds other than specialized investment funds (that is, those that accept vouchers). Such funds are licensed by the Ministry of Finance, whereas specialized investment funds are licensed by the GKI. In theory, both open-ended and closed-ended funds may be created under this regulation, though in practice, open-ended funds are inoperable in the current market. One important provision is that state bodies cannot establish funds; the restriction defines such a body as one in which the state has an interest of more than 25 percent. This was to meet a concern that investment funds might be used to retain or regain control of enterprises to be privatized.

Founding and registering of funds. The Ukaz also established the procedure for founding and registering funds and the required capital paid in by the founders. There is no ban on the participation of foreigners either as fund management companies or founders of funds.

Investment limitations. Investment restrictions cover the maximum percentages of the portfolio that can be invested in any one security, in the voting stock of any one issuer, and in affiliated companies. Borrowing is also restricted. The limit on investments in a single company (a maximum of 10 percent of the voting stock) caused much debate. Some institutional managers wanted the limit to be increased to make it easier to exert pressure on companies to improve their effectiveness, but the countervailing argument (that this might place too much power in the hands of financial institutions) won. The limit was later increased to 25 percent. It is too early to determine whether fund managers, in formal or informal combination, are starting to use their voting power. There have been one or two instances of shareholders flexing their muscles, and the emergence of a shareholders' rights campaign is encouraging.

Management and supervision. This regulation establishes the supremacy of fund shareholders voting at an annual general meeting to determine key matters such as appointment of directors and auditors, approval of annual accounts and dividends, changes in the charter of the fund, and liquidation. Duties of fund directors are also defined, as is the requirement for formal contracts with the depository and auditor. Maximum management charges are laid down (10 percent for voucher investment funds and 5 percent for other).

Distribution of profits. The phrasing of the section on distribution—in which dividends, interest, and trading profits are distributed, subject to a decision by directors—seems likely to cause difficulties over excessive dividend payments and taxation of funds. Most fund regimes (except in the United States) treat income from investments and interest as separate from capital gains for tax purposes. Some regimes forbid the distribution of capital in any form.

Reporting to shareholders and regulators. Funds are required to report quarterly to shareholders and to regulators, providing a balance sheet and portfolio breakdown, a profit and loss account, a statement of net asset value per share, a statement of fees, and information about changes in management or in other contractual arrangements. Guarantees of future performance or returns are outlawed. Even so, problems concerning the difference between a guarantee and a forecast continue and overenthusiastic marketing has raised expectations to unjustified levels, particularly in relation to dividends.

Liquidation. This must be the subject of shareholders' approval at a general meeting.

Specialized investment funds

These funds are covered by provisions more or less similar to those for ordinary investment funds. The main differences are:

- They are licensed by the GKI or by regional KI;
- They cannot be open-ended funds;
- Since funds are intended for mass ownership, the investment restrictions are more onerous. The restrictions include no investment outside the Russian Federation, and the funds are not permitted to accumulate more than 5 percent of all vouchers in issue (approximately 7.5 million); and
- Permitted charges are higher (an all-inclusive 10 percent) than the 5 percent ceiling on nonvoucher funds.

Model documents

The section on model documents was designed to provide guidance for founders of funds, fund management companies, and their professional advisers. Another aim was to make the task of the licensing body easier by having a standard against which to judge licensing applications. In theory, an application using the "standard format" documents may be given a "fast track" to a license.

Much of the information contained in the documents is repetitive. The significant points are:

Model charter. This is the founding document of a fund whose provisions include:

- The legal nature of the fund and details of its founders;
- Investment objectives and a description of investment policies and restrictions;
- A statement of the opening capital of a fund;
- Rights of shareholders;
- General meetings;
- Terms of reference;
- Valuation and distribution of profit statements;
- Arrangements for, and cost of, management;
- Details of the custodian of the fund's assets;
- Accounting and reporting;
- Audit; and
- Liquidation.

Model depository agreement. This agreement establishes the important relationship between the depository, the fund, and the manager and defines the duties and responsibilities of each party. The important role a depository must play in investor protection is emphasized, but banks have been unwilling to undertake depository functions. They are unconvinced of the commercial viability of such operations in an environment where banking operations have been so profitable. Funds and management companies have been obliged to create their own parallel operations, a less than ideal solution. It is somewhat surprising that the major firms engaged in global custody have not taken more interest in this field, but once the market becomes better established, separate custodians and depositories will likely emerge.

The depository is similar to the custodian (or trustee) in other fund markets in that it:

- Holds all the assets and cash of the fund;
- Receives all the interest, dividends, and other income;
- Executes transactions in securities and for cash on instructions from the manager;
- Applies money to the payment of dividends according to the decision of directors;
- Confirms notices received from investee companies relating to meetings, capital changes, and dividends;
- Informs the board of the fund and the manager if there are any breaches of the Russian Federation Law or the fund's charter; and
- Maintains accounts of the capital and income of the fund and of expenses for statutory, regulatory, and shareholder information purposes.

Managers must provide depositories with all necessary cooperation to enable them to fulfill their functions.

Fund management agreement. This agreement defines the role of the fund management company or the fund manager and their responsibilities in relation to the fund, its directors, and shareholders. It requires the management company to act in accordance with the charter of the fund, the Russian Federation fund, and other legislation. To protect fund shareholders, it also provides for revocation of the contract by the directors of the fund (on the grounds of inadequate or nonfulfillment of the contract by the management company) and sets maximum expenses and charges payable by the fund to the management company. In essence, the management company is required to:

- Manage the assets of the fund within the terms of the charter;
- Report to the directors, detailing investment strategy and decisions;
- Present a formal annual report to fund shareholders;
- Report quarterly to directors on fund expenses;
- Prepare quarterly fund accounts;
- Carry out administrative work on behalf of the fund;
- Maintain confidentiality and carry out duties (such as payment of dividends) correctly;
- Issue reports to fund shareholders; and
- Market the fund.

The agreement entitles the manager to:

- Deal in securities for the fund, within the terms of the Charter and Russian federal law;
- Represent the fund at meetings with investee companies and relevant organizations;
- Appoint a representative to attend meetings of the board of directors; and
- Request necessary powers from directors to sign documents, and so on.

The directors of the fund are required to:

- Assign the manager any necessary authorization as signatory for the fund; and
- Monitor the manager's satisfactory performance within the management contract.

The agreement specifies a fixed annual remuneration to the manager or management company based on a standard calculation of the fund's average net asset value over a year. The agreement also determines whether a performance fee is payable and, if so, at what level and on what criteria. It also prohibits the management company from investing the fund's assets in itself or in affiliated organizations and from making agreements with other investment funds or with investee companies in which 5 percent or more of voting equity is held without the authority and prior agreement of the board of directors.

Finally, the agreement specifies the term of the contract and provides for termination with particular notice periods, together with fees payable upon such termination. It also lays down the legal resort for contractual disputes.

Model prospectus. This document outlines the minimum required contents of the issue or other prospectus of the fund, which include:

- Investment purpose, policy, and limitations;
- Information on the size of the charter capital;
- Details of the value of a single share, the type of shares to be issued, and the starting price on subscription;
- First and last date of placement of shares;
- Information on the founders, its directors, and their background, and similar information on the management of the company or manager;
- Details of the depository and independent auditor;
- Charges and expenses payable by the fund;
- The most recent accounting report of the fund;
- Shareholders' rights;
- The form and powers of the annual general meeting;
- A set of warnings to investors regarding risk and inability to guarantee results in dividends or capital growth; and
- A summary of the investment portfolio and results in dividends or capital growth over the last reporting period, including a cost to net asset ratio.

Issues

Several practical issues emerged in the early stages of implementing these regulations.

Licensing

How could it be assured that fund sponsors are fit and proper? In Russia, government organizations were barred from launching funds. Thus the balance was tilted toward the applicant to obtain a license to operate funds. This was not entirely risk-free. To be licensed, management company applicants had to provide details of their company, its officers, and its capitalization, together with a rudimentary business plan and a declaration that none of the key officers or employees had been convicted of criminal offenses.

The investment funds also needed a license. That application included details about the founders, the directors, the aims of the fund, the amount of founders' capital, and the amount of shares to be issued. That funds are closed-ended presents some problems. Specific amounts of capital need to be authorized and issued; when a tranche is exhausted, a new tranche must be created, but not until three months after the closing of the previous offer. Since fund sponsors find it difficult to estimate demand, what would ideally be a continuous offering from a supply of "shelf" stock has become a series of secondary issues. The problems of this procedure were compounded by the initial requirement to issue quarterly (at least) valuations of vouchers held at a mandatory 50 percent discount to their 10,000 rubles face value. This, however, has been rescinded and vouchers can be valued at market value (later increased to 40,000 rubles). If equity is to be preserved between incoming and existing shareholders, the valuation regulation needs to be reviewed.

Originally, the fund and its management company were to be separate entities; this would have protected shareholders against the possibility that a "self-managed" fund might have financial problems where excessive management expenses were charged against the fund's income. A fund that contracted with a management company, even though the latter might find itself in financial difficulties, would be immunized against any threat to shareholders' equity. But many funds have been set up on the basis of self-management, and it now seems that excess expenses are eating into shareholder equity.

Regional KIs were given the task of licensing both funds and the fund management companies. This has raised a number

The valuation problem will grow as more funds take in cash or raise cash through market sales, as companies start to be listed, and if the voucher prices continue to rise.

of concerns. The first is some loss of control over the process. Not all KIs have been scrupulous in providing information to the central database, which means it is not possible to be precise about the number of funds in existence. Nor is it possible to determine whether regulatory disciplines are being applied evenly.

The real problem of licensing, however, is the failure of unscrupulous operators to seek a license, either by deliberately ignoring the law or through a series of ruses that appear to eliminate the need to be licensed. These funds operate as "trust companies" or argue that by purchasing vouchers from subscribers for cash and then directly investing the vouchers in the fund or trust, the requirement to be licensed as a voucher investment fund is irrelevant. But even if this were true, a license would need to be obtained from the Ministry of Finance; in most cases, this does not occur.

National and regional regulators are taking their responsibilities seriously, but there have been notable scandals involving unlicensed funds. Year-end filings of results (due by the end of February 1994) uncovered several problems that will need to be dealt with. There is the possibility of further compensation of distressed investors. Beyond that, further training and technical assistance are needed to consolidate and improve the quality of regulation.

In a country as large as Russia, creating a regionally-based securities supervisory system is rational, but prudent regulation and planning is required.

Subscription to funds

Voucher investment funds were originally designed to provide a home for vouchers not destined to be applied to the shares of enterprises or sold for cash. It was felt, however, that cash subscriptions should also be allowed. This created a dilemma. A fund with both vouchers and cash would have a potential valuation problem during a continuous offering. This problem was compounded by the ban on changing an issue price basis during the issue of a tranche of shares based on any one prospectus. This was made even harder by the requirement to value vouchers in funds' portfolios at 5,000 rubles, but, to redress the balance, a value of 23,600 rubles was established for 1993 year-end valuations. With the voucher price at 11,000 rubles in September 1993 and predicted to rise further, funds that kept a stock of vouchers for attractive future opportunities would be at a disadvantage compared with funds that invested all their vouchers (and were thus able to carry the shares of companies in which they were invested at the equivalent of face value if they could establish a market price or at a 50 percent discount if not traded). This threatened the preservation of equity among different classes of shareholders and seemed likely to cause competitive disadvantages to funds when net asset values were published in comparative form.

These problems come from the unresolved question of whether a voucher is a security or whether it is a claim on future assets, in which case its current value is irrelevant. Most funds have adopted a pragmatic approach, offering (usually) between one and ten shares per voucher and requiring cash subscriptions to be made at the voucher price on the day of subscription. This way, subscribers enter the fund on equal terms. Cash subscriptions have typically accounted for between zero and five percent of subscriptions, though this figure increased as the voucher period drew to a close in June 1994.

The valuation problem will grow as more funds take in cash or raise cash through market sales, as companies start to be listed, and if the voucher prices continue to rise. It can be argued that net asset value calculations are unimportant, or less important for closed-ended funds than for open-ended ones. But with semicontinuous subscription, even without opportunities to redeem, it is necessary to adjust the subscription exchange rate, however crude. And, once the shares of funds themselves can be traded, a guideline to calculate net asset value will be needed.

Since a voucher is a bearer document, markets in vouchers quickly sprang up on street corners and in the slightly more formal exchanges that operate all over Russia. These exchanges are the centers of entrepreneurial trading activity, providing some liquidity for the trade of goods and commodities. Nationwide trading quickly harmonized regional variations in voucher prices—to the point that the day's voucher price became announced in the media. The decision to free voucher valuation was sensible, but there is still inequity in the issue price, given the prohibition on varying the "exchange rate" during the issue of a tranche based on each prospectus. Later-subscribing shareholders thus get a bargain at the expense of those who subscribed earlier.

Now that active trade in the shares of newly-privatized enterprises is beginning to develop, the valuation problem is becoming more acute. Most business is done off-market, and there is no coherent scheme for collecting and publishing prices. This is a great concern, since the inability to establish a fair valuation undermines the most fundamental principle of collective investment funds.

A decision in May 1993 preventing funds from trading vouchers was a surprise; it was based on the mistaken belief that such trading was driving the price down. Liquidity in the voucher market provided funds with cash needed to pay fund management fees. Apart from founders' capital, subscribed in cash, funds have no regular revenue streams from dividends and interest.

The fact that the voucher price rose after the May 1993 decision was unrelated to the ban. It was a function of stronger demand for shares at auctions, which entered into full swing in the summer of 1993. Shrewd fund managers made the calculation, based on auction results, that the net asset value of "Russia Incorporated" was a considerable underestimate of the real value of the enterprises to be privatized in the Mass Privatization Program. The price of the voucher rose from a low level of 4,000 rubles in early 1993 to 11,000 rubles by July, and to nearly 30,000 rubles by end 1993. Many predicted a further rise until the theoretical expiry date June 30, 1994. The price hit 42,000 rubles in June 1994 as the final phase was announced. Many fund managers are ignoring the restriction on voucher trading or circumventing it (for example, they are paying management expenses and commissions in vouchers).

Research shows that the better fund managers are investing their funds' vouchers, with some funds more than 50 percent invested, but they are still hard pressed for cash. Their portfolios have become more illiquid, as higher percentages are invested in shares rather than in vouchers.

Investment activities

Having obtained operating licenses and gathered subscriptions, managers must invest. This is proving to be the most difficult task yet. Data and accounts to be analyzed are generally inadequate. But the fact that company accounts and profit and loss accounts fall short of international standards has proven less of a challenge than the uneven flow of information about forthcoming auctions. Only the most progressive managers have been able to track the results of auctions and derive statistical data on valuations. Local pressure to prevent outsiders from participating in bidding for regional companies is common, and sometimes successful. Moreover, there is a growing security problem that derives from transporting large amounts in bearer documents. Physically transporting the vouchers is risky and it consumes resources. Representatives of the fund must accompany the vouchers to the auction and often must go through nonstandard bidding systems—devised they suspect, simply to make life difficult for nonlocals.

Now that active trade in the shares of newly-privatized enterprises is beginning to develop, the valuation problem is becoming more acute.

Dividends to shareholders

The payment of dividends is the prime, and in some cases the sole, objective of many managers. Given that for taxation and accounting purposes the whole portfolio is regarded as inventory, all capital gains are regarded as trading profit, taxed, and paid out to shareholders.

This has led to competition among managers as to who can promise and pay the biggest dividend. Many shareholders have been manipulated by claims and counterclaims. Some advertising claims dividend payments of several hundred percent, but such dividends have been paid to about twenty among thousands of shareholders.

The opportunities are enormous for domestic or foreign management companies that have the patience to deal with initial difficulties and the vision to see what could be.

Long-term capital growth is misunderstood or ignored by the public. The better managers find this frustrating, since they are pressed to liquidate their most promising investments, pay tax on the gains, and pay the net amount as dividends.

The process is seriously eroding shareholder equity in many cases, particularly when excessive management expenses are taken into account. In the more serious cases, funds may become inadvertent "Ponzi" schemes as new subscriptions are used to satisfy the appetite of existing shareholders for unrealistic returns. This may result in some surprises when year-end accounts are filed, as expenses have eaten away the value of smaller funds and as the supply of new shareholders starts to run dry. One solution would be to halt any distribution of capital gains or capital itself; the latter is illegal since charter capital is nominally sacrosanct.

Taxation

The Russian fiscal regime may tax dividends to shareholders at least twice. Realized gains will be taxed at normal corporate tax rates in the hands of the fund and must then be distributed as if they were "short" gains, as in the United States. This is a contrast to the system known in most of Europe, where the concept of fiscal transparency is universally accepted (though not always rationally applied). Under this system, realized capital gains made inside the fund are not taxed, but the shareholder is taxed when the eventual gain is realized as a result of the sale of fund shares. Some proposals to adopt a more equitable taxation regime seemed likely to create even greater complexities through taxing short and long gains at different rates, as well as having another rate for gains that are not distributed, but reinvested.

It is always a long process to change a finance ministry's mind on taxation. But it is important that a regime be established that does not disadvantage shareholders in funds compared with those who invest directly. This is particularly necessary if investment funds, or any kind of pooled or managed funds, are intended to form the foundation of a savings industry that encompasses pension, life insurance, and investment funds.

Charging

There has been much debate on fund charges, which are high by international standards. Annual charges are capped at 10 percent for voucher investment funds and 5 percent for other types of funds. Typical charges in developed fund markets range from 0.25 percent for money market funds to 3.0 percent for highly specialized funds of a venture or emerging market type. To be fair, the Russian figures represent a total expense ratio—stated charges elsewhere may not include a range of items taken as a separate charge on the fund's income or assets.

The charges are not as extreme as they appear since they are levied as an asset value heavily discounted by the accounting rules. Charges on real asset values, when they emerge, will likely be 3 to 4 percent.

Those who argue in favor of this high maximum stress the start-up nature of much of the expenditure, the large number of small shareholders (with vouchers at 25,000 rubles and the exchange rate at 1,300 rubles to the dollar, the average holding is $20), and the need to encourage the formation of funds and management companies as commercial enterprises. In any event, charges are governed by regulation that is subject to administrative change rather than by decree—changes that would take time. It is thus argued that time will determine whether the high charges are pressing too hard on shareholders' equity. As it happens, a number of managers have taken a commercial view and opted to lower charges to roughly 4 percent. The main problem remains liquidity from which to pay the managers their fees, together with cost overruns that result from excessively ambitious marketing expenditures.

Conclusion

Investment by the better funds in enterprises being privatized is moving at a fast pace. Any business that evolves in less than a year against a background of inadequate financial infrastructure and in an uncertain political and economic climate, is inevitably going to have initial difficulties. But if the technical and logistical problems discussed here are not addressed quickly, scandals and collapses may discredit the whole process.

Not all funds are fraudulently or incompetently managed. Many are striving to meet the highest international standards. Some managers are becoming frustrated at the failure to address problems—they argue that dishonest operators are undermining the entire system.

Still, the investment funds business is quickly becoming established. It will go through a difficult period as problems are exposed in 1994, but if solutions to those problems are forthcoming, the business should grow and eventually flourish. The opportunities are enormous for domestic or foreign management companies that have the patience to deal with initial difficulties and the vision to see what could be.

Voucher Investment Funds

Andrei Volgin and Yuri Milner

All established processes undergo a dramatic and rapid change when a country as big and as complex as Russia drastically alters the nature of its economy within a few years. The implementation of Russia's system of voucher investment funds is an excellent case in point. In a short span of eighteen months, investment funds were conceived, then collected vouchers from citizens and invested them. In 1992, less than ten small funds existed in Russia. A little more than a year later, more than 640 funds were competing for individual vouchers. As of mid-1994, voucher investment funds have millions of shareholders, and have proven to be the most active players on the privatization field.

As the first stage of Russian privatization—voucher auctions—comes to an end, investment funds will try to survive in a highly competitive environment, while maintaining their images as sound financial institutions. This chapter analyzes the present status of voucher investment funds, describes how they arose, and reflects on pertinent characteristics of their present forms.

Voucher sales and their results

Approximately 150 million vouchers were distributed in Russia, with each eligible individual receiving one voucher. Some employees of companies undergoing privatization used their vouchers to purchase stock in their own firms. All other voucherholders had to either take part in a voucher auction, exchange their vouchers for shares in investment funds, or sell them on the open market for cash. A survey carried out in June of 1994, revealed that:

- 30 percent of those questioned had sold the voucher
- 18 percent had exchanged the voucher for stock in privatized companies
- 28 percent had exchanged the voucher for shares in voucher funds.

The option of exchanging vouchers for shares in investment funds proved to be quite popular, despite a number of apparent obstacles. Initially, there was a great deal of speculation that lower-class and elderly citizens would sell their vouchers immediately for cash. However, available information indicates that a large proportion of working-class voucherholders decided to invest in funds. Furthermore, inexperience with securities and market operations and a lack of understanding of the nature of investment funds was supposed to create a reluctance to invest. A third factor impeding fund investment was that no infrastructure existed for the distribution of the funds' shares. Given such obstacles, the fact that 28 percent invested in funds is quite remarkable.

The option of exchanging vouchers for shares in investment funds proved to be quite popular despite a number of apparent obstacles.

Most funds hired their own sales forces to collect vouchers. Inter-regional funds established networks of sales offices in different cities. In addition, several funds used existing networks of Sberbank (a state-owned savings bank with 42,000 local branches) and post offices. This approach proved more effective in terms of collecting vouchers, but was quite expensive. Some funds invited individuals to send in their vouchers by mail. Unfortunately, due to the poor quality of the Russian postal service, thousands of vouchers were lost in transit.

Kinds of vouchers

In order to analyze the role of voucher funds in Russia, one must disaggregate the funds into categories and identify them by their representative characteristics. There

BOX 5.1

Voucher fund classification by type of promoters and managers

Voucher funds promoted by large Financial Institutions

Special fund management companies were set up by a few large banks. Most of these funds raised their capital with vouchers from the banks' individual clients and from employees of institutional customers. These fund management companies chose to pursue very conservative investment strategies. Most of the assets were invested in privatized companies that were and remain the banks' customers.

Voucher funds promoted by smaller financial and consulting firms

Many investment funds were organized by brokers or investment consultants working in the field of financial services. These funds have followed a range of investment strategies and have used varying investment techniques without a discernable pattern.

"Amateur" funds

Amateur funds were so called because they were designed by industrial plants (nonspecialists) to encourage employees to buy shares of their companies at voucher auctions. Some amateur funds were also started by individuals and private companies. Of the amateur funds that were set up, few have survived due to their lack of capital or professional expertise.

Many amateur funds were organized by local or regional authorities. Although regulations supposedly prohibited authorities from directly promoting funds, local bureaucrats designed numerous ways to indirectly create and support funds.

Fraud funds

Unfortunately, a number of funds were set up with only one goal in mind—to collect as much money and vouchers as possible and then subsequently disappear. These funds capitalized on the naivete of Russian investors and on the lack of well-developed of Russian financial regulatory law.

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are several ways to classify voucher funds. Box 5.1 offers a classification criteria based on the goals of promoters and managers, while Box 5.2 characterizes funds according to their size and geographic spread.

Advertising and public relations

Most funds started to market their shares within one or two months after their registration. Each fund had to overcome the liability of being a new and untested institution and had very little time to build confidence based on actual results. The most successful marketing strategies included aggressive advertising and huge public relations campaigns. In fact, most voucher funds spent 3 percent to 10 percent of their assets on advertising.

Marketing approaches tried to capitalize on the strengths of each individual fund. Regional funds that promoted local investment sought to exploit sentiments of regionalism or nationalism in ethnicly homogenous areas, while large firms claimed that stability was naturally associated with size. Some funds tried to stress professionalism and the expertise of their managers with advertising slogans such as "leading foreign investors trust us." Some funds appealed to sectoral interests of valuable assets (for example, oil, gold, and diamonds), while others targeted specific social groups including the military, veterans, and police officers.

Several funds even turned to gimmick advertisements to lure the attention of individual investors. One fund advertised that investors could win a luxury apartment in Moscow, while another claimed—falsely—that it had been given a certificate of Honor by the King of Belgium. In most cases false advertising backfired on the fund. Interestingly, in many cases the appeal of an advertising campaign did not seem to bear a strong correlation to the actual content of the advertisement. Instead, advertising success appeared to be based on the frequency with which advertisements appeared on Russian television or radio programs. Russian investors proved to be highly responsive to advertisements heard most frequently and were attracted by funds with large advertising budgets.

Registrar system

Fund managers had no prior experience in placing large issues, but surprisingly their actions proved quite effective. Most funds issued certificates of shares, while only a few maintained book-entry systems. There was no depository and registrar system available for voucher funds in 1992. Consequently, the creation of registrars was very time-consuming and expensive. In a number of large funds reviewed, between ten and thirty-six people were simultaneously entering in computers information about shareholders. A two to three month delay in registering shareholders was the norm.

Under registrar guidelines fund shareholders either had to apply to registrars personally (quite a difficult feat for shareholders of inter-regional funds), or they had to apply through a fund's local office that acted as a transfer-agent for registrars. However, most funds scrapped their decentralized system of local offices after they finished selling shares, thus further complicating the process.

Trading and liquidity

The lack of an efficient registrar system placed severe limits on the organization of a liquid secondary market for fund shares. However, now that regulations on registrar and depository activities have been introduced, it has become possible to increase the number of secondary transactions by developing local secondary markets.

For example, Adamant Financial Corporation (Derzhava fund manager) became a market-maker in Derzhava shares in January 1994. The volume of secondary transactions has increased to about 20,000 shares a month (0.8 percent of shares outstanding) in approximately 500 transactions in Moscow and five local offices.

Unfortunately, there is still no use of stock exchanges because of the inadequate trading, clearing, and settlement systems. Secondary markets for funds shares are thus based solely on market-makers. Many managers have begun the process of buying and selling funds shares, but most markets are insufficiently liquid due to poor registrar systems, insufficient sales infrastructure, or inadequate cash reserves of fund managers. In their transactions, fund managers prefer to deal with each other face to face for the following reasons:

- There is a lack of public corporations with listed stocks. Most corporate stocks attract just a few investors; usually large institutions or top corporate management, both fighting for control, with the result that liquid secondary markets do not exist.
- Trading, financial information, depository, custodial, clearing and settlement systems are being developed, but they are still embryonic and ineffective.
- While some "networks" exist, there are no obvious leaders in trading systems. Consequently, fund managers hesitate to join any one particular network because the probability of their customers being members of the same trading system is very low.
- There is not enough competition between banks and brokers in existing trading systems, and the high cost of commissions is prohibitive for investment funds. At the same time, fund managers are not admitted to these markets directly.
- Privatized companies do not follow full disclosure principles. Investment managers have partial and conflicting information about the same companies and prefer to deal in a more confidential manner.

In these circumstances, every transaction on the market takes a great deal of time, effort, and money. Counterparts have to meet each other face-to-face to sign contracts (to date there are no other ways to manage this in the Russian legal system). Furthermore, taxes on securities' transactions are paid independently, and then the contract and confirmations of tax payments have to be brought to the registrar of the company to transfer the stocks.

To some extent, these issues do not present major problems since most funds are not actively managed and have only three to ten transactions each month. Voucher speculations were something of an exception, but in their case there was no need to register deals.

It is still too early to discuss the possibility of "opening" existing funds. First of all, the low liquidity of the stock market

BOX 5.2

Voucher funds classified by size and geographic spread

Small regional funds

Several hundred small regional funds were started. With 1,000–10,000 shareholders and capital of $20,000–$300,000 they do not have the resources to cover the expenses of fund management. Recognizing this, many small funds have already started the process of merging with larger ones.

Larger regional funds

There are about fifty regional voucher funds comprising 50,000–300,000 shareholders, possessing a capital base of $1.5 million–$12 million. Most of the assets in these funds are invested within their own region. Due to the local nature of investments, regional funds tend to have much better information with regard to the status of privatized companies, and also tend to enjoy more personal relations with firm management. While greater access to information serves as a definite advantage for regional funds, the closer relationship with management can also operate as a serious shortcoming from a shareholder's perspective.

Inter-regional funds

Between forty and sixty inter-regional funds possess 40,000–250,000 shareholders and enjoy a capital base of $1 million–$10 million. These funds have expanded their marketing and investment activities across a number of different regions.

Large national funds

Five large voucher funds in Russia possess 1 million–3 million shareholders and a capital base of $25 million–$50 million. These funds profited from aggressive advertising in all regions of Russia, and from share sales by post offices.

Unfortunately, there is still no use of stock exchanges because of the inadequate trading, clearing, and settlement systems.

makes it impossible to raise cash quickly by selling stocks, and also prohibits the use of net asset valuation (NAV) as a basis for share prices. Secondly, registrar and depository systems need to expand in order to serve a large number of transactions more efficiently, and fund managers need time to develop their back offices. The final reason why it is premature to "open" existing funds is that special accounting for closed investment funds and mutual funds needs to be introduced. Currently, funds cannot create and cancel shares simultaneously.

While it will take at least two or three years for mutual equity funds to appear on the market, it is possible that open money-market funds could be started in six to twelve months, if the accounting system for open funds is introduced.

Commissions

Most funds pay their fund managers the legal limit of compensation, or 10 percent of average net assets as a fund-management fee. While some have complained that this payment is exceedingly high, it is important to take note of several considerations. First, the fees are usually paid after the end of a quarter and high inflation reduces the real value of payment compared to the real value of assets at the end of the period. Second, Russian fund managers have to spend a great deal of money finding information on privatized companies and developing their activity. These start-up investments should increase the performance of portfolios significantly to the benefit of funds' shareholders. Third, net assets are now calculated on the basis of the historical costs of assets. The book value of a particular holding may be exactly the same for a few years in spite of a rise in the market price. Furthermore, all balance values of stocks must be multiplied by 0.5, except stocks 'with market value.' The Securities Commission is supposed to announce the list of such securities, but to date the announcement has yet to come. Therefore, a lot of stocks bought in January of 1993 for 10 million rubles had a NAV of approximately $11,236 (445 rubles to the dollar times 0.5) in January of 1993, and $2,577 (1,940 rubles to the dollar times 0.5) in June 1994. Fund managers are forced to buy and sell assets much more than necessary, simply to keep the balance value closer to the market price.

Some fund managers initially employed too many people, an especially pressing problem for small funds. At the same time, any increase in management fees would damage funds. Consequently, fund managers are looking for ways to strike a balance between the quality of management and its costs. Unfortunately, most managers manage small funds, and therefore the realistic alternatives open to them are expanding their businesses by raising additional capital, launching new investment and pension funds, or simply getting out of the fray.

Investments

Very few funds followed one specific investment strategy throughout the privatization process. Most funds changed their investment objectives repeatedly, thereby making the classification task more difficult. Nevertheless, some of the most popular investment approaches may be defined.

The speculative approach

Many fund managers made their investments purely on a speculative basis, with the hope of immediately reselling the stocks. Privatization in Russia provided fertile ground for speculative adventures for two reasons. First, managers and insider-owners in privatized companies fought for control against external investors. Quite often top-level management used the cash of the company to do so. This practice was technically illegal, but impossible to effectively control. Consequently, there was always at least one buyer interested in keeping control of a company regardless of price. Second, the voucher auction procedure was guided by the principle that the more vouchers invested, the higher the stock price. While it was nearly impossible for a single investor to buy all of a company's shares, in many situations large investors bought lots of shares from other participants at an auction. Frequently, it was more efficient to take part in the auction with a small amount of vouchers and use saved cash to buy stocks after the auction.

Many funds benefited as a result of this favorable environment for speculation. At the same time, it was hard to predict whether large investors would participate in a particular auction, or if an auction would prevent insiders or large external investors from buying shares at the higher price.

Furthermore, in many cases it was easier and less expensive for large investors to buy shares from employees who had obtained them at a discount. One voucher fund bought 15 percent of the shares outstanding for the same amount it had previously paid for 4.6 percent of the company's shares. As a result, although speculative funds benefited from lucky reselling, they also held many nonliquid stocks of poor investment quality.

Some funds concentrated on speculations with vouchers. Buying small lots of vouchers from individuals or small dealers, and then selling them in big lots to various companies proved to be a profitable business. However, several sharp unpredictable changes in the price of vouchers (three times a gain in price of 100 percent to 150 percent within a week, once a loss of 60 percent within three days) brought big losses for voucher speculators, because voucher prices went up when most speculators held cash and vice versa. Overall, speculative funds have thus far produced quite moderate results compared to other funds.

Sector specific approach

Many funds chose specific industrial sectors as their investment priorities. Better knowledge of specific industries was supposedly a serious advantage of these funds in the mass privatization environment. Sector specific funds ended with almost no stocks of poor investment quality in their portfolios. But most of these funds were promoted by companies from the same industry, and therefore managers had—and have—other goals in mind besides simply insuring the top performance of portfolios for the benefit of their clients.

For the next several years, industry oriented investment funds will remain among the most stable. But when amateur and fraud funds disappear and competition among funds and between other institutions becomes severe, fund managers using the sector specific approach will probably have to revise their investment strategies.

Short-term speculation plus venture investments

Some fund managers decided to finance new ventures or develop new investment projects and have invested a substantial part of their assets in business centers, industrial plants, or high-technology companies. The huge discrepancy between funds' assets and capital required for any serious greenfields venture forced managers of these funds to be very active in forming various financial groups, or issuing stocks of new companies. The First Voucher Fund now promotes a First Pension Fund to increase capital available to finance their numerous projects. Many smaller funds have followed this policy, and some thirty to forty private pension funds have been started recently by voucher fund managers. This group of funds has not managed to announce any positive results thus far, though a quick and high return for investors was promised in their advertising.

Long-term portfolio investments plus venture investments

This group of funds started with long-term portfolio investments in privatized companies. Managers of these funds are now developing restructuring and investment projects mainly for the companies where they have major holdings. Fund managers expect large returns on capital invested from the increased efficiency these companies should, it is hoped, soon enjoy.

Portfolios of these funds may be easily divided into active and passive components. Managers try to be active investors in a select set of privatized companies and therefore attempt to influence their management. In most cases, fund managers would prefer to have dominant control of the company so that post-privatization restructuring, unpopular with employees, can be performed as quickly and decisively as possible. Investment funds are allowed to purchase up to 25 percent of the common stocks of any one company, and they actively do so in the firms in which they have a major interest. Two or three voucher funds often share effective control of these companies. As passive investors in other companies, fund managers are not terribly involved in their management, but still carefully monitor the actions of companies' top executives to prevent any serious damage.

The existing tax system will kill investment funds if substantial change is not forthcoming.

Uncertainties and persisting problems have forced managers to select stocks more carefully and pay attention to investment quality rather than speculative potential. This group of managers has not promised any immediate profits for investors and, consequently, the financial position of these funds is much more stable than most others.

Diversified funds

Most regional funds diversified their portfolios and currently hold shares from 70 to 240 (usually) small companies. The average investments of $15,000 to $20,000 are too small to make a difference, and operational costs and the costs of protecting funds' ownership rights are high. Due to over-diversification, all future prospects of these funds are closely intertwined with the economic situation in Russia in general.

Taxation

Investment funds in Russia are not tax transparent for final investors. Funds pay tax on profits (38 percent in Moscow) that is equivalent to a capital gains tax. Since January of 1994, voucher funds have received a tax exemption on dividends received within two years of initial registration. However, this privilege does not cover dividends from 1993, and most voucher funds will celebrate their second birthday before the end of 1994. Most funds will thus not be able to reap the fruits of this tax relief.

Investment funds must pay municipal taxes (for roads, police support, and education), while investors have to pay an individual income tax which can be no lower than 12 percent on dividends received from investment funds or on capital gains.

Inflation levies heavy burdens on investment funds as well. If a stock was bought in January 1993, for 10,000 rubles ($22.47 at the current exchange rate) and sold in June 1994, for 20,000 rubles ($10.31), the fund would have to pay a 38 percent tax on 3,800 rubles ($1.96), even though this investment turned out to be a net loss.

The existing tax system will kill investment funds if substantial change is not forthcoming. As it currently stands, the system significantly hinders and distorts the investment decisions of fund managers.

Accounting

Investment funds do not have a special system of accounts and accounting procedures; yet they still use accounting principles of normal enterprises. Consequently, accounting is inconvenient and costly for fund managers because they must go through many useless steps and procedures. It is also impossible for investors to evaluate the current position and financial results of investment funds, and numerous opportunities for account manipulation exist. It is quite possible that manipulations cannot be prevented before a truly liquid stock market develops or before funds hold listed securities. However, a way should be found to make accounting more appropriate for fund managers and investors in the interim.

Prospects

Although many investment funds did not announce any dividend payments after 1993, the financial positions of most funds are not terrible. Speculations with equities of privatized companies have proven profitable enough and the potential for long-term growth is great. But many fund managers still feel uneasy in the fund management business. Most managers want to diversify their business, seek the right to buy real estate, borrow money, or provide commercial loans. They want to continue their business expansion but not in fund management, because other types of financial services are not nearly as regulated. Moreover, the current dissatisfaction of investors makes it difficult to raise more capital in existing funds, and the tax system is viewed as unfair.

Possible scenarios for voucher funds include:

- *Bankruptcy.* Many small voucher funds will merge with each other, with larger funds, or will eventually be managed by large groups. Some fund managers will simply disappear, unable to survive in the new competitive environment.
- *Holdings.* Many sector-oriented funds will prefer to hold portfolios of closely-related stocks over a long period of time and will choose to be actively involved in managing these companies.
- *Investment companies.* The most popular role for a fund manager to behave is that of investment consultant, broker, or investment banker. Many funds will take on more of a role as providers of investment services and financial advice.
- *Venture and portfolio investments.* Some funds will continue to follow strategies of long-term portfolio and venture investments. These funds will be among the most active players on the post-voucher stock market.
- *Portfolio investments.* It is difficult to imagine voucher funds becoming normal portfolio investors, at least in the near future. Some new investment funds will be managed according to established portfolio principles.

Few opportunities for quick profits remain in the fund management business. Fund managers may hope for high and stable profits, but this will only come about in an environment of equal treatment of all financial services and with the implementation of a fair tax system. As foreign investment in Russian equities grow and the Russian private sector actively invests, the liquidity of the Russian stock market will continue to improve. This will create a more comfortable environment for portfolio management. The first international fund management groups have started their operations in Russia. It is hoped that they will increase foreign investments substantially and will introduce high standards of fund management.

In the next century, Russian fund management companies will continue to grow. They will manage more funds with larger assets and play an increasingly vital role in the restructuring of the Russian economy and the development of a sound financial system.

Techniques of Mass Privatization: Implementing the Voucher Auction Program October 1992 to June 1994

Jeffrey L. Schwartz and Zoanne L. Nelson

This paper presents a summary of the operational phases of the voucher auction process which was adopted by the Russian government in 1992 as part of the mass privatization program. The overall results of the voucher auction program's transfer of more than 12,000 enterprises from government to private hands are well known. In part, the success of mass privatization in Russia is due to the program's design and mechanics, which allowed for rapid replication and implementation across the country. Between October 1992 and January 1993, the Russian government issued each Russian citizen a privatization voucher; almost 150 million vouchers were distributed. A mechanism of publicly-held voucher auctions was established by the government to provide the opportunity for citizens to invest directly in large-scale enterprises undergoing privatization or to participate in one of more than 600 voucher investment funds which were licensed to operate in Russia.

The mass privatization program was initiated by the State Committee of the Russian Federation for the Management of State Property (Goskomimushchestvo, GKI). According to the Russian Privatization Center, as of April 30, 1994, eighty-six of the eighty-nine regions in Russia had initiated voucher auction programs, and approximately 11,000 enterprises had been privatized. The program was scheduled to be completed with the expiration of privatization vouchers on June 30, 1994.

The overall design of the mass corporatization and privatization program included the use of simple and standard procedures at each level of the process. The deliberate lack of complexity in the process facilitated the timely implementation and contributed to the success of the program. This design also made it possible to effectively use targeted international technical assistance and financing to support the program's replication throughout the country. As the coordinating ministry, the GKI has been highly effective in using technical assistance to support the program's design and implementation. Technical assistance has been provided by professional staff and private consultants supported by USAID, the World Bank, and the EBRD.

In outlining the design and mechanics of the voucher auction privatization program, this paper examines the three operational components of the program. The first step in the mass privatization program was the mass corporatization of enterprises which were to be privatized. The key steps in the mass corporatization process are outlined in the first section. The public and operational focus of the mass privatization program were the public voucher auctions which were conducted in almost every region across the Russian Federation. The main elements of the regional voucher auction process are outlined in second section. The last section summarizes the operations for national auctions, such as for the mass privatization of enterprises which were simultaneously auctioned in multiple regions.

Key steps in the corporatization and preparation for privatization of an enterprise in the mass privatization program

The initial phase of the mass privatization program involved the preparation and mass

The deliberate lack of complexity in the process facilitated the timely implementation and contributed to the success of the program.

corporatization of thousands of enterprises across the country. The mass corporatization process included standard procedures for the selection of privatizatio: options, the drafting of a privatization plan including a standard valuation of an enterprise's assets, the transformation of enterprises into joint stock, companies and the compilation of documents to register the shares to be distributed and sold at internal and public auctions.

In practice, options 1 and 2 have been predominant choices for enterprises undergoing privatization.

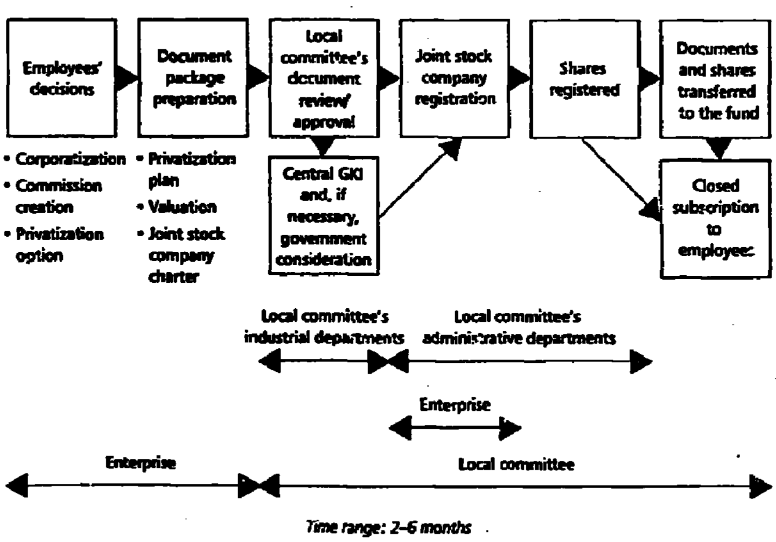
Phase 1: Preparation for privatization

There were three key preparation steps required to transform an enterprise into a joint stock company. The Director General of each enterprise was responsible for establishing a working commission for privatization of the enterprise. The commission was charged with the following tasks (see figure 6.1).

Valuation of assets. Enterprises' valuations were mechanically derived summaries of an enterprise's assets. These valuations were primarily driven by book values and were prepared according to requirements specified in GKI Regulation No. 763p.

Privatization options. According to the 1993 State Program of Privatization in Russia, each commission was required to provide information to the employees of the enterprise in order to choose one of three

Figure 6.1 Preparation of a Russian enterprise for voucher privatization



options for privatizing the enterprise. The three privatization options involved a range of share allocations to enterprise insiders (enterprise managers and employees) and outside investors. Shares available to outside investors were distributed through voucher auctions or investment tenders. Each of the privatization options specified that 29 percent or more of available shares would be distributed through voucher auctions unless the enterprise belonged to a group of enterprises whereby less shares were required to be sold, such as energy, extraction, and refining enterprises. The share allocations for the privatization options are summarized in table 6.1. A dominant feature of the mass privatization program was the availability of large percentages of shares to employees and managers in enterprises to be privatized. Each of the three options involved between 50 and 60 percent of the initial shares of newly privatized companies to be distributed to enterprise managers, employees, or the Enterprise Employees' Shareholder Fund (EESF).

The selection of privatization option 2 or 3 required the approval of two-thirds of the employees either in a general meeting of the workers' collective or by obtaining signatures of the employees. If options 2 or 3 were not selected, option 1 was chosen by default. In practice, options 1 and 2 have been predominant choices for enterprises undergoing privatization. Approximately 70 percent of enterprises selected option 2 and approximately 30 percent of enterprises selected option 1. Less than one percent of enterprises selected option 3. Many of the largest enterprises chose option 1 by default due, in part, to difficulties in organizing a workers' meeting or difficulties for employees in purchasing the majority amount of shares for large enterprises with high levels of statutory capital.

The key elements of the privatization options are summarized below.

OPTION 1. Enterprise insiders can obtain control of up to 50 percent of the shares. Fifty percent of the shares are available to outside investors through voucher auctions or investment tenders. From the authorized capital,

- Employees are given preferred nonvoting shares representing 25 percent of the charter capital. These shares are distributed free of charge to all members of the work collective provided the value does not exceed 20 times the legal minimum remuneration for the employee;
- Common shares constituting up to 10 percent of the charter capital, but not exceeding six times the legally established minimum remuneration of one employee, are sold by closed subscription to the work force at a 30 percent discount from the nominal price of a share. Payment can be made in installments over a three-month period with a 50 percent initial payment of the nominal price;
- Management can acquire common shares constituting five percent of the charter capital at a nominal price not to exceed 2,000 times the legal minimum remuneration; and
- The work force may establish an Enterprise Employees' Shareholding Fund (EESF) which is eligible to receive 10 percent of the charter capital with a two year option to purchase the shares at their nominal value. Transfer of the shares from the EESF to the employees is conditional upon the completed sale of 80 percent of shares including the sale for vouchers of the shares established by legislation.

OPTION 2. Enterprise insiders can acquire 56 percent of the shares and 44 percent are available to investors through voucher auctions and future cash sales or investment tenders:

- Employees have the right to buy common voting shares representing 51 percent of the authorized capital at a price equal to 1.7 times the nominal value of the shares and
- The EESF may retain up to 5 percent to be purchased within two years.

OPTION 3. Enterprise employees and managers can acquire 60 percent of the shares with 40 percent of the shares to be sold through voucher auctions and investment tenders or cash sales.

- If a group of workers or any physical or legal person takes the responsibility to fulfill the privatization plan and to ensure the solvency of the enterprise, and receives the consent of the general assembly of the work force under an agreement which should not exceed one year, the group has the right within a specified period to acquire 30 percent of the common shares at the nominal price.
- Enterprise workers (including members of the above group) can purchase common shares constituting 20 percent of the charter capital not exceeding 20 times the minimum remuneration at a 30 percent discount from the nominal price payable over a three month period with a 25 percent initial payment.
- If the managing group cannot fulfill the provisions of the agreement, the shares of the group will be sold to the public at a specialized voucher auction (or for cash after July 1, 1994).
- Shares transferred to the EESF should not exceed 10 percent of the charter capital.

Table 6.2 illustrates the allocation of shares among internal and external investors for selected enterprises.

Privatization plan. The privatization plan for an enterprise details basic information on a company and its privatization. This includes a sign valuation of the enter-

Table 6.1 Allocation of shares under privatization options 1, 2, and 3
(percent)

Description	*Option 1*	*Option 2*	*Option 3*
Free to employees	25		20
Sold to employees at 1.7 index of nominal value (cash or vouchers)	10	51	
Sold to management at nominal value (cash or vouchers)	5		
Sold to employee group committed to fulfilling the privatization plan and managing the enterprise at nominal value after one year (cash only)			30
Sold to Enterprise Employees' Shareholder Fund (EESF) with two-year right to purchase (cash only)	10	5	10
Subtotal retained by enterprise	50	56	60
Voucher auction (minimum percentage by law)	29	29	29
Investment, tender, retained by government, or other	21	15	11
Subtotal available to investors or government	50	44	40
Total	100	100	100

prise's assets and the proposed number and allocation of shares to be issued. A typical privatization plan depicts the following information:

- Summary characteristics and information including the name, address, ownership status, bank name and account numbers, names and addresses of wholly-owned and partially-owned subsidiaries, number of employees, founding capital, list of products made by the enterprise, and information regarding the location of company plants and operations. The plans also include lists of all social, as well as productive, assets.
- The selected privatization option and the names of the commission members.
- The distribution of shares according to the privatization option including the calculation of shares outstanding, and for whom specified amounts of shares are available.
- The proposed placement of the shares of the enterprise including the new name of the joint stock company, the total number and nominal value of shares, the percentage of preferred and common shares, and the form of shares (actual certificates or central registrar). The plan should include a table which summarizes the proposed placement of the shares to employees and management, along with external placements (such as voucher auction and investment tenders).

The privatization plans were signed by the chairman and members of the auction commission and chairman and members of the local property committee.

Articles of the joint stock company. A model corporate charter was provided in the attachment to Presidential Decree No. 721 entitled, "Regulations for the Commercialization and Transformation of State Enterprises into Open Joint Stock Companies." The decree provided a detailed example of a company charter including the company's purposes and the role of the board of directors and company's management.

Table 6.2 Distribution of shares for selected Russian enterprises

Company (principal industry)	*ZIL (automobiles)*	*Saransk Factory Orbita (semi-conductor devices)*	*Amurenergo (electric utilities and thermal power)*	*Lukoil Kogalim-neftegas (oil drilling and gas extraction)*	*Krasnoyarsk Tire Factory (tires)*	*Krasnoyarsk TsBK (cellulose, paper, and cardboard)*	*Tekstilmash (textile looms)*	*Tomsk Neftekhimiches Factory (oil-based chemicals)*
Privatization option	1	1	1	1	2	2	2	2
Internal placement *(percent)*								
Preferred stock placement for employees (option 1 only)	25.0	25.0	18.5	18.6	0.0	0.0	0.0	0.0
Closed subscription of common stock for employees	10.0	10.0	5.6	10.0	51.0	51.0	51.0	51.0
Common stock placement for managers (option 1 only)	5.0	3.6	5.0	5.0	0.0	0.0	0.0	0.0
Enterprise Employees' Shareholding Fund (EESF)	10.0	10.0	10.0	0.0	5.0	0.5	0.0	5.0
Total internal placement	50.0	48.6	39.1	33.6	56.0	51.5	51.0	56.0
External placement *(percent)*								
Voucher auctions	35.0	29.0	11.9	17.3	29.0	29.0	29.0	44.0
Retained by government or holding company	13.0	20.0	49.0	38.0	15.0	19.5	20.0	0.0
Distribution to population in the far north and employees of the oil transportation companies and subcontractors	0.0	0.0	0.0	9.7	0.0	0.0	0.0	0.0
Investment tenders	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Cash sale	2.0	2.4	0.0	1.4	0.0	0.0	0.0	0.0
Total external placement	50.0	51.4	60.9	66.4	44.0	48.5	49.0	44.0
Total shares *(percent)*	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Note: Figures are rounded to the first number after the decimal point.
Source: Privatization Plan of the Enterprises.

Phase 2: Transformation to a joint stock company

Enterprises changed their legal status to joint stock companies through the registration of their privatization plans and founding documents by the Local and Federal Property Committees. The process included:

Approval. Privatization plans were to be submitted by October 1, 1992 to the industrial departments of the local property management committees. The committees were required to approve these plans within seven days of their submission. If a plan was not approved, the committee had one week to amend and approve the plan. The approval of the central government and the GKI were required for certain size companies and industries.[1]

Registration. Within the property committees, the industrial department submitted an application, foundation documents for registration, and a prospectus for the registration of a securities issue for approval by the administrative department. The enterprise is considered transformed into a legal joint stock company upon its registration. The new shares of the enterprise are registered by the finance department of the regional authority.

Board of directors. As part of the legal registration and transformation process, the enterprise formed a Board of Directors which by law included the director general or a representative from that office, a representative of the property committee, a representative of the work force, and a representative of the local authorities. The board of directors' composition and duties were outlined in the model corporate charter included in the attachment to Presidential decree No. 721.

Phase 3: Distribution of shares to employees (closed subscription)

According to the privatization option chosen, enterprises were obliged to allocate shares within the company according to the approved privatization plan.

Distribution of shares. Upon registration, the company had fifteen days to conduct a closed subscription auction in order to either transfer the shares free of charge to the employees under option 1, or to make available for purchase the shares under options 1, 2, or 3. Employees, pensioned employees, and under certain regulations, the employees of suppliers or native inhabitants of the regions, submitted applications for the receipt or purchase of shares. Applications were processed to determine the allocation of shares.

Share registry. Following the distribution of shares to employees, the list of applicants formed the basis for drawing up a register of shareholders. These lists were later expanded to include new shareholders such as the winning participants in voucher auctions and investment tenders.

Phase 4: Voucher privatization

In accordance with government regulation and the approved privatization plans, a percentage of shares from each enterprise was allocated for distribution by the government to external investors through public voucher auctions. The percentages for distribution through closed and public auctions were specified in the privatization plans. Typically 29 percent of an enterprise's shares were allocated to be distributed through public voucher auctions.

Voucher auctions were conducted by sellers designated in the privatization legislation. The local property committee transferred the enterprise's registration documents to the seller who assumed responsibility for the shares created in the process of privatization. Sellers were generally the Federal Property Fund for companies which were federally owned, or the appropriate local property fund for companies that were under ownership of the territories, regions, the cities of St. Petersburg or Moscow, and municipalities.

The sellers managed the voucher privatization process. At the regional level, voucher auctions included a number of fundamental steps.

- Assigning an auction commission to provide oversight to the conduct of the auction and approval of the auction results

Typically 29 percent of an enterprise's shares were allocated to be distributed through public voucher auctions.

The location and reach of voucher auctions was a function of the size of the enterprises...

- Arranging for publication of required announcements for the upcoming auction
- Conducting the voucher auction
- Compiling and calculating the results of an auction, legitimizing the auction by the signing of a protocol of auction results, and ensuring that the shareholders are entered into the share registry of the enterprise
- Announcing the results of the auction to the public
- Ensuring the cancellation or return of vouchers
- Conducting a cash sale auction for a small percentage of shares to cover the expenditures of conducting the auction.

The regional voucher auction process

The initial voucher auction phase of the mass privatization program emphasized the development of regional voucher auction capabilities to conduct auctions for medium-sized, local enterprises in the regions where companies conducted their primary activities. Eighty-six of the eighty-nine regions in the Russian Federation had initiated and conducted regional voucher auctions prior to the program's close at the end of June 1994.

The Russian Federation Committee for the Management of Property (GKI) was responsible for overseeing and supporting the development of regional auction capabilities and ensuring that local regional programs conformed to the laws, decrees, and regulations governing the mass privatization program. Following the program's basic design, regions participating in the program established comparable systems providing the opportunity for citizens to invest in privatization vouchers through auction centers or bid reception centers located in cities and towns throughout the regions. The use of basic auction procedures and decentralized bid reception centers facilitated a widespread implementation of the program. The use of common bid reception and auction procedures also made it possible to integrate regional voucher auction capabilities into a national system to conduct auctions simultaneously in multiple regions for the largest Russian enterprises participating in the voucher privatization program. To establish voucher auction programs, regions developed similar systems of processing voucher auctions which included the basic steps outlined below.

Pipeline management

Working with the local property committee, the property fund identified enterprises which were eligible for selling shares through voucher auctions. They then performed a minimum level of due diligence on the enterprises, and generally organized an auction "wave" for the auctioning of several enterprises simultaneously. A typical wave would include anywhere from five to fifty companies being auctioned simultaneously in a two week period.

The location and reach of voucher auctions was a function of the size of the enterprises: companies with a fixed asset value of less than 250 million rubles could be auctioned only in the seller's region, enterprises with a fixed asset value of between 250 and 500 million rubles were required to be offered in at least five regions, and enterprises with a value of greater than 500 million rubles were to be auctioned nationally.

Bid collection

The local property fund established a regional auction center and several bid reception locations throughout the region depending upon the size of the region and distribution of the population. Over 750 bid collection sites were operating nationwide (approximately 10 sites per region) during the last six months of the voucher auction program.[2] Each region operated a central regional auction center which was run by the property fund or their designated agents. The property fund or agent generally subcontracted with commercial or government entities to open a network of bid reception sites which received applications for voucher auctions. Consultants at the bid collection sites provided basic information (drawn from the privatization plans) to potential applicants about the voucher auction process and companies being auctioned. Additional staff accepted and processed applications, and submitted the collected applications to the regional auction center for processing and calculating auction results.

Type 1 versus type 2 bids

Two types of bids were allowed under the voucher auction program. Each applicant, whether an individual or legal entity, was entitled to select the type of bid to be made in an auction. If an applicant submitted a type 1 bid, he would automatically become a winner in the auction and receive some number of shares in the auction. Type 1 bidders were indifferent to the strike price (the number of shares per winning voucher). Under a type 2 bid, the applicant specified the minimum strike price at which he was willing to accept shares in the company. If the calculated strike price was equal to or lower than the indicated bid, the applicant became a winner (for example, an applicant who specified a strike price of five shares per voucher would be a winner in an auction where the strike price was five shares per vouchers or lower). An estimated 95 percent of all bids in the voucher auction program were type 1 bids.

Auction results processing

Once the auction was closed, all bids were entered into a computerized database program. The auction results were calculated according to an algorithm which determined the strike price of shares per voucher. If there were no splits in the number of shares being offered at the auction at least 80 percent of the shares were to be sold. If there was a split in shares being offered (for example, 300,000 shares of 1,000 rubles nominal value were split to 600,000 shares of 500 rubles nominal value), one of two things occurred. If there was a split in shares being offered and less than 29 percent of the shares were offered for the auction, then 95 percent of the shares were to be sold. However, if a split occurred and 29 percent of the shares or more were offered, then 90 percent of the shares were to be sold.

To ensure the accuracy of voucher auction calculations, GKI developed and distributed standard auction software to the regions. Regions were permitted to develop and use their own software provided that it was tested and certified by GKI. Most regions used versions of the standard auction software issued by GKI.

Results of the auctions were presented in a protocol which was approved by the Auction Commission. Attached to the protocol summarizing the auction results was a list of winning applicants which was transferred to the share register of the company. After auction results were announced, the vouchers of winning applicants were canceled and the vouchers of the losing type 2 bids were returned to the applicants for resubmission in subsequent auctions.

Cash sale

To defray the operating costs for local voucher auctions and to provide incentives for agents operating local bid reception centers, post voucher auction cash sales were organized in regions which conducted voucher auctions. These were typically simple open outcry auctions where lots with varying numbers of shares were sold for cash. Regional property funds could sell up to 5 percent of the amount of shares sold through the voucher auction for enterprises which sold less than 29 percent of their shares, or they could sell up to 10 percent of the shares allotted to voucher auctions if 29 percent or more of an enterprise's shares were sold through voucher auctions. Proceeds from cash auctions were collected by the property fund and redistributed to participating agents which operated bid reception centers. Agents were generally reimbursed on the basis of the number of vouchers which were collected and canceled (the presentation of a cancellation protocol to the seller was necessary in order to receive compensation). Lists of winners of shares in cash sale auctions were also forwarded to the company or its registrar to be included in the share registry.

Examples of regional voucher auction systems

To illustrate the operations and results of regional voucher auction programs, the activities of five regions are summarized below.

Sverdlovsk Regional Auction Center. The property fund designated the Ural Stock Center (USC), a commercial entity, to act as the agent for the region. The fund played a key role in creating this entity in cooperation with a private consulting firm with funding provided by USAID. Initial funding of the bid process was provided by USAID until the introduction of post-voucher auction cash sales enabled the system to become self-financing.

- *Bid reception network.* The USC opened approximately 30 bid reception sites to provide coverage in the 20 districts of the region. Locations were primarily in the local house of culture or the district property funds or committee offices.
- *Auction software.* The property fund developed their own software which was certified by GKI for use in local auctions, but uses the GKI standard auction software for national auctions.
- *Auctions results.* By the end of June 1994, the property fund conducted an estimated sixteen auction waves for a total of 350 enterprises.

Omsk Regional Auction Center. The regional auction center was managed directly by the property fund and was created with start-up technical assistance and funding provided by USAID. After the introduction of post-voucher auction cash sales, the operation became self-financing.

- *Bid reception network.* The property fund subcontracted with the local Sberbank (government-owned savings bank) branches, which opened two bid collection sites in the city of Omsk and two in other population centers in the region.
- *Auction software.* The property fund used the GKI standard software for calculating the local and national auctions.
- *Auctions results.* Omsk property fund conducted an estimated twenty waves of auctions for a total of 194 enterprises. Auctions were typically held for a period of two weeks.

Saratov Regional Auction Center. The property fund originally delegated the auctions to the local stock exchange. Towards the end of the program, the property fund ended this arrangement and developed its own center. This was a trend in several regions as the privatization program was drawing to a close and property funds were seeking to identify future roles for their organization in the post-voucher privatization system.

- *Bid reception network.* There were six bid reception centers that were operated directly by the property fund and its agent. In addition, twenty-three bid reception sites were operating in the region at the local postal offices and district property fund or committee offices.
- *Auction software.* The property fund used the GKI standard auction software for calculating local and national auctions.
- *Auctions results.* Saratov property fund has auctioned approximately 250 enterprises in twenty-five auction waves, each wave consisting of approximately ten companies. Enterprises were auctioned for a two week period.

Orenburg Regional Auction Center. The property fund signed an agreement with a local currency exchange to act as their representative in the region. The exchange received start-up funding from the local property fund and committee. At the request of GKI, periodic technical assistance was provided with funding from USAID.

- *Bid reception network.* Up to twenty bid reception points were operating in Orenburg through an agreement with the local Sberbank.
- *Auction software.* The property fund used the GKI standard auction software.
- *Auctions results.* Approximately 100 enterprises have been auctioned, each company being auctioned for four weeks. The property fund auctioned companies individually as opposed to grouping them into waves.

Tula Regional Auction Center. The property fund managed the regional auction center directly. The voucher auction program had been financed by the property fund without outside assistance. Periodic technical assistance was provided at the request of GKI with funding from USAID.

- *Bid reception network.* Over forty bid reception sites were opened by the property fund by subcontracting with a privately-held bank to open sites in twenty-five branch offices and with the district property funds and cc.mmittees in another fifteen locations.
- *Auction software.* The property fund used the GKI standard auction software.
- *Auctions results.* 166 enterprises were auctioned by the property fund in thirty-eight auction wa'ves. Each enterprise was auctioned over a two week period.

The National Auction System

In February 1993, the National Auction System (NAS) was created as a mechanism for conducting voucher auctions for large Russian enterprises in multiple regions simultaneously. It was designed as an "overlay" of the regional auction system utilizing the processes and procedures that had already been implemented at the regional level. The National Auction System enabled voucherholders throughout Russia to participate in voucher auctions for the largest enterprises without travelling to the region where the companies were located.

Russian legislation stipulated that enterprises with a fixed asset value greater than 500 million were to be offered for sale nationally.[3] The first company to be auctioned through the NAS was the giant automaker ZIL which was offered in twelve regions throughout Russia. These twelve regions included the locations of ZIL plants, major suppliers, major investors and voucher investment funds. From March 1993 until the conclusion of the voucher auction program on June 30, 1994, 313 companies were auctioned through the NAS in eighty regions. Regional participation in the NAS is presented in table 6.3 and a summary of the performance results of the NAS is presented in table 6.4.

To coordinate the national auction system, the National Network Center (NNC) was initiated under the auspices of GKI. The NNC facilitates the cooperation among participants to conduct national auctions. The procedures for national auctions remained essentially the same as regional auctions except that bids were received in local bid reception centers across the country. The bid reception process for national

Table 6.3 Participating regions in the National Auction System

The following regions in the Russian Federation participated as selling agents for the national auction system. Regions with an asterisk offered companies to be privatized through the national system.

1. Abakan	*	41. Nefteyugansk	
2. Anadyr		42. Nizhni Novgorod	*
3. Arkhangelsk	*	43. Novgorod	*
4. Astrahan	*	44. Novosibirsk	*
5. Barnaul	*	45. Omsk Oblast	*
6. Belgorod	*	46. Orel	
7. Blagoveshensk	*	47. Orenburg	*
8. Bryansk	*	48. Penza	*
9. Cheboksary	*	49. Perm	*
10. Chelyabinsk	*	50. Petropavlovsk Kamchatski	*
11. Cherckessk		51. Petrozavodsk	*
12. Chita	*	52. Pskov	
13. Dudinka	*	53. Rostov-on-Don	*
14. Ekaterinburg	*	54. Ryazan	*
15. Elista		55. Salekhard	*
16. Irkutsk	*	56. Samara	*
17. Ivanovo	*	57. Saransk	*
18. Izhevsk	*	58. Saratov	*
19. Kaliningrad	*	59. Smolensk	
20. Kaluga		60. St.Petersburg	*
21. Kemerovo	*	61. Stavropol	*
22. Khabarovsk	*	62. Sycktyvkar	*
23. Khanty-Mansijsk	*	63. Tambov	*
24. Kirov	*	64. Tomsk	*
25. Kostroma		65. Tula	*
26. Krasnodar	*	66. Tumen	*
27. Krasnoyarsk	*	67. Tver	
28. Kurgan		68. Ufa	
29. Kursk	*	69. Ulan-Ude	*
30. Kyzyl		70. Ulyanovsk	*
31. Leningradskaya Oblast	*	71. Vladikavkaz	
32. Lipetsk	*	72. Vladimir	*
33. Magadan	*	73. Vladivostok	*
34. Mahachkala		74. Volgograd	*
35. Maikop		75. Vologda	*
36. Moscow	*	76. Voronezh	*
37. Moscow Oblast	*	77. Yakutsk	
38. Murmansk	*	78. Yaroslavl	*
39. Nahodka	*	79. Yoshkar-Ola	
40. Nalchick		80. Yuzhno-Sahalinsk	*

Table 6.4 Performance results of the National Auction System

	May 1, 1993	*May 1, 1994*	*June 30, 1994*
Number of companies			
sold (closed)	3	113	313
sold or in process	3	157	313
Total charter capital (thousand rubles)			
sold	6,082,034	239,060,698	439,425,289
sold or in process	6,082,034	316,532,042	439,425,289
Vouchers collected	1,149,038	23,763,134	34,060,139
Bids received	80,526	269,697	325,270
Number of regions	26	79	80
Number of shares			
offered	1,910,764	83,086,466	118,917,045
sold[a]	4,701,750	160,188,649	239,102,861
Number of regions transmitting bid data electronically	0	36	40

a. Number of shares sold will exceed number offered in the case of share splitting during the calculation of the auction.

auctions was typically four weeks as opposed to two weeks for local auctions. The NNC was responsible for essentially the same basic functions as the regional auction centers. These main functions are summarized below and summarized in figure 6.2 which outlines the auction process at the regional and national levels.

Managing the auction pipeline

The NNC worked closely with the GKI, regional and federal property funds, local property committees, and the enterprises to coordinate the pipeline and to schedule those companies to be auctioned nationally.

Contracting with the seller

The NNC drafted and arranged for the signing of contracts between the regional property fund responsible for selling an enterprise, and participating property funds in other regions which accepted bids for shares through local bid reception centers. The NNC was required to invite all regions to participate in the auctioning of enterprises available for national auctions.

Developing regional participation

By the end of the program, seventy-nine regions had participated as agents in the NAS: shares of companies slated for national auctions were offered through their local bid reception networks. All regions participating in the NAS received initial training and inspections by NAS staff prior to participation in the system to ensure compliance with national auction standards and procedures.

Announcing the auction

The NNC worked with the sellers to ensure that the legal requirements for announcing auctions in the national press were met before any deadline.

Commencing the auction

Privatization plans and other essential documentation necessary for the bid reception sites to conduct an auction were delivered to all participating regions. Each region confirmed that the bid collection had commenced in their region.

Closing the auction

At the end of an auction, regions collected the applications and entered them into the standard computerized database program. The actual bids and vouchers were maintained at the local bid reception centers where application bids were offered. The summary auction data from participating regions was then carried by hand or transmitted electronically to the NNC. Upon receipt, the data was tested for accuracy and completeness prior to being incorporated into the national database for the calculation of the auction results.

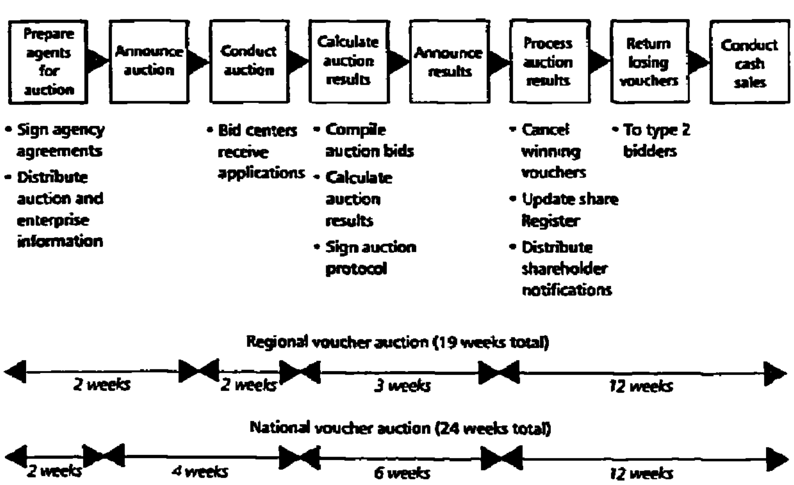
Compiling and calculating the auction

In the presence of a member from the auction commission, the NNC compiled the data from participating regions and calculated the auction results. A draft protocol with the auction results was prepared and presented to the auction commission for approval.

Processing the auction results

Following approval of the auction by the commission, the NNC prepared summa-

Figure 6.2 Sequence of regional and national voucher auctions



ry reports for the selling property fund, enterprise, participating property funds, and winning applicants. Each new shareholder was issued a notification of ownership confirming the information that was to be entered into the share registry of the enterprise. Results of the auction were announced in the Federal press. At the local level, winning vouchers were canceled and destroyed and losing voucher bids were returned.

National cash sales

In addition to managing national voucher auctions, the NNC coordinates a post-voucher auction cash sale to sell a percentage of the company's shares for cash. The proceeds from these cash sales are used to defray the costs of conducting national auctions. The percentage of shares offered for sale is the result of the difference between the amount of shares available for the voucher auction and the amount of shares actually distributed during the voucher auction. The maximum level of shares available for cash sales is the same as for regional cash sales: either 5 percent of the shares sold in the voucher auction if less than 29 percent of the enterprise's shares were put up for auction or 10 percent if 29 percent or more of the shares were available for auction.

Upon conclusion of the cash sale, proceeds are distributed to participants in the voucher auction to finance the operational costs of conducting the auction. The NNC monitors the cash auction process until all funds have been distributed. Since the inception of the National Auction System, several mechanisms have been created to implement the post-voucher auction cash sale. These include the following.

Interregional open cash auctions

The NNC has overseen the management of cash sales in up to four regions simultaneously. Cash sales typically are managed by a third party general agent including brokerage companies or stock exchanges which are responsible for organizing and conducting the cash auction. The responsibilities of these general agents include the following steps:

- Polling potential investors,
- Collecting applications and deposits prior to the auction,
- Agreeing with local agents in other regions to participate in the auction,
- Connecting the agents to a telecommunication network to conduct a simultaneous auction in multiple regions,
- Conducting the auction in an open outcry format (lots of shares are sold to the highest bidder),
- Processing the auction results, and
- Coordinating distribution of proceeds to the participating voucher auction agents.

Regional auction

In certain cases, given the relatively low percentage of total shares available for the cash sale and the limited number of potential investors interested in purchasing shares, cash sales for national auctions are conducted in the region where the selling property fund and enterprise are located. The NNC works with the local property fund or their designated agent to conduct the cash sale using one of a variety of formats:

- *Open out-cry.* The shares are divided into varying sized lots which are auctioned to the highest bidder.
- *Brokering.* Shares are placed on the exchange at a fixed price which can be modified by the broker according to the buyers' demand. This approach was used in a number of regions, with active local stock exchanges such as Vladivostok.
- *Closed tender.* During specified time periods, closed bids are accepted in sealed envelopes that are opened on the announced date by the auction commission. Shares are sold to the highest bidder in the amount indicated by the bidder until all shares are sold.

Cash sales for national auctions have generated significant funds to defray the system's operating costs. By the end of April 1994, cash sales had been conducted for seventy companies which had been auctioned by thirty-nine property funds in national auctions. These cash sales generated approxi-

Cash sales for national auctions have generated significant funds to defray the system's operating costs.

mately 7.4 billion rubles or an estimated $4.1 million. While the results for the largest companies generated the largest proceeds, the average result for national cash sales was 105,000,000 rubles or $58,500.

Conclusion

Between early 1993 and mid-1994, voucher auctions were conducted nationally and locally in eighty-six regions across the Russian Federation for shares in more than 12,000 medium-size and large companies. The successful completion of the mass corporatization and privatization of an unprecedented number of companies was the result of a number of political and economic factors. This paper has focused on the standard operating procedures utilized in the corporatization and voucher privatization programs. The use of standard program procedures facilitated the rapid and geographically far reaching implementation of voucher privatization. One of the main challenges in designing and supporting post-voucher privatization programs, including efforts aimed at providing restructuring and financial assistance to newly privatized enterprises, will be the development of standard approaches, tools, and systems which also can be widely replicated and implemented with targeted international technical assistance and financing.

Notes

The authors of this paper are management consultants with Price Waterhouse's International Privatization Group. They directed and participated in a program of technical assistance, supported by USAID, to work with the GKI in the development and implementation of the national auction system.

1. In practice it was not always possible to meet these deadlines as there were logistical and political delays in both the preparation and approval of the plans.
2. The last six months of the voucher auction program was the first half of 1994.
3. Some large enterprises below these levels were offered the option to use the National Auction System.

Next Steps in Privatization: Six Major Challenges

Maxim Boycko and Andrei Shleifer

By July 1, 1994, mass privatization in Russia was officially complete. Some 15,000 medium- and large-scale enterprises will have been privatized through distribution of shares to insiders and voucher auctions. In a situation incomprehensible five years ago, two-thirds of the Russian industrial labor force will be employed by privatized firms. Equally as astonishing, over 50 million Russians will have become shareholders in either privatized enterprises or investment funds. This transfer of ownership has been accomplished in approximately eighteen months, with relatively few major scandals or severe setbacks.

The successful sale of state-owned enterprises does not tell the entire story of economic transformation. While privatization may be labeled a success, privatization is not the goal, but a means of accomplishing a larger goal of economic development and stability in Russia. Therefore, after the transfer of ownership has taken place, a more significant change in enterprise restructuring must occur. In some instances, there are real economic successes behind these numbers as well. Most privatized enterprises have begun to restructure. They are changing their product lines, reducing employment, starting joint ventures with foreign companies, and so on (World Bank 1994). Corporate governance mechanisms are rapidly becoming established, as large investors, who accumulated their blocks in voucher auctions and in post-auction trading, begin to actively challenge and displace old-school managers. Perhaps most importantly, privatization has created a political constituency of owners who have begun to lobby the government for further reform in corporate governance, including the creation of securities markets, improved law enforcement, and other reforms essential for a market economy, rather than concentrating their lobbying efforts in favor of further subsidies.

...privatization is not the goal, but a means of accomplishing a larger goal of economic development and stability in Russia.

Yet despite these successes, privatization has only started the long and arduous process of restructuring the Russian economy, which, after all, is its ultimate goal. Most enterprises continue to be run unchallenged by the old management teams, which often lack the human capital and interest to initiate significant restructuring. While these enterprises dabble with restructuring and try new products and markets, their management is principally dedicated to preserving traditional product lines, which may have no markets, as their core activity. In many cases, enterprise managers have consolidated their control by buying shares in the aftermarket and are simply killing time hoping for a miracle (and credits). Enterprises that do want to restructure often lack the capital to move aggressively. Private markets have not succeeded in delivering capital to privatized firms, so the government continues to be the principal source of finance. Of course, with government finance, the hope of depoliticizing privatized firms is entirely in vain. Finally, the legal and regulatory environment in Russia has greatly discouraged foreign investment, which Russia needs as an important source of knowledge and capital. Despite the joy over the speed and success of the Russian privatization program, the limited progress that has been attained in enterprise restructuring, indicates that the real work has only just begun.

This slowness is both economically and politically troubling. The restructuring of the Russian economy is necessary for a successful transition to a market-based economy. Newly privatized enterprises must create jobs if reforms are to be sustainable. They must produce goods that are attractive to consumers both in Russia and abroad if production is to grow. A substantial number of privatized enterprises must show their ability to survive in private markets for the government to significantly reduce its influence on the economy. If privatization fails to deliver a substantial restructuring, its political opponents in Russia will be only too ready to renationalize the economy when they gain political power.

As long as enterprises, privatized or not, continue to address the wishes of the politicians and bureaucrats in exchange for subsidies, no genuine restructuring can take place.

Perhaps the most important factor of restructuring is that, in the short run, enterprise restructuring is essential for macroeconomic stabilization of the Russian economy. Stabilization is not just a matter of moving towards a balanced equilibrium. To succeed, stabilization requires a viable economy that can survive with limited subsidies and generate tax revenues on which the government can support itself. In recent months, the Russian government has shown an interest in stabilization, but has done very little to accelerate reforms that will decrease the social price-tag associated with it. The restructuring of the Russian economy, therefore, must be accelerated for the sake of both growth and stabilization.

Not surprisingly, both the reformers and the conservatives in Russia support enterprise restructuring. The question at issue however, is how is restructuring to occur? This paper addresses this question on two levels. The first part of this paper will broadly outline six key strategies for enterprise restructuring. Although progress in these six areas might vary in degree, it is reassuring to observe that the political conditions exist to make some progress possible in all of them. The second part of this paper discusses one of these strategies, namely the transfer of social assets from enterprises to local governments, in greater detail in order to illustrate how the broad strategies can be translated into viable economic policies.

Six priorities of restructuring

Policies that promote restructuring have three goals. The first, overarching, goal is depoliticization (see Boycko, Shleifer, and Vishny 1993 and 1994). As long as enterprises, privatized or not, continue to address the wishes of the politicians and bureaucrats in exchange for subsidies, no genuine restructuring can take place. And while privatization has gone a long way toward reducing political influence over firms, politicians continue to dominate the allocation of export rights, capital, space; and other essential "inputs."

The second goal of restructuring policies is to provide private capital to privatized firms, so that they have the resources to restructure. Undoubtedly, firms can make many improvements with their own capital, such as employment reduction and modest changes in the product lines. Yet serious restructuring requires a more substantive change in operations. It requires an influx of capital.

The third goal is to facilitate management turnover. Many managers in Russia are unqualified or ill-motivated to oversee the restructuring of their enterprises, so a change in management is a precondition for a change in operations. Barberis, Boycko, Shleifer, and Tsukanova (1994) have found that, in a sample of small-scale privatizations in Russia, complete ownership change is the best predictor of restructuring. These goals suggest six policy priorities, listed below in no particular order. It is apparent that these priorities can be implemented as viable reforms and that the political climate in Russia is ripe for them to be imposed.

Transition to cash privatization

With voucher privatization completed, the political imperative of creating millions of shareholders has vanished. As a consequence, it is now possible to move to cash privatization, which will take the form of cash sales of shares. These shares can be residual stakes that the government still owns in already privatized firms or they can be shares in state enterprises that have so far escaped privatization. The principal point is that proceeds from share issues will be, to a significant extent, retained by enterprises and can be used to finance restructuring. In the case of new privatizations, some of the cash proceeds will also be kept by local governments and by privatization authorities to increase their incentives to privatize. Prime Minister Chernomyrdin has endorsed this approach and has bravely rejected the notion that privatization proceeds should be a source of federal revenue.

Politically, cash privatization is the most sustainable approach to privatization at this juncture. It is sure to enjoy broad support of the relevant stakeholders, including enterprise managers, local officials, and Moscow politicians concerned with finding resources for enterprises in a regime of (relative) austerity. Cash privatization also addresses all three objectives of restructuring that were mentioned above.

First, cash privatization is likely to move more firms into private ownership, initiating the process of their depoliticization. Cash sale of residual government blocks also reduces the risk of local officials using their power to vote these blocks to influence privatized firms.

Second, cash privatizations in which proceeds are retained by enterprises supply privatized firms with sorely needed capital and, in this way, provide them with resources for restructuring. The need for expanding private ownership of large enterprises and building a political coalition for reform through large-scale privatization is not as great now as it was in 1992 and 1993, when mass privatization started. Rather, privatization should be seen primarily as a mechanism for getting necessary capital to firms.

Third, cash privatization speeds up the process of management turnover as suppliers of capital demand control in exchange for cash. As in Western economies, incumbents give up control only when they have to, and, as some recent surveys show, bringing in new capital may be the best way to remove control from them.

Corporate governance and legal reform

Although substantial progress has been made in improving corporate governance procedures in the last few months (such as the decree on independent share registrars), managers of privatized Russian firms in most cases remain unchallenged by shareholders. Part of the problem is that managers and workers own over 50 percent of most privatized firms. Outside shareholders often have trouble even exercising their minority rights. They have difficulty getting information, communicating with fellow shareholders, voting their shares, getting share transactions registered, and so on. Many outside investors believe that minority shareholdings in Russian companies are worthless.

The situation with creditor rights is even worse. Neither the commercial banks nor creditor enterprises have any legal mechanisms for collecting what is owed them. The new bankruptcy procedure largely ignores the creditors and gives the control rights in bankruptcy to a new government agency, rather than to the creditors who have actually lent the money.

The shortcomings of corporate governance pose severe problems for enterprise restructuring. First, many directors incapable of overseeing enterprise restructuring are entrenched at the helm, while the most obvious mechanisms for throwing them out, such as outside shareholder insurgency or bankruptcy, remain fairly ineffective. Second, the likelihood that investors will supply private capital to enterprises, given the weakness of both shareholder and creditor rights, is remote. With private capital provision lacking, enterprises rely on public capital, which, of course, preserves political control over firms. Improvements in corporate governance, including both shareholder and creditor rights, are thus essential for speeding up restructuring.

Fortunately, privatization has created a political constituency of new owners and commercial lenders who are exerting political pressure for putting in place governance mechanisms. New regulations giving outside investors more rights, including the right to vote and to transfer shares, are being implemented. These regulations will become more important as employees continue selling their shares and long run ownership structures emerge. If corporate governance regulations are sufficiently aggressive, outside investors will begin supplying capital to the privatized firms once

...cash privatization... is sure to enjoy broad support of the relevant stakeholders, including enterprise managers, local officials, and Moscow politicians concerned with finding resources for enterprises in a regime of (relative) austerity.

The weakness of the legal system has been a major deterrent to the provision of capital and know-how to the Russian enterprises.

they can obtain tangible control rights in return for their capital.

The progress with creditor rights has been excruciatingly slow, as control over bankrupt firms has been turned over to a new government agency. In fact, many would argue that rather than being labeled progress the decision to turn bankruptcy issues over to a government agency constitutes a step backward. This central agency has the power to decide whether to try to restructure these firms using government subsidies or to liquidate them. The one fundamental principle of bankruptcy, namely that of private creditor rights, has been completely ignored. As a result, the new bankruptcy procedure will not only fail to promote restructuring, it will delay it for a number of reasons. First, the enormous powers of the bankruptcy agency will only increase political control over firms, as managers beg (and perhaps bribe) bureaucrats for restructuring subsidies, rather than face the alternative of liquidation. The goal of depoliticization is thus defeated. Second, if private creditors have no rights and a government agency decides the fate of a firm, private loan markets are unlikely to develop. Third, the agency is likely to be captured by the existing management and therefore work to keep that management installed, rather than threaten the stability of their jobs. A new approach to bankruptcy that gives power to creditors instead of the government is needed if private credit mechanisms are to work in Russia.

We conclude our discussion of governance by noting that a wide variety of governance mechanisms exist around the world. Some countries, such as Japan and Germany, have developed governance mechanisms based largely on bank debt. Other countries, such as the United States, have equity-based governance mechanisms. It is not yet clear what type of system will emerge in Russia. A mechanism that gives control rights to the private suppliers of capital is essential if they are to turn resources over to privatized firms. The mode of financing that accommodates the investors' needs most efficiently will dominate.

The shortcomings in corporate governance are just a few examples of a legal problem that significantly slows down enterprise restructuring. Tax laws in Russia are inconsistent and impossible to obey, and scare away both domestic and foreign investors. Contract law does not exist and contracts are not enforced by courts. The result, of course, is that organized crime enters to protect property rights and enforce contracts (Shleifer 1994). Laws governing creditor rights and collateral do not exist, and, as a consequence, only government- and mafia-enforced lending play important roles.

The weakness of the legal system has been a major deterrent to the provision of capital and know-how to the Russian enterprises. It has been the greatest complaint of foreign investors, whose role in enterprise restructuring is likely to be prominent. The weakness of the legal system also strengthens the role of the bureaucracy as the arbiter of disputes and the protector of last resort, and so retards the desired effect of depoliticizing firms. All of these factors point to a sore need for legal reform in tax, bankruptcy, and commercial law, and in land and other reform to speed up restructuring. A genuine demand for such reforms now exists, primarily because privatized and newly private firms need legal protection and commercial laws to restructure. Critics of privatization, who argued that legal reform had to precede privatization, simply have missed the boat in their assessment of political capital. A year ago the political demand for legal reform did not exist. At this post-privatization point in the Russian economic reform process, however, legal reform is both essential and politically feasible.

Creation of securities markets

New equity issues are likely to become an important source of capital for privatized firms in Russia, in part because of continued problems with bankruptcy and creditor rights that stifle the private loan market. Many firms are already planning to issue equity, but are concerned about their ability to distribute shares to investors. These firms are providing the needed demand for the services of a securities market that can facilitate the distribution of shares. Many others need securities markets as well. Some potential blockholders need them as a way to consolidate share ownership and to buy shares from the workers. Foreign investors unwilling to participate in disorganized markets are waiting for organized securities markets before they begin investing in Russia. The time for securities markets has come. They hold the potential both to address the capital needs of the Russian firms and to facilitate corporate governance.

The difficulty in creating capital markets in Russia is to make them a mechanism of depoliticization, rather than the reverse. Many countries have opted for one centralized exchange, a choice that offers significant benefits of transparency and liquidity. In principle, one centralized exchange also can offer firms raising capital access to the largest possible number of investors. In Russia, however, establishing one centralized exchange is not desirable at this point, since such an exchange is likely to become controlled by the Central Bank or the Ministry of Finance. The result would be that a government agency, rather than market forces, would determine who gets capital. A less centralized network of exchanges, controlled by broker dealers rather than a government agency, could offer greater benefits in terms of smaller political influence at the current stage of the Russian economic reform process.

Land and real estate reform

There are several components of land reform in Russia, including the reorganization of collective farms, the creation of private ownership rights (including transferability) in small land plots used for both recreation and small-scale farming, the creation of ownership rights in land used by the enterprises, and the privatization of real estate. Over the last two years, despite President Yeltsin's forceful efforts to decree change, land reform in Russia has been systematically sabotaged by the agrarian interests and, most notably, by the State Committee on Land Management (Roskomzem). Moreover, privatization of real estate has been delayed in most instances by local governments, who view control over real estate as the most convenient mechanism for controlling both business and corruption income. Indeed, in large cities, such as Moscow and St. Petersburg, real estate is probably the most valuable asset enterprises have (as confirmed by the extremely high valuation of firms in these cities—see Boycko, Shleifer, and Vishny 1993). Not surprisingly, the governments of these cities, including Moscow city mayor Luzhkov, have passed various decrees designed to maintain government control over the leasing of real estate and to prevent the creation of private real estate markets. In this political environment, the creation of private property in urban land has been as slow as that in agricultural land.

There are several components of land reform in Russia, including the reorganization of collective farms, the creation of private ownership rights in small land plots... the creation of ownership rights in land used by the enterprises, and the privatization of real estate.

Since control over agricultural land is connected to the politically sensitive subject of food security, the bureaucracy has managed to prevent both privatization of land and registration of ownership of the existing private land plots. At the moment, it is clear that Russia is not politically ready for a genuine reorganization of collective farms. Although the government has accepted some models for farm reorganization, such as the so-called IFC model, participation in reorganization is voluntary and few collective farms will join, especially given their fear of losing subsidies. There is no serious program for mass reorganization of collective farms. Thus, for the near future, collective farms in Russia are likely to remain intact and will continue to waste an enormous amount of public resources.

At the same time, prospects for consolidation of ownership rights over personal land plots, and land under enterprises, in particular, are much better. Making the land under enterprises a private asset that enterprises both own and trade can do a lot to stimulate restructuring. First, it eliminates the principal mechanism of local political control over firms, namely the control over real estate. Not only do enterprises benefit, all others who need or have land indirectly benefit as well, as the local governments lose their monopoly over urban real estate. This will open doors for local business growth in Russia, an area where progress has been conspicuously lacking. Second, because en-

At the core of the problem with the Russian social safety net is the undeniable fact that the majority of social services are provided by enterprises.

terprises own a lot of land and buildings that they don't need, sale of this land can provide enterprises with badly needed capital (without a social cost), which they can use for restructuring. Third, land under enterprises can be used as collateral, providing enterprises with debt capital. This can be the beginning of private loan markets in Russia, as banks will begin to lend to firms if they can grab land and buildings in the event of a default. Thus, establishing property rights in enterprise land can become a very effective and productive restructuring strategy.

In Russia, the principal mechanism of urban real estate reform is registration of interests in land and real estate. Until now, control over registration has been shared by many overlapping jurisdictions, including various agencies of the local governments and Roskomzem, a conservative federal agency. However, it appears that there are now two factors that make progress in land registration more likely. First, privatized enterprises and other business interests have a genuine interest in this reform and are creating enough political pressure actually to make it happen. Second, local governments are finding themselves in great need of tax revenues. Registration of urban real estate will be a first step toward creating the most natural tax base for local revenues and, hence, conditions for real estate taxation. From a political viewpoint, the registration of real estate is more likely to happen now than it was in the recent past.

Competition policy

The principal driving force behind restructuring in most countries is product market competition. Under competitive pressure, firms change their products, reduce costs, fire incompetent managers, reduce labor forces, and take many other actions associated with restructuring. Moreover, product market competition leaves less room for political control of firms, since competitive firms cannot offer politicians the rents to dissipate on politically motivated activities, such as excess employment. For this reason, as stressed by Joskow, Schmalensee, and Tsukanova (1993), product market competition is an essential element of a national restructuring strategy.

Progress in this area in Russia has been relatively slow. The central government has imposed a variety of foreign trade barriers, including tariffs and quotas. Local governments have also caught the disease, imposing many administrative barriers to interregional trade. Both the central and the local governments have instituted a variety of licensing requirements that handicap entry. Perhaps the greatest danger is the constant risk of formation of the industrial holding companies, which aim to monopolize their industries and extract credits from the central government (Boycko et al 1993 and Joskow et al 1993). Russia does not yet have an active competition policy.

Nonetheless, even in this area there are signs of progress. First, so far the privatization agency has resisted most major efforts to form financial industrial groups. As a result, except in a few regions, such as Yekaterinburg, these groups have not taken hold on a major scale. Second, the antimonopoly agency is beginning to develop a rational pro-competition policy, that focuses on monopolistic abuses rather than on regulation of all large firms. Third, Russian trade, despite all the regulations, is expanding. While we continue to be skeptical about the likelihood of an aggressive competition policy, it does not appear to be quite as remote as it did a year ago, when Boycko, Shleifer, and Vishny (1993) wrote.

Social safety net

Perhaps the single most important deterrent to effective enterprise restructuring in Russia is the social safety net. At the core of the problem with the Russian social safety net is the undeniable fact that the majority of social services are provided by enterprises. This includes such services as housing, kindergartens, and hospitals, which enterprises provide to their employees free or at a price substantially below cost. Even unemployment insurance is now effectively paid by enterprises. From an efficiency standpoint, the logic behind this system seems incredible, as enterprises are forced to keep people on long-term vacations at very low wages, rather than lay them off. Effectively, a Russian worker now relies on his enterprise for both income and consumption, whether or not the worker is productively employed by the enterprise.

This situation presents severe problems for restructuring. First, paying for the social safety net is a tremendous financial burden that takes up an enterprise's resources that might be better used elsewhere. It also drains substantial management time, which can serve as a large cost as well. Second, commitments to the social safety net keep some potential investors, particularly foreign investors, from taking equity positions since they are afraid of the social liabilities. This might explain the prevalence of joint ventures with foreigners, rather than direct investments by them. But joint ventures are no substitute for substantial equity investments from the viewpoint of restructuring. Third, social commitments give enterprises enormous leverage in bargaining with the central government for cheap credits and subsidies. This constitutes one of the principal deterrents to the depoliticization of privatized firms. Fourth, by tying workers to firms, enterprise-provided social safety nets reduce the mobility of labor and hinder the formation of a vibrant and productive private sector in Russia. There is little doubt that restructuring in Russia is dramatically inhibited by the existing social safety net arrangements.

There are two approaches to solving this problem. The first is the creation of a social safety net, such as unemployment insurance, outside of firms. While the issue of creating an unemployment insurance program is urgent, it will only be created when significant open unemployment (above the current 2 percent) appears in Russia. As a result, this issue is not addressed below. The second complimentary approach is the transfer of social assets from enterprises to the local governments. In the next section, a method to transfer social assets is presented that is both politically feasible and potentially productive as a restructuring strategy.

Transferring social assets

Maintenance of social assets for employees, including housing, child care (kindergartens), medical care, sports and cultural facilities, and so on, unquestionably represents a substantial financial burden on enterprises. One estimate places the cost of social assets between 5 and 25 percent of total labor cost. Another estimate reports that the cost of social assets for Russian employees represents up to 80 percent of enterprise profits (Yasin 1994). In a business environment where enterprises are barely surviving, these expenses are enormous. Maintenance of social assets also consumes a large amount of top management time. Some reports indicate that directors of large enterprises spend hours organizing plumbing repairs for employee housing and kindergartens.

By far the largest expense is represented by housing, which, according to World Bank estimates, is over half of total social asset costs. (This total does not include on-the job unemployment insurance.) Enterprises subsidize the housing of their employees, including, most importantly, utilities and maintenance expenses. In some cases, enterprises own the housing; in others. they pay for it even though the housing is controlled by the local governments. Interestingly, the World Bank estimates that only approximately 60 percent of the residents in enterprise housing are employees; the rest are outsiders benefitting from the generous subsidies.

The second largest expense is on the maintenance of child care (kindergartens), which represents between a quarter and a third of the total. According to a study by the Russian Privatization Center, it cost about 25,000 rubles a month to support one child in a kindergarten in 1993. Of this, the parents paid between 5 and 20 percent, and the rest was paid for by enterprises. The key point about these numbers is that the full cost of child support is a substantial fraction of an adult's monthly income, perhaps as much as 50 percent for the less advantaged workers. This implies that a full privatization of these organizations would deprive many people of their services. This would bear tremendously harmful social costs upon the Russian populace. The same problem applies to housing, where many occupants are simply unable to afford the

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full cost of living in the apartments they occupy. In the cases of both kindergartens and housing, some subsidies are essential as part of the social support of the population.

Not surprisingly, many privatized firms have found the maintenance of kindergartens to be too expensive and have been closing them down. Moreover, in many cities, kindergartens occupy valuable real estate that enterprises would rather lease to commercial entities. As a result, the number of kindergartens in Russia has been falling. (It is important to remember that birth rates in Russia have also fallen sharply and mothers have been getting fairly extensive leave when they have children—so the demand for child care has fallen sharply as well.)

This type of financing of services by enterprises creates serious economic and social problems. When credit constraints on enterprises tighten, the first things cut are these social expenditures. The most direct consequence of this is that the government's attempts at financial tightening are made with a maximum social cost, since they immediately translate into a reduction of vital social expenditures. Further complicating the matter is the fact that the existing arrangement gives enterprises tremendous bargaining power with both the national and the local government for credits and subsidies. As a result, local governments such as Yaroslavl have been increasing their subsidies to enterprises in recent months. Of course, when local governments give subsidies to enterprises, they demand political quid pro quos that are not typically consistent with restructuring. The extreme version of this problem is that an enterprise in Russia cannot go bankrupt, since, if it does, its employees not only lose jobs, but also housing, child care, and so on. Because the social obligations of enterprises are so high, the new bankruptcy procedures probably will lead to an attempted rehabilitation of all firms using government subsidies and to virtually no liquidations.

This analysis raises the obvious question: what is wrong with the provision of social services (including unemployment insurance and housing) through enterprises? Why create new institutions that take responsibility for these services when enterprises already do the job? The answer is that public financing of social services through enterprises is extremely inefficient. This type of equation does not bode well for a country whose economic viability is intertwined with the degree to which it can successfully restructure newly privatized enterprises.

First, there is no guarantee that the subsidies are used for the social safety net only. Some undoubtedly are used to increase the production of goods that the management is dedicated to producing. Inevitably, some of the subsidies also go into managers' pockets (Blanchard 1994). Much more of the subsidy is wasted than would be the case if the money were directly dedicated to social safety net expenditures.

Second, the provision of safety net services through enterprises greatly reduces labor mobility. A person quitting a job with a firm risks losing benefits, including housing, in addition to employment. If the housing were provided by the municipality, the employee would be more likely to leave, thus providing greater efficiency in the marketplace.

Third, using enterprises as providers of social services means that enterprises must survive if social services are to survive. This is a dangerous implication for an economy where thousands of firms may be going out of business.

Fourth, social safety net commitments (perhaps even more than environmental obligations) make firms extremely unattractive investment candidates. As a result, enterprises lose access to the capital needed for restructuring. In sum, enterprise financing is a poor way to maintain social services.

The privatization program attempted to solve this problem, but it was not very successful. In the program, enterprises were given the option to transfer their social assets to the budget of the local government, if the latter agreed. In some cases the local governments have accepted responsibility for the social assets, but in the majority of cases they have refused. As a result, despite rapid progress with privatization, most social assets remain financed by the now privatized firms.

For the reasons outlined above, most people who have looked at this problem—both in Russia and in the West—have found the situation unacceptable. Indeed, a consensus proposal seems to be emerging on how to deal with the social assets. The essence of this proposal is the transfer of responsibility for social asset financing to local governments. Some versions of the proposal allow for continued subsidization of social assets by enterprises on a declining scale, even after the local government assumes the responsibility.

However, if the temptation for local governments to dump these social assets back on the enterprises is to be avoided, a clean break must be made. The link between enterprises and the provision of social services should be severed immediately. There is also an issue of whether individual social assets should become juridical persons. Alternatively, they can become part of the local government or part of some pseudo-independent corporations controlled by the local government. It makes a great deal of sense to make kindergartens and apartment buildings juridical persons, since this would greatly simplify their privatization and condominiumization in the future. This would also allow simpler mechanisms for foreign aid support of social assets. However, to advocate immediate privatization of social assets would be foolish since that might deprive too many people of access to their services.

The transfer of social assets to local governments obviously provides enormous benefits to privatized enterprises, since substantial liabilities are now gone. These firms will be in better shape to use their own resources to restructure, as well as in a better position to attract additional resources from both domestic and foreign investors. At the same time, enterprises will lose much of their political clout and, hence, the ability to obtain credits. Both the central and local governments will lose some of their interest in supporting the inefficient firms and some of them might decline significantly or even go bankrupt. This is exactly what restructuring should accomplish—it should allow viable firms to survive and nonviable ones to go under. Also, workers will be less attached to firms, therefore, labor mobility should increase. In sum, the transfer of social assets will promote depoliticization of enterprises and increase their access to private capital.

A possibly crucial obstacle standing in the way of this transfer could be firm managers. Managers understand that a transfer of social assets to local governments is, effectively, surrendering the one hostage that allows them to extract money from the government. Why would managers agree to give this up? The managers of viable firms are likely to embrace the transfer because it will free up resources they need for restructuring. The managers of bankrupt firms may, in some cases, recognize that the inevitable shift to a market-based economy will eventually doom their enterprise. Therefore, managers might accept the transfer, as the additional resources it creates would allow them to stall a little longer. In a few cases, this extra time could be incentive enough for managers to give up their hostages. On the other hand, most managers of nonviable firms will resist giving up, in which case some central government encouragement (such as a threat to eliminate credits anyway) could be in order.

The transfer of housing and kindergartens to municipal governments has to be mandatory, since they are not interested in assuming the additional costs. This raises the next question: where will the local governments get the money to finance these additional expenditures? It is quite possible that some of the main benefits of the transfer will materialize in the form of local government finance reform that will be stimulated by the transfer.

The transfer of housing and kindergartens to municipal governments has to be mandatory, since they are not interested in assuming the additional costs.

First, the local governments are likely to generate revenue by raising some prices (including prices of utilities and kindergartens). They may try to discriminate against those who are qualified to pay for the services so that only the poor are subsidized. Either way, the price under the budgetary pressure may come closer to the marginal cost.

Second, the local governments will try to raise revenue through taxation, as they have already tried in the last two years (for other purposes, including enterprise subsi-

At the same time, the problem of fiscal federalism must be addressed sooner rather than later.

dies). This is a healthy development, since the Russian government has not been an effective tax collector. One strategy for taxation will be to tax enterprises for the services the local government provides (as in Yaroslavl). An example would be the payroll tax, which makes sense since the level of services is roughly proportional to employment. An alternative way to finance social expenditures is real estate taxation. The great advantage of this is that, to raise such revenues, local governments have to expand their tax base—which, in Russia, means privatization of real estate. This reform, as mentioned above, is desperately needed.

Third, the local governments will try to use privatization as a mechanism for raising funds to support social spending. This, evidently, is what happened in Poland and the former Czechoslovakia. If this approach is adopted, privatization of real estate (the conspicuous laggard in the Russian program), will accelerate, which will give a big boost to small scale privatization and new business development. Putting social pressures on the local budgets may turn out to be the most successful strategy for getting local governments out of the business of controlling local assets.

These three types of financing are all desirable. In fact, if the transfer of social assets to local governments entails a decrease of local subsidies to enterprises, an increase in real prices charged for social services, privatization of local assets and real estate, and a switch to payroll and real estate taxation by local governments, the whole local government in Russia, and not just industrial firms, will be restructured. This would move all reform (including stabilization) rapidly forward.

Of course, in Russia, things often happen differently from what is expected. In the case of the transfer of social assets, there are two significant risks. The first risk is that local governments will simply ignore these assets and continue to spend money on other activities, such as enterprise and agriculture support (as they do, to some extent, in Yaroslavl). This strategy is probably not the greatest danger, since it is likely to lead to massive social unrest that local governments will not survive. Populist politics work in Russia in ways very similar to those elsewhere in the world.

The greater risk is that the local governments will use their responsibility for social assets to lobby the central government for more funds or for the right to retain more of the tax revenues they collect. This is Russian-style fiscal federalism, in which local governments, by threatening separatism and social unrest, extract resources from Moscow (which of course finances the expenditure by printing money). In fact, Russia's record in this regard has been dismal. Triesman (1993) provides remarkable evidence that the separatist regions of Russia have been able to extract vast sums of money from the central government. Opposing Yeltsin seems to be a reliable way to get cash. Other evidence indicates that regional governments have been keeping more and more of their tax revenues at the expense of remittances to the central government (see Freinkman 1994 for Yaroslavl.) The result is that the central government finances its expenditures—including agriculture and enterprise subsidies, defense, and so on through—inflationary finance.

There is no easy solution to this problem. Many scholars have recently expressed great enthusiasm for fiscal federalism using the example of China. They believe that this arrangement creates hard budget constraints for local governments and enterprises. Russia also has fiscal federalism, but the result has been much less satisfactory. The central government has been unable to deny subsidies to regional governments for enterprise and agriculture support. As usual, superficial analogies between China and Russia do not work.

At the same time, the problem of fiscal federalism must be addressed, and it should be addressed sooner rather than later. The fiscal relationship between Moscow and the regions, currently best described as bargaining over tax remittances and transfers, probably cannot continue in the long run. In many countries (including, for example, the United States, Italy, and China), the relationship has been determined by a kind of constitutional convention that determines the nature of cash flows between the capital and the regions. These conventions have proven to be an effective antidote for separatism. Russia desperately needs such a convention in the immediate future. The success of all economic reforms in Russia will depend on the central government in Russia negotiating a long-term constitutional agreement with the regional governments about tax remittances and regional subsidies.

Foreign aid

The previous section illustrates how the transfer of social assets from enterprises will entail significant fiscal tensions between the various levels of government. One mechanism for reducing these tensions is foreign aid. In fact, the Tokyo package that G-7 has proposed in 1993 allows for substantial amounts of aid to be used to support the social safety net. The transitional support of the financing of social assets as they are transferred from the enterprises to local governments is a very good use of these funds. It will prevent the closing of kindergartens and heat and utility cutbacks, while also facilitating enterprise restructuring. It will also, indirectly, reduce pressures on the federal budget and, hence, support stabilization.

This raises the question of how to design a foreign aid project in support of the transfer of social assets from enterprises. While such projects are still discussed on a grand scale, the Russian Privatization Center (RPC) as proposed the World Bank a $20 million pilot project (financed from the loan already allocated to the RPC) that may show how foreign assistance funds could be used to support the transfer of kindergartens. The RPC proposes to start its program in several regions. All kindergartens currently supported by privatized enterprises in these regions will be eligible. The RPC proposes to use foreign assistance funds to subsidize the kindergartens accepted by the local governments on a declining scale for three years. Over time, the local government assumes greater and greater responsibility over the finances of each kindergarten, until, after three years, it is fully responsible. Organizationally, the program turns out to be relatively straightforward to implement.

Research by the RPC estimates that the initial subsidy that may be needed to finance the transfer is $10 per child per month. If a region manages to bring 10,000 children into the program, the direct cost of the subsidy will be roughly $1 million in the first year and perhaps $2 million over three years. Note that the city of Yaroslavl had under 10,000 children in kindergartens in 1993, the city of Vladimir had under 20,000 and the city of Yekaterinburg, Russia's fourth largest, under 60,000. Not all of these children, of course, are enrolled in kindergartens supported by privatized enterprises and not all privatized enterprises will choose to join the program. Thus, even if one were to double the expenditure to take overhead and other extraneous expenses into account, the $20 million budget for the pilot can take care of about 50,000 children, which easily covers half a dozen major metropolitan centers in Russia. Recall that the total World Bank assistance to the Russian social safety net, promised in Tokyo but hitherto undisbursed, is at least several hundred million dollars.

One potential problem with this program is that it will not stick. Specifically, local governments will take the subsidies, but then renege on their commitment to finance the social infrastructure after subsidies expire and either close the kindergartens or dump them back on the local governments. This is a legitimate concern, for it underscores the need to combine this program with fiscal reform of the local government, which includes accelerated privatization, expansion of the tax base, and introduction of new taxes to finance local government expenditures. Once the local governments realize they can afford these expenditures, they might show a willingness to take them on (just as the governments in the West have), especially when they learn that these expenditures win votes.

The above analysis is not intended to be definitive. Rather, it shows that a reasonably small amount of aid, properly designed and administered, can go a considerable way toward addressing a major social problem in Russia—encouragement of enterprise restructuring—and perhaps even towards reform of local government finance. As of this writing, the World Bank has not approved the use of the RPC loan for this purpose.

Conclusion

In this paper, the priorities of the next stage of the Russian enterprise reform and enterprise restructuring, have been presented. Six major reform challenges—cash privatization, corporate governance and legal reform, creation of the securities markets, land and real estate reform, competition policy, and social safety net reform—have been outlined, and an argument has been presented claiming that the Russian economy is politically ready for these reforms on some scale. The final portion of this paper is dedicated to looking beyond the generalities in order to portray how one critical reform, the transfer of social assets from enterprises to local governments, can actually be implemented with modest amounts of foreign assistance. We can only hope that the Russian reformers are as successful at this stage of enterprise reform as they have been with privatization.

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Part Two

Capital Market Development

Capital Markets Development and Financing Russia's Transformation

Claudia Morgenstern

For Russia, the development of capital markets is a necessity, not a luxury. Given the scale of the tasks that its financial sector will be called upon to perform in the coming decade, Russia cannot rely principally on its banking sector to provide necessary financial services through classic intermediation of deposits and loans. Furthermore, the mass privatization program has produced an ownership pattern of financial assets more akin to that of countries with highly-developed equity markets. When it comes to Russia's capital markets, the question is not whether, but how to promote their healthy development.

Over the last two decades, long before "emerging markets" became fashionable, a substantial portion of the International Finance Corporation's (IFC) activities has been devoted to promoting capital markets. IFC's emphasis on capital markets development is predicated on the fact that the principal source of financing for sustainable economic development must be domestic savings. Applying experience from other emerging markets to Russia requires a close reexamination of assumptions often taken for granted. Transition economies present a number of issues that are not found in most other emerging markets. But even within the category of transition economies, it is safe to say that Russia is unique.

The objective of this paper is to examine some of the distinctive characteristics of what has been witnessed over the last year and a half, since the launch of voucher auctions. First, why is the existence of healthy and active capital markets so important to Russia's transformation? Second, what are some of the factors special to Russia that are likely to affect the process of capital markets development? And finally, an obligatory gaze into the crystal ball will attempt to identify ways in which healthy market development might be encouraged and major risks avoided.

This paper must be prefaced by several caveats. It should be recalled that almost the only safe generalization that can be made about Russia is that Russia is rarely susceptible to generalizations, and this is particularly true when talking about the beginnings of capital markets activities. Each region has its own institutional characteristics and activity patterns, with Moscow, St. Petersburg, and Vladivostok especially distinctive. Both the extreme youth and the characteristics of the emerging Russian equity markets dictate that "data" about market activities and institutions are more anecdotal than the results of formal surveys, and are more qualitative than quantitative. In addition, conditions in Russia are so fluid that any analysis of the market is partly out of date by the time it is presented.[1] The final caveat is a familiar one—that the following are personal observations which do not necessarily reflect policies of the International Finance Corporation.

...the political success of mass privatization depends on the rapid development of capital markets institutions.

The importance of capital markets to Russia

A number of factors which characterize Russia's transition economy make the development of capital markets a key objective of Russia's reforms. Each of these factors has important implications for policies that have been and will be pursued by the Russian government.

- Perhaps the most urgent reason to pay attention to Russian capital markets is

Well-functioning capital markets are also important sources of disciplines and incentives for restructuring enterprises.

that the political success of mass privatization depends on the rapid development of capital markets institutions. The mass privatization program represents an implicit contract between government and citizenry that the assets distributed in mass privatization represent meaningful property rights. Privatization has created a huge class of small shareholders, who need basic capital markets infrastructure (registrars and transfer agents, secondary markets, shareholder voting, and dividend payment arrangements) to realize the property rights they have acquired.

- Well-functioning capital markets are also important sources of disciplines and incentives for restructuring enterprises. Privatization is simply not complete without the development of a properly functioning and competitive financial sector. In its absence, enterprises will, of necessity, continue to structure their planning and operations around their ability to lobby the government and legislature for subsidies, privileges, and protections. Capital markets provide a particularly effective form of financial sector discipline. The transformation of the Russian economy requires that managers be accountable to enterprise owners, not to government bureaucrats. Small and large shareholders alike must be able to discipline nonperforming managers, either through direct exercise of voting rights or by "exiting" their investment in the secondary market, thereby threatening the value of the managers' economic stake as the market price for the enterprise's shares drops. For these reasons, Russian policymakers have repeatedly adopted rules to strengthen minority shareholders' rights.
- Of course one of the most vital functions to be performed by Russia's capital markets will be to improve the access by enterprises to new capital. Russia's young banking industry is small relative to the productive sector and quite inexperienced. Only a handful of banks are actually in the commercial lending business. The balance have been acting principally as conduits for subsidized directed credits or are, in effect, merely the corporate treasury departments of large enterprises. It is unlikely that the banks will be institutionally capable of meeting the enormous demand for financing enterprises in the coming several years. Furthermore, given the current economic environment facing Russian enterprises, most commercially viable enterprises will need additional equity. Enterprises are unlikely to have sufficient retained earnings to build up their capital base, and heavy reliance on bank lending would leave the corporate sector over-leveraged. Finally, even on the debt side, in the current macroeconomic climate, banks will not be able to provide much intermediation of term structure. Enterprises will have to look to the capital markets for an important part of their long-term financing.
- Discussion of the importance of Russian capital markets tends to focus primarily on the urgent financial needs of enterprises. But markets are a two-way street, and in Russia it is equally appropriate to take a populist view and look to the needs of the general public in promoting capital markets development. The creation of a range of reliable financial services for individuals will be a critical element of the transformation of the Russian economy—the Russian public needs a variety of ways to acquire property and provide for their own financial security. From an economic standpoint, the emergence of attractive savings vehicles is necessary to pool domestic savings for investment. Politically, the availability of reliable savings vehicles is also essential. The Russian public has seen inflation eradicate savings, destroying the most widely-distributed form of private property. Given the lack of credit for durable goods and housing, individuals who want to buy a car or a residence must save.

This is not just theory—recent economic surveys confirm a rapid increase in Russian savings. But the Russian public has no place they trust to place their savings. It is, therefore, not surprising there has been a similarly rapid proliferation of nonbank financial products, including purported equity investments such as the infamous MMM A/O, targeted at retail investors. The advertisements can be found everywhere in Moscow—on television, billboards, and even in the Metro. With eroding confidence in the government or enterprises to ensure employment or provide for old age, the public's interest in financial products like pensions and insurance is also certain to grow.

Concern about the quality of many new products was behind two presidential decrees in June 1994. One introduced truth-in-advertising standards, and the other began better regulation of the distribution of new issues and financial reporting by issuers.[2] The decrees were followed in July by accelerating pressure against apparent Ponzi schemes through a string of warnings by public officials against practices of MMM and other so-called finance or investment companies.

It remains to be seen whether the example of MMM's collapse and the government's enforcement of restrictions on advertising by MMM's competitors will have a salutary effect on the expectations and behavior of small investors. At least initially, the principal impact has been on MMM itself, not on promoters of similarly dubious retail products. The lesson learned by many Russians seems to have been that buying into pyramids can be highly lucrative, as long as you time your exit before the crash. Further government action may be required explicitly to outlaw pyramids and other fraudulent activity. The MMM episode has, however, highlighted the existence of a significant potential demand for nonbank financial products at the retail level.

- Most of the attention paid to Russia's capital markets has been devoted to equities because of the vast number of shareholders and publicly-held companies that Russian privatization has produced, virtually overnight. But important institutional innovations have also been happening in the government securities markets, with the support of a team at the Central Bank. These are important first steps in developing a range of government securities that will facilitate the conduct of monetary policy.

The more unusual role for Russia's government securities markets is likely to be in the area of municipal finance. As responsibility for services like health, education, and housing shifts from large enterprises to local authorities, there is a huge and growing demand for cash to fund these services. This desperation, when matched with the increasing appetite of Russians for nonbank savings instruments, is likely to produce an explosion in municipal bonds, many of which will be of very low quality. But if the municipal securities markets are developed with care, municipal securities could play an important role in helping local authorities manage their revenue and expense streams. Especially in infrastructure projects, where user fees can generate cash flows that, at least for Russia, are fairly predictable, like airport reconstruction or expansion, revenue bonds could make an important contribution.

- Organized capital markets will play a critical role in attracting larger volumes of foreign investment to Russia. Interest of foreign investors in making portfolio investments in Russian securities has been growing rapidly. Well-functioning capital markets will also contribute to the climate for foreign direct investment, because publicly-traded Russian enterprises will be encouraged to meet higher standards of information (especially financial reporting) and governance. As the marketplace insists on higher standards, the financial interests of Russian enterprises will create greater economic incentives for development of the Russian auditing and legal professions and the adoption of corporate transparency and governance standards, even for enterprises that are not publicly traded.
- A strong emphasis on capital markets development has the further advantage of reducing systemic risk in the rapidly growing Russian financial system. Even if banks were able to take in sufficient deposits to meet enterprise financing demands (and increase their capital sufficiently to support those deposits), such a strategy would be dangerous. With no experience in assessing commercial

The control market is not a particularly auspicious environment for the rapid development of collective institutions that make up an active secondary market...

credits and limited mechanisms to secure loans with adequate collateral, the majority of banks would have balance sheets loaded with questionable assets. This would represent a significant danger for the solvency of the Russian financial system. Encouraging the direct provision of capital by investors through capital markets instruments, rather than relying on intermediation through bank balance sheets, would help to limit an excessive expansion of risk in the nation's deposit-taking and payment systems. Of course, given Russia's decision to pursue a universal banking model, these protections will be undermined in the absence of appropriate controls over the conduct by banks of securities activities and careful surveillance of their financial condition.

Characteristics of Russia's emerging equity markets

Russia's mass privatization program is truly one of the most amazing undertakings in economic history.[3] In the course of approximately 18 months, the majority ownership of over 12,000 Russian enterprises was transferred into private hands. The number of Russian citizens owning shares in privatized enterprises or in voucher investment funds is somewhere between 30 million and 40 million. These facts alone have had, and will continue to have, a profound effect on the shape of Russia's capital markets. International bankers and investors familiar with the typical sequence of emerging markets development must take all their old, comfortable assumptions and simply stand them on their heads.

The scope of the privatization program is not the only feature of Russia's capital markets that will make its development pattern unique. A number of other characteristics are affecting the institutionalization process, especially in the equity markets. Most of these characteristics tend to encourage fragmentation rather than integration of market structures. Some of these characteristics appear to be transitory, but others will most likely be around for some time to come.

The post-privatization market is a "one-way control market"

Current share transfer activity is dominated by a post-privatization "control market," which is characterized by one-way transfer of shares from small holders who acquired their shares in privatization. Buyers are most often enterprise managers, using a variety of techniques to sop up small shareholdings. Sometimes they buy in their personal capacity. In other cases, the enterprise sets up an affiliated investment company to do the acquisition, using enterprise resources. Other closely related businesses, such as the enterprise's principal suppliers or customers, may also make up part of the insider group of buyers.

As voucher investment funds and other strategic investors have become better organized during the year-and-a-half of voucher auctions, an increasing number of share purchases have been arranged by brokers on behalf of outside investors. During 1994, these outsiders increasingly have included emerging market surfers hoping to catch the world's next great emerging market wave and longer-term foreign investors acquiring stakes in critical sectors at what appear to be, relative to fixed assets, bargain-basement prices. The potential competition between insiders and outsiders is becoming an important feature of the control market.

The control market is not a particularly auspicious environment for the rapid development of collective institutions that make up an active secondary market—particularly stock exchanges or organized over-the-counter trading systems and clearing and settlement arrangements. Despite the fact that there are more than 100 exchanges licensed to trade in securities in Russia today (down from several hundred over the last several years), virtually all trading of equities takes place off-market. Successful exchanges in most cities are those that are open to the public for the auctioning of bearer instruments, principally vouchers but recently new issues of documents purporting to represent an equity interest. Exchange-based trading is estimated to be no more than 10 percent of the transaction volume in registered shares, even for shares of companies where a control market does not dominate.

Most economic incentives faced by securities intermediaries during the control market stage operate to discourage rather than encourage collective action by market participants. There are recent signs that these incentives are starting to shift in a healthier direction, but the control market continues to create impediments to institution-building in the secondary markets. The following description of the control market, although impressionistic, may help explain why none of the existing exchanges have succeeded in attracting or stimulating significant trading volumes to date.

The brokers' principal customers, and often the brokers themselves, have little economic interest in transparency and liquidity.[4]

- During the post-privatization control market, issuers are usually not interested in having an active market for their shares. Brokers' customers (whether they are managers or outside investors) are principally interested in vacuuming up small holdings at as advantageous a price as possible. If a control battle between insiders and outsiders is possible, secrecy is also of prime interest to the broker's customer.
- A broker who is assembling blocks on behalf of a client will usually prefer to have little or no price and volume transparency. The broker's trading activity will not lure competition from other brokers (who might steal the client) or from other investors. Lack of transparency also allows the broker to achieve much more substantial spreads, and published prices can be more readily manipulated.

Control market transaction patterns do not involve turnover of securities between intermediaries, and consequently there is little "two-way trading" that would benefit from collective formalization or institutional support.

- Trading is currently dominated by one-way transactions between off-market small sellers and large buyers. Although broker-to-broker volumes are increasing, they still remain fairly rare as a percentage of transactions. As a result, there has been no great pressure to standardize inter-broker procedures and manage inter-broker counterparty obligations through collective institutions. The limited amount of broker-to-broker trading has not necessarily been bad for the long-term competitive health of the Russian securities industry. It has allowed the entry of entrepreneurs with modest capital into the brokerage business without creating concerns over the lack of prudential surveillance of financial condition by regulatory authorities. By the time conditions are ripe for a real secondary market, brokers will have had the opportunity to build up their capital base from operations. Hopefully, once efficiency gains of an organized market begin to appear attractive, brokers will also have greater incentives to introduce financial responsibility and accept a certain degree of regulation to make the system work.

Investors participating in the control market do not value the price formation function of a liquid trading market.

- When brokers use exchanges to trade equities, the exchange is rarely used as a way to find the best current price or determine a market value for the shares. Many transactions on exchanges are entered into merely, as one young Russian fund manager has put it, to "beautify" the company, for advertising or price-manipulation purposes.
- The general public does not yet seem attracted to trading gains. Most activity reflects a "bond" mentality driven by the issuer's promises of exceptionally high current payout (often plus a lottery-type premium) rather than an "equity" mentality that looks to price appreciation. The large amount of current retail activity in new issues is in response to mass advertising rather than information on the issuer's prospects. To the extent trading gains are an attraction for small investors, the gains are simply the result of the issuer's redemption practices or "market-making" activities and not the reflection

of investors' supply and demand in a true secondary market.

- Brokers acting as distributors or resellers of the new mass-distributed issues view their role either as order processors (acting for the issuer) or as wholesalers (acting for their own account). The provision of services to a customer base of potential repeat investors is rarely part of their calculus. The dealers have few expectations that investors might want to trade through them as well as buy new products, and for future sales to the same investors, the distributors rely on mass advertising by the issuer to bring them to the door.
- Analyzing the potential market value of a share is extremely difficult, given the limited financial information available on company performance, the inability to project future profitability from past performance, and the frequent desire of managers to, at best, hide cash flow and, at worst, siphon it off. It is not uncommon for managers to avoid paying dividends to make it cheaper to buy up shares from discouraged small investors and employees. Consequently, share prices often remain tied to some multiple of nominal value, since the nominal value was originally set in relation to the historical value of the enterprise's fixed assets—only quasi-reliable financial indicator available. Furthermore, most Russians' experience with securities was limited to state bonds, so they tend to endow the notion of nominal value of shares with excessive meaning, using it as a reference to establish dividend expectations and determine market value. The recent experience with vouchers, which had a nominal value but a widely fluctuating market price, will hopefully go some way to changing these expectations.

Each broker sees control of economic environment as a higher priority than operating efficiency, especially where efficiency gains would be achievable only through giving up some control over operations to others.

- It would be difficult to exaggerate the level of distrust among many market participants. Brokers are especially suspicious of collective institutions, such as exchanges or depositories, because of the potential for abuse of information such institutions could gain from having a "view of the market" or knowing about the activities of brokers.
- In order to control risk, each broker tends to develop its own trade contracting, securities delivery, re-registration, and payment procedures. Firms are reluctant to rely on outside institutions to perform these functions, even if they control those institutions, in a sense, through collective ownership. Each broker must be assured that the collective facility is as competent to perform the function as the firm's own internal staff. Currently, the back-office processing capacity in which a broker has invested is often viewed as an important source of competitive advantage. As a result, brokers are hesitant to give up this advantage when the prospective return is an increase in the overall efficiency of the market. Similarly, successful brokers have had to develop a sophisticated network of contacts that allows them to find shares and determine an appropriate price to pay for them. Unless an exchange or formal over-the-counter market can do a much better job of reducing search costs and determining market price, the brokers will continue to internalize these functions.

In most regions of Russia, brokers view their principal customers as the issuers rather than the investors. This is particularly the case when the broker is a stock department of a bank that has a financial relationship with the issuer.

- This accounts, in part, for the high degree of integration often found within a securities firm (or affiliated group). The same firm acts as broker, market-maker (in the sense either of being the principal firm advertising for sellers on behalf of a single purchaser or of using the information in the issuer's register to locate potential sellers), transfer agent, registrar, and depository.

The broker often gives away some of his services to the issuer. This has been especially prevalent in the performance of registrar functions, where the broker's objective is not to make money on the registrar business but to monopolize the transaction flow for a given issuer, making money through transaction charges, commissions and spreads, often borne disproportionately by small sellers. Clearly, such a strategy is not consistent with the establishment of an active and competitive trading market. The good news, however, is that, as the market develops in regions like Moscow and St. Petersburg, there are healthy signs of functional segregation, if not specialization.

There is no single system for evidencing ownership and transfer of securities

The most immediately visible factor in the post-privatization stage is a subject usually reserved for back-office specialists, computer system designers, and legal scholars, but which has been a topic of heated debate in Russia for the last two years. Some foreign advisers have advocated that Russia take a single great leap forward, skipping the stage of market development which relies on certificated securities to evidence ownership and effectuate transfer. They have argued that immediate introduction of book-entry systems would avoid getting Russian citizens in the bad habit of relying on documents. Russia would not have to incur the costs involved in converting to a "paperless" system at a later date, once active trading starts to develop.

Arguments for an across-the-board imposition of book-entry arrangements ignore the important economic functions that certificates perform. They also overlook the fact that a system of uncertificated securities, in order to perform the same functions as a certificate-based system, would require an immediate installation of highly sophisticated, nationwide communications and accounting infrastructure as well as a reliable arrangement for delivering confirmations and periodic account statements, which the Russian postal system cannot provide. It is often forgotten that an uncertificated system actually generates a great deal more paper than a certificated one. For a variety of highly practical reasons, in today's environment Russian investors and market participants often prefer a certificated security. Furthermore, given the uncertainty under current Russian law regarding finality of transfer of registered certificates (that is, without re-registration due to the absence of a "bona fide purchaser" rule for registered securities), a preference for bearer paper is widespread among small traders, who also find the immediacy of trading without re-registration attractive.

Arguments for an across-the-board imposition of book-entry arrangements ignore the important economic functions that certificates perform.

For a number of practical reasons, the privatization program did not require enterprises to incur the cost and administrative burden of issuing certificates for shares distributed during privatization. Consequently, privatization did result in a large number of uncertificated shares being handled by book-entry. But these book-entry arrangements are not maintained by a centralized depository set up to facilitate secondary market activity, as contemplated by the G-30 recommendations for international standards. Instead they are the responsibility of issuers and their registrars, scattered in thousands of locations across Russia, and controlled by the issuers rather than by the markets.

Realistically, it is to be expected that Russia will have, for some time to come, a number of share ownership and transfer systems operating in parallel. This is not necessarily a negative characteristic—a variety of mechanisms may more easily accommodate the highly heterogeneous nature of both the securities being issued and investor preferences. The different systems will, however, have an impact on trading behavior, the evolution of market institutions, and the ways foreign investors can enter the Russian markets. Because of their importance, they will be reviewed in some detail.

Direct holdings of uncertificated registered securities. Equity securities in Russia are, by law, required to be registered rather than bearer instruments. For at least the next decade or so, the largest number of registered shareholders will be small individual investors (employees and voucher auction winners) who own shares they received during privatization. Typically, these small shareholders will own the shares in their own name, not through a nominee. Of these shares, a substantial portion are uncertificated, because the privatization program permitted newly privatized companies to confirm ownership of shares upon the shareholder's request by the issuance of a confirmation (called a register extract) rather than by a stock certificate.

These small shareholders will justifiably expect the issuer's registrar to maintain their records of ownership and to provide the basic services of processing shareholder entitlements, such as voting rights and dividends. Sales among friends or transfers by gift or inheritance can be performed by the registered owner trotting along to the company's registrar, often located on the company's premises or at a nearby bank branch. Such nonmarket shareholders have no need to use the services of market institutions, such as a broker or depository, until the time they want to obtain a market price for their shares.

Direct holdings of certificated registered securities. A large number of Russia's citizens exchanged their vouchers for shares of a voucher investment fund (VIF). Most often these funds issued pieces of paper called certificates, with the name of the investor written on the document and entered in the VIF's shareholder register. Whether many of these documents satisfy all of the safety features that should be met by negotiable securities is highly questionable, but the documents are in theory capable of being used to effect transfer of VIF shares in the secondary market. It must be recalled that VIFs are closed-end funds, so trading in their shares is not outside the realm of possibility, and several large VIFs have taken steps to list their shares with trading markets.

The shareholdings of large investors also often take the form of direct holdings of certificated, registered shares. Investors engaged in assembling blocks of shares in privatized companies often insist on receiving confirmation of re-registration in the form of stock certificates rather than register extracts. Given the cash-on-the-barrelhead nature of the market, it is not surprising that large investors want to have their securities at hand, ready for delivery, if they decide to sell.

Indirect holdings of registered securities. It is difficult to overstate the potential for market efficiency gains if traded shares can be "delivered" by a broker merely by instructing a depository to transfer shares held in the broker's account to the account of another member of the depository. For a customer of a brokerage firm who wants to be able to move quickly to sell his shares when the price is right, maintaining the shares in the broker's custody is particularly attractive, and the costs of that custody service will be significantly less if the broker can hold the shares in street name rather than in the customer's name. Depository and custodial services using nominee arrangements are starting to emerge in Russia, and the process should be assisted by the recent depository regulations issued by the RFCSE (Commission on Securities and Exchanges under the President of the Russian Federation), which defined nominee arrangements as a valid type of custodial service and clarified rights and duties of depositories and their customers.[5]

It is unreasonable, however, to expect large numbers of shares to move immediately into nominee holdings for a variety of reasons. As mentioned above, the large majority of shareholders are small unit holders who have no need to pay for custodial services and will, accordingly, remain direct holders. The brokers are only now starting to see repeat investors as a developing client base of prospective customers. It will take a while for those customers to have the confidence in both the quality of operations and the financial strength of the brokers to be willing to leave their shares in street name. Only as the one-way control market shifts to a two-way trading market, with brokers on both sides of anonymous trades, will there be a significant need for centralized depository services to effect rapid delivery of shares.

Bearer securities. Given the difficulties in getting in and out of a company register at the time of a trade, first to confirm ownership (if the shares are uncertificated) and then to re-register the shares in the name of the buyer, it is not surprising that a growing number of bearer instruments are finding their way into the Russian marketplace. The principal use of bearer instruments is by very large offerings targeted at very small investors. The classic example is AVVA, the All-Russian Automobile Alliance, which is a shell company affiliated with AvtoVaz. AVVA was established to raise $3 billion through a nationwide distribution of shares over the next four years to finance a proposed joint venture with General Motors. This paper will pass over the merits, or lack thereof, of the company and its offering to focus exclusively on the type of security that AVVA has quite imaginatively invented and that other issuers have rapidly copied.

Russia's joint stock company regulations require company shares to be registered securities, but AVVA wanted to avoid the costs and delay of establishing a registrar and transfer agent system large enough, and with sufficient geographic outreach, to handle inputting the ownership information on all the small investors they hope would buy the shares. Furthermore, without organized trading markets hooked directly into the bookkeeper for the AVVA issue, small investors would find it difficult to transfer the securities if they were registered—under Russian law, each time registered securities are transferred it is at least highly advisable, if not legally necessary, to return to the registrar for re-registration.

AVVA's solution was to create bearer depository receipts, which can be converted into shares held on deposit with the company. The receipts have dividend coupons, which can be clipped and taken along to a dividend payment agent if and when dividends are declared. Ingeniously, the receipt also serves as a lottery ticket for a series of drawings for new cars (to be purchased from AvtoVaz with a portion of the proceeds of the offering). To reduce the incentive to convert the receipt into shares, the lottery ticket ceases to be valid when exchanged for shares. From AVVA's standpoint, the scheme has a further advantage—while the shares are on deposit with the company, management in effect has the ability to vote the shares.

AVVA's strategy cleverly appeals to several characteristics of many small Russian investors—they think of buying securities as buying paper rather than financial assets (the term for securities in Russian means valuable paper); they prefer an emphasis on current return (dividends, interest, or "guaranteed" future redemption price) rather than appreciation, an attitude which the physical dividend coupon helps to reinforce; and they prefer their "up-side" to be in the form of tangible premiums (lotteries for cars, houses) rather than as trading gains. To give some comfort to investors that the value of their investment is not being eroded by inflation, AVVA adjusts the primary distribution price of the shares upwards weekly to reflect inflation and changes in the U.S. dollar exchange rate with the ruble.

The push for bearer equity instruments is coming from a number of market participants and exchanges, who view bearer shares as a way to rapidly replace the lost trading activity in vouchers (which for most purposes expired at the end of June 1994). On the debt side, a growing number of state and local authorities are issuing bonds in bearer rather than registered form because of the lower up-front expense required to create an easily tradable security. Apart from the attractions to the investor in terms of confidentiality and tax avoidance, bearer instruments have the benefit to the issuer that they do not require institutional infrastructure to support primary distribution and secondary trading. Transfer is effected simply by physical delivery and is not dependent on getting in and out of the "book," whether a depository or the issuer's register.

There are a number of policy reasons to discourage the proliferation of bearer instruments. They create considerable costs, such as physical safekeeping, anti-counterfeiting measures, provisions for lost, stolen, or destroyed documents, and so on. In the current environment in Russia, the widespread acceptability of bearer paper would seem to be an invitation to fraud by any enterprising scam artist who produces handsome certificates issued by shell or fly-by-night companies. The difficulties in handling shareholder entitlements when equity interests are represented by bearer documents should also not be underestimated. It is likely that bearer documents will prove unacceptable to foreign investors, who will demand the certainty that their property rights will be recognized by the issuer. Finally, because bearer instruments can be transferred by anyone on the street corner or in the Metro, they draw significant activity away from the organized markets where regulation and transparency are easier to introduce because they are more consistent with economic incentives of market participants. The important market discipline, created by brokers' accountability to their customers, is completely undermined in the street-corner trading of bearer securities. By diverting retail demand into bearer instruments, registered securities are made uncompetitive, and intermediaries are discouraged from investing in the operating systems and infrastructure necessary to support the participation of retail investors in organized markets.

Most costs associated with bearer certificates are not direct costs, and advocates of bearer equity instruments do not appear concerned about how those costs will ultimately be paid. Strategies to limit the use of bearer instruments should, therefore, also address how the deficiencies in infrastructure, which bearer instruments help to overcome, can be mitigated.

There are large and immediate demands for complex infrastructure to support securities ownership and transfer

In the post-privatization stage, a major difficulty in the emergence of equity market activity has been the absence of legal rules and commercial practices with respect to evidence of ownership, registration, transfer procedures, and nominee holdings. A presidential decree in October 1993 was a major step forward in clarifying the role of securities market infrastructure institutions.[6] The decree required companies with more than 1,000 shareholders to use the services of an independent registrar. In April of this year, in its first regulations, the RFCSE chose to issue two important sets of rules on registrar and depository operations. These rules help to resolve a number of practical questions about the nature of the responsibilities of these types of institutions and the legal rights of investors, as well as give guidance on how to effect a transfer or pledge of shares.

Although the registration process remains highly imperfect, a growing number of Russian issuers and registrars have a basic understanding of the function and are beginning to perform it with some regularity. This process has been greatly assisted by USAID-funded projects, which have supported the dissemination of how-to information, demonstration registrar pilots, and development of procedures and software for registrars interested in improving their operations. Shareholders and potential investors have a growing set of shared expectations about the basic standards of performance that issuers and registrars are, in theory, obliged to meet.

Currently, there are four major concerns about the future development of the registration function:

- The function will be performed at a low standard of operating efficiency and reliability, due to the ease of entry into the business by small, unqualified registrars (often captive operations of their client issuer) and the lack of regulatory oversight;
- The fragmentation of the registrar industry will make interfaces slow, expensive, and unreliable, between the plethora of small registrars and clearing and settlement arrangements for trading markets;
- The likelihood that smaller independent registrars will not be commercially viable, both because of their lack of business experience and because issuers are reluctant to pay for the service; and
- The risk that current efforts to produce legislation governing securities issuance and trading (Civil Code, Joint Stock Company Law, Securities Market Law) will utilize legal concepts or implicitly dictate institutional arrangements which will be incompatible with emerging practice in this area.

Depositories are, in theory, one of the principal protections for small investors in investment funds, which are required, by law, to have their cash and securities handled by an independent depository. Few investment funds have followed the spirit of this requirement, and the forthcoming shake-out of the VIF industry will also probably have an impact on the depositories. Surviving VIFs will be pushed to regularize their relations with independent depositories, which will hopefully stimulate the development of this important industry segment by creating greater demand for quality depository services.

Depositories that provide services to permit more immediate trading (brokers holding securities for customers) and support clearing and settlement (depositories holding securities for brokers or other financial institutions) are also beginning to emerge.

Critical issues for depository development concern chiefly the legal principles on which the depository/depositor relation is based (including restricting potential claims by third parties to assets held on behalf of the depositor), the financial capacity of depositories, and potential conflicts of interest in the case of affiliations between a depository and other financial service providers.

In addition to actions that the RFCSE can take or encourage, the marketplace is likely to provide certain incentives for the development of both the registration and depository functions.

- Some large issuers are already demonstrating an appreciation of the importance of quality registration services. Enterprises which are interested in obtaining new capital by issuing shares have an economic incentive to assure new investors that their shares will be reliably transferrable property rights and that they will be able to enjoy shareholder entitlements (voting, dividends, and the like).
- As the volume of secondary market activity becomes more important, the demand by investors will grow for brokers to provide reliable depository services. In fact, for registered securities to be competitive with bearer securities, the development of low-cost customer accounting services will be key.
- The participation of significant foreign institutional investment in the markets will require the rapid creation of custodial arrangements that meet international standards. There are increasing indications that foreign banks or domestic and foreign joint ventures will shortly be developing services to satisfy client expectations.

The Russian payments system does not satisfy the requirements for efficient and reliable share issuance or transfer

Horror stories abound about the inefficiency of the Russian payments system, and many of the cash flow problems of Russian industry have been attributed to its inadequacies. In the last year or so, however, the Central Bank of Russia (CBR) has made strides in improving processing. Equally important, the private banking system has not stood idle but has invented a variety of ways to make funds move, principally through large correspondent banking networks that can handle inter-regional payments. Common estimates are that good funds (that is, credit to a CBR settlement account) can be moved within a maximum of three days in Moscow and two weeks inter-regionally. Nonetheless, it would be a major leap from today's payment system to a system capable of supporting clearing and settlement systems for securities that achieve delivery versus payment (DVP), especially inter-regionally or internationally, without awkward and costly pre-positioning of funds.

Horror stories abound about the inefficiency of the Russian payments system...

To date, the general unreliability of the process of transferring and re-registering shares has meant that the inadequacy of the payment system has not been a binding constraint on the development of the equity markets. Due both to the characteristics of current supply and demand and to the awkward mechanisms for delivery of securities and payment, the market is characterized by cash-on-the-barrelhead. Often, a trade is not treated as binding until physical cash and securities have changed hands. Furthermore, investors often distrust the issuer or its registrar, fearing that re-registration of a large number of shares in the name of an outside purchaser will be refused or at least delayed excessively. Accordingly, some large buyers require, prior to payment, the delivery of new stock certificates already registered in the name of the buyer. Where the transfer of a large packet of shares is involved, ingenious arrangements must be devised, sometimes flying representatives of both buyer and seller to the city where the company's register is located and using foreign banks to move the funds.

As the transfer of shares becomes more standardized and reliable, and as potential trading volume grows, the current "payment after delivery" arrangements will become less acceptable for investors and brokers alike. In order to reduce the exposure to sellers, some sort of mechanism for achieving DVP will be required. The difficulties in moving funds will then become a bottleneck to market development. It cannot be expected that the CBR will have a redesigned payment system in operation by that time, so special funds settlement arrangements will need to be developed for the equity markets which meet the safety expectations of large investors, especially foreign portfolio managers.

Russia's capital markets have a strong regional bias

As anyone who has traveled or worked in Russia will confirm, Moscow is not Russia. Apart from the political ambitions of the regions to be independent of Moscow, the sheer geographic scale and diversity of the country dictate that there will be a number of economic centers. Although Moscow will be an international money center, it is both politically and economically unrealistic to expect other parts of Russia to look to Moscow institutions to serve all their financing needs.

Just which cities will develop viable independent financial sectors is somewhat difficult to predict. St. Petersburg stands out, with its large privatization program and rapid growth in financial activity, including participation by investors from abroad and other regions. So do Vladivostok and Novosibirsk, both with major ambitions to be financial capitals of large subnational regions of Russia. The prospects for other areas are less self-evident. There is evidence of an Urals center forming around Yekaterinburg. Nizhny Novgorod hopes to develop a Volga Region market, with itself as a leader, but whether the proximity to Moscow will tug the Volga Region within Moscow's institutional domination remains to be seen. The South would seem to be a candidate for another large subnational catchment basin, but the center of that region is not obvious.

In the area of capital markets development, the regional bias of Russia's economic and political arrangements was reinforced by the fact that the large-scale privatization process was dominated by regional distribution patterns for shares. Most companies selected the privatization option that resulted in 51 percent of the shares going to employees. In addition, the organizers of large-scale privatization auctions and sellers of the privatization shares were the local property committees and funds. Although some companies went through a system of inter-regional or national auctions, the bulk of the enterprises were auctioned only in voucher auction centers located in the oblast in which the enterprise was headquartered. Some intrepid investors, particularly voucher funds, traveled to auctions around the country. But obviously, the great majority of the direct shareholders of a newly privatized enterprise are residents of the oblast where the enterprise was auctioned.

This regional pattern is likely to continue in the future for many of the medium-sized enterprises that will have public distribution of their shares. Especially in the current environment of little available information on the financial condition and prospects of enterprises, it is the "locals" who typically possess the most reliable and relevant information, with regard to both new issues and secondary trading. As was found during the voucher auction process, the neighbors and employees are likely to have a feel for what has been happening to the company's cash flow, any problems with major customers or suppliers, the company's capital investment patterns, how plans for restructuring operations have proceeded, and so forth. Furthermore, a medium-sized company may have strong local name recognition but little ability to raise its profile with investors in a national context. Yet such a company may already have a substantial number of shareholders, often numbering in the several thousands. A regional over-the-counter market to support occasional trading, like the old U.S. "pink-sheets" system, might serve these companies well, and could be organized at low cost.

There is a striking heterogeneity of issuers and investors

The foregoing comments suggest another important force pushing toward multiplicity of market structures. There is, and will continue to be, an extreme diversity in the types of companies (size, sector, current condition, prospects) with publicly-distributed shares. As foreign investors become more interested in Russia, and as financial institutions look for ways to provide a wider range of products to retail investors, the types of investors likely to be interested in investing in shares will continue to diversify.

This suggests that a one-size-fits-all trading structure is an inappropriate design to satisfy Russian requirements. These factors, combined with the natural regionalization of market activities, make a single central market, and central infrastructure supporting it, not only politically impossible and operationally and technologically impractical, but also probably not healthy for the long-run ability of the capital markets to meet the needs of both Russian issuers and investors.

Other sources of market fragmentation

Many of the factors previously discussed are sufficient to explain on economic grounds why Russian markets are fragmented, but there appear to be other sources of fragmentation as well. The last several years have seen a remarkable number of attempts to create trading institutions, despite the fact that their early profitability was highly unlikely. Russia has an absurdly high number of licensed exchanges, given the small amount of current activity. Moreover, the brokers conduct most of the limited transaction volume off-market rather than through a formal trading market. Although there has been some consolidation of exchanges, most of the reduction in number is simply due to the disappearance of money-losing structures.

This raises a troublesome question. If, indeed, a two-way trading market starts to emerge in the coming year, will brokers channel their activity into a small number of effective institutions, or will there be a proliferation of new institutions all trying to become the market (whether national or regional), the depository, the settlement organization, and so forth?

The apparent motivations behind the proliferation of trading institutions give some cause for concern. It is difficult to account for the survival of such a large number of exchanges unless they are the result of some market participants trying to dominate a particular market by imposing their structures on others. Some of this behavior may be attributable to Russian experience, when success was achieved by using influence to obtain grants or charters for economic privileges from a mercantilist Tsar or a central planner. Consequently, at the beginning of the transition process, before the potential profitability of a particular market could be determined, people with ambitions to be players organized themselves into what might be best understood as lobbying groups or clubs. They were not really interested in the immediate commercial viability of the club as a provider of services to the market. Instead, the club was established so it could stake out its position in the market-to-come and use its influence with political and bureaucratic mentors to capture a variety of privileged profit opportunities at the expense of other potential competitors.

By the current stage in Russia's economic transition, attitudes have started to shift sharply. As brokers gain concrete experience running brokerage operations, the more serious among them are thinking about who their potential clients are, how the market is

Russia has an absurdly high number of licensed exchanges, given the small amount of current activity.

likely to evolve, and how they can position themselves competitively to provide services their clients will want to buy. These brokers will demand quality services from collective institutions, and on a commercially acceptable basis. Such a shift in attitudes should, in turn, lead to a much smaller number of competing market institutions.

The danger, of course, is that some of the lobbying groups will be able to attract sufficient political and bureaucratic support so as to undermine the viability of those institutions trying to operate on a commercial basis. It is unlikely that any lobbying group will be able to succeed in creating a marketplace attractive to market participants, issuers, and investors. But such initiatives may have negative power, that is, the ability to block other, more realistic and modest initiatives.

Prospects

Given the extremely fluid conditions in Russia's emerging markets, it would be foolhardy to predict what market activity will look like a year from now. Certain factors can, however, be identified which will affect the pattern of development, for good or for ill, and which can be grouped in two main categories:

- The constantly shifting constellation of economic incentives and disincentives of Russian market players—issuers (both companies and local authorities), investors (both domestic and foreign), and intermediaries; and
- Actions taken and not taken by the Russian government and legislature.

Bilateral and multilateral assistance, both at the policy level and to support market development projects, have to date and will in the future play an important role in accelerating positive developments and consolidating gains. But such assistance can only stimulate and build on, not substitute for, undertakings of the Russian private and public sectors.

Shifting market incentives—the rosy scenario

The brightest hope on the development horizon is the apparent convergence of a rapidly rising demand by Russian citizens for nonbank financial instruments with the growing interest by enterprises to use the markets to raise new capital. Many managers are starting to realize that continued lobbying of the Duma and government will not produce sufficient financing resources for the restructuring and modernization ahead of them. Equally important is that managers who have succeeded in consolidating control positions, often through the acquisition of shares in the current control market, are now willing to see a more active and transparent secondary market in their shares develop. Sophisticated managers have realized that eventually they will have to comply with greater disclosure, fuller protections for minority shareholders, and the like. However, these managers have tried to postpone compliance with higher standards until they were comfortable that they were operating from a position of strength.

The appearance of new corporate issues by enterprises whose managements have a strong interest in active trading in their shares will be a necessary condition for the emergence of collective institutions that form an efficient secondary market. This is because it will accelerate the shift of incentives of securities intermediaries. Brokers will cease organizing their business around supporting managers' control objectives and will start to look at investors as a potential customer base.

A change in brokers' focus from issuer to investor can represent the beginning of a virtuous circle, as the desire for new product to meet the interests of investors will create an incentive for brokers to work with enterprises to bring new products to market. Broker-to-broker activity will grow, increasing the attractiveness of efficiency gains offered by collective institutions and reducing the imperative of controlling risk through internalizing all functions. Control market disincentives with respect to market transparency will be reduced. And incentives will increase to improve transparency in order to enhance the attractiveness of the market to investors.

If shifting incentives begin to produce quality new issues and the beginnings of organized trading, participation by foreign portfolio investors in Russian equities will accelerate rapidly. This in turn would provide a host of other, highly important, financial incentives for positive broker behavior and the development of market institutions, particularly in the areas of custody and clearing and settlement. Leading Russian brokers are already investigating ways to improve the quality of their services in these areas in order to meet the standards that foreign institutional investors insist upon. Participation by foreign investors would also have important benefits in generally improving the quality of disclosure and corporate governance practices by domestic issuers. Availability of foreign funds for primary offerings would reduce some of the pressures on large offerings to raise all of the financing domestically. And finally, despite the bouts of xenophobia which will no doubt continue to be reflected in Russian political debate, a high degree of foreign interest will enhance the confidence of Russian investors and improve the credibility of the markets generally.

Policy development and implementation

For the shifting incentives of market participants to produce healthy development of market institutions, certain areas of policy will require attention. Unfortunately, common to most policy issues is a set of problems that cannot be resolved exclusively on technical grounds but are part of a major debate over the structure and regulation of the financial sector. Before examining specific issues on which policy attention is required, the broader regulatory debate needs to be reviewed.

Designing a regulatory structure. Capital markets are, in an abstract sense, nothing but a set of commonly recognized rules. Unlike tangible property, financial assets have only those characteristics that society agrees they have, and they can be produced, possessed, and transferred only through recognized institutional arrangements. Some rules are found in basic law on contracts, negotiable instruments, secured transactions, and so on. Others are in special laws and regulations governing activities in the financial sector. By far the largest body of rules are the constantly evolving industry customs and practices (including rules of industry organizations such as stock exchanges and clearinghouses) that allow market participants to do business with each other efficiently.

The Russian approach to date, sometimes consciously and sometimes by default, has been to leave much of the rule development and institution-definition process to private actors. This is not to suggest that there are no Russian laws or regulations concerning the issuance and trading of securities. On the contrary, a variety of government bodies are responsible for the licensing of exchanges, securities intermediaries, and investment funds, and licenses can be, and have been, withdrawn. Brokers are subject to examination requirements. New issues of securities must be described in a prospectus registered with the Ministry of Finance or Central Bank. A growing body of rules concerning corporate governance can be found in laws, presidential decrees and privatization regulations. Ministry of Finance regulations provide a basic outline for a securities market regime that has a number of features familiar to developed markets.

In some ways, these rules have helped to shape the institutions and practices that are appearing in Russia today. But in other ways, these rules have been irrelevant to market activity. This should not come as a surprise, because people typically try to avoid or ignore rules that are incompatible with their economic circumstances or objectives. This is especially true in Russia today, where economic opportunities and interests are in a constant state of flux. There are several reasons why many of the formal rules concerning the capital markets have been irrelevant to market development. First, the rules often do not resolve basic matters regarding the issuance and transfer of securities. Most of these questions are being settled pragmatically by rapidly emerging industry practice, but on some matters there remains a fundamental legal vacuum that custom alone cannot fill. Second, compliance with law and regulations often has been unnecessary or impossible for new market participants. Russia's securities industry is going through a number of stages at an extremely rapid rate. Brokers have only recently begun to engage in certain types of primary and secondary market activities that present important questions of rule compliance. Similarly, investment funds were first authorized by regulations issued in late 1992, but only now are independent custodians starting to offer services that will allow funds to comply with the spirit of the regulations. A third source of difficulty can be attributed to the multiplicity of sources of rules—legislature, presidential decree, government decree, and ministry regulations, instructions and the like. Each rulemaking body has its own set of urgent practical problems to solve, institutional ambitions, and constituencies, resulting in a piecemeal approach to rulemaking which often creates technical inconsistencies and policy conflicts.

One of the greatest problems with the rules has been the almost complete "disconnect" with mechanisms for their enforcement. Of course, enforcement is effective only if the majority complies with the rules, so that discipline need be applied only to deviant behavior at the margin. If noncompliance is sufficiently widespread, attempts at enforcement are fairly useless. However, that does not explain the lack of enforcement against clearly deviant behavior, that is, fraudulent or obviously unsound practices. There are a complex set of factors that explain, in part, the lack of enforcement. Many of these factors seem to underlie the broader problem of introducing sensible economic regulation in Russia more generally.

Even though the laws and regulations governing securities activities contain quite a bit of detail defining acceptable behavior, the duties expressly assigned to the government regulatory authorities are typically limited to such matters as licensing or registration functions. Reflecting rulemakers' deep suspicion that government bureaucrats will abuse their authority and have little understanding of the new economic structures, the licensing procedures are mostly a matter of assuring compliance with form requirements. Similarly, authority to suspend licenses is usually on the grounds of failure to file mandatory reports or meet certain objective qualifications. Licenses are generally not taken away for failure to conduct the business in accordance with the spirit of the laws or regulations. It is easy to be sympathetic with the rulemakers' suspicion, if daily reports in the Russian press accurately depict the chaos being created by constant changes in rules and interpretation, especially by middle-level functionaries in the tax and customs services.

Without important functions tied to oversight or surveillance, the responsible agencies have usually chosen to react to problems only once they have become highly visible. Even then, the authorities have often been slow to take action, and when they do act, the outcome is uncertain. Setting aside possible corruption, bureaucratic infighting, or simple incompetence as reasons for slow response, it is clear that pursuing effective enforcement action is difficult at best. Prosecutors are overworked and inexperienced in bringing these sorts of cases, and courts are inexperienced in reviewing them. The definitions of, and evidentiary rules for, "economic crimes" such as fraud, so misused under the Soviet system, remain murky. And standing is also highly uncertain for private parties to bring suit, if they have been damaged by another person's failure to comply with regulatory standards. The reform of administrative law and the civil and criminal court system is beyond the scope of this paper, but it is part of the background for understanding the constraints on introducing a sensible regulatory regime. It also helps explain why Russian regulators seem to swing from one extreme to another—from being paralyzed to conducting armed raids of companies which are alleged to have violated the rules.

Although the process of rule development for the Russian capital markets has been fairly chaotic over the last year or so, the Russian reliance on industry practice and market discipline, rather than bureaucratic controls, is beginning to show results. A legitimate equity market is starting to appear, in which participants (brokers, investors, and issuers) have begun to place value on the quality of products and services as well as on that important intangible, reputation. Brokers are beginning to organize themselves into associations to formalize trading practices, and they are looking for ways to increase the amount of new product available for trading which meets higher standards. Similar self-regulatory functions will be played by the new clearing and settlement organizations (CSOs) being established with USAID assistance. For example, as the CSOs begin to offer more complex services to improve efficiency, such as netting, the success of the CSOs will depend increasingly on the financial qualifications and operating practices of participating brokers. The CSOs will undoubtedly need to oversee the financial condition and operations of their participants, much as is already done by several of the private bank clearinghouses that handle payments.

Despite these recent signs of progress, pressures are building for the adoption of a comprehensive Securities Market Law, together with more aggressive regulation. There is a significant range of views with respect to both the future shape of the capital markets and the manner of regulating them. The battle is not simply between those with a deeply ingrained hostility towards finance capital and those for whom an effective financial sector is a top priority. Among people who see the importance of capital markets to Russia's future, an important power struggle is occurring over such issues as institutional structure (especially the relative role of universal banks and specialized brokers), limiting versus encouraging industrial-financial linkages, government establishment of specific markets versus competition among private market structures, and the degree and allocation of regulatory control (within the government and between government and industry). Complexity is added by the multiplicity of government ministries which already claim some jurisdiction over the securities markets, or which have ambitions to do so. Furthermore, central bureaucratic initiatives are certain to be attacked from the regions, not only by market participants who do not want to be forced to use central institutions but also by local authorities with their own ambitions to build or control market structures. This configuration of conflicting interests has, to date, generally produced inaction, but in the wake of MMM, it is likely that new laws or regulations will be produced.

The lawmaking process introduces several risks for the organized equity markets that are emerging. For many aspects of Russia's infant markets, it is premature to codify appropriate industry practice and institutional structures in laws and regulations. This would not be a significant problem if rules could be drafted around basic principles or economic functions which would be flexible enough to accommodate the rate of innovation and changing economic incentives in the markets today. But compliance with form requirements plays an extremely important role in Russian lawmaking and enforcement. Premature codification on the basis of legal form rather than economic function would simply encourage the invention of clever and non-transparent arrangements that slip through loopholes or bypass the intent of the rules.

...pressures are building for the adoption of a comprehensive Securities Market Law, together with more aggressive regulation.

Of the coming battles over a securities markets law, the one which is likely to be most vigorously fought will be over the assignment of regulatory functions among government entities and between government and the securities industry. Foreign advisers have almost universally recommended a single, specialized, and professionally-staffed agency, which would consolidate regulatory authority of the securities markets and oversee the self-regulatory activities of market participants. Given the existing bureaucratic interests and other political forces that are at play, however, such a straightforward solution appears unlikely.

The outcome of this battle is unpredictable. Proposals to increase the regulatory authority of existing ministries will be opposed vigorously by many Russian reformers and market participants. Their opposition is based on the conviction that the ministries will undermine the essential contribution of capital markets to Russia's economic transformation. The reformers look to the capital markets, much more than to the banks, to ensure that financial re-

The nightmare of both Russian reformers and the new entrepreneurial class is illustrated all too vividly by the current Russian tax system...

sources will be pooled and allocated to commercially viable businesses on market rather than administrative criteria. Privatization, which is rapidly moving assets out of the hands of the state, is only the first step in the creation of a market-oriented economy. Currently much of the Russian economy resides in a neverland between bureaucratic controls and market forces. The Russian government remains dominated by structures that are obsolete but that have budgetary resources and are looking for a mission. Redeploying their staff, who have little understanding of markets but a tradition of control, is an unpromising strategy. For a generation to come, Russia will have to bear the costs of these anachronistic government structures while encouraging them to atrophy. In the meantime, there will be insufficient resources for regulatory capacity appropriate for a market economy.

The nightmare of both Russian reformers and the new entrepreneurial class is illustrated all too vividly by the current Russian tax system—a proliferation of poorly written rules administered by *apparatchiks*. Compliance by legitimate business is virtually impossible, which pushes otherwise healthy market activity into nontransparent arrangements and leaves legitimate business at the mercy of local power barons, corrupt middle-level bureaucrats, and criminals. There is considerable potential for bureaucratic interference in the markets, for arbitrary abuse of power, and for corruption when current government structures are given regulatory authority. Russian policymakers are therefore faced with a dilemma which will require a careful balance between objectives and constraints, and this in a political system which has difficulty achieving balance through anything resembling an open process.

Priorities for policy. Setting to one side policy issues that would be presented by a comprehensive securities market law, there are several areas which need immediate policy attention. Some call for disciplinary action while others have market development objectives.

The political fallout from MMM dictates that immediate attention be paid to the quality of financial products available to small Russian investors. This is not only necessary to address investor protection. Given the dominance of advertising over market information in distributing securities to Russia's inexperienced investing public, offerings by responsible issuers will be drowned out by the siren calls of Ponzi schemes.

Some product enhancement will come from the market itself. Legitimate operating enterprises interested in attracting significant domestic and foreign capital will begin to differentiate themselves in the marketplace on the basis of product quality. They will improve their access to capital by showing that they comply with international standards for prospectus disclosure, financial reporting and corporate governance. These quality standards will also become increasingly important for brokers engaged in underwriting the securities and for trading markets that want to have a reputation for reliability.

There are, however, a range of harmful activities which have been impervious to market discipline. The most common fraudulent and abusive practices today do not involve the organized markets. Instead, these scams internalize all market functions, from production, through distribution, to exit for the investor. Pyramid schemes are not harmed economically by the refusal by legitimate market participants to do business with them. An MMM is simply indifferent to such threats.

The MMM-type problem is not, however, a securities market problem, and it cannot be controlled by normal securities market regulation. Instead, it is a broader matter of fraudulent or unsound practices in the arena of retail financial products, whether they are called securities issued by a joint stock company, shares in an investment fund, deposits with a finance company, investment contracts with an insurance company, or any other form of financial promise to a small saver. Any attempt to attack this problem needs to be based on economic effect, not legal form, in order to hold in check creative Russian scam artists. The objective should be to place competition among different types of financial products on a healthy basis.

A second, closely related area will be to tame some aspects of the primary markets, such as addressing the proliferation of bearer instruments, reducing the offering periods for new issues, and controlling redemption activities by issuers. Currently, the distinction between the retail distribution and secondary trading of bearer securities is hopelessly blurred, with the concomitant obliteration of responsibility of those engaged in distributing new issues for what they sell to the public. Dealers are disciplined neither by the market, since reputation is not an asset for dealers handling bearer securities for small investors, nor by the legal and regulatory regimes.

The development of secondary market institutions is also weakened by these practices. Pricing is managed by the issuer, by frequent increases in primary offering prices during indefinite offering periods and, on the sell side, by either redemption policies or manipulation of the limited amount of secondary trading. Of course, the issuer's pricing policies are designed to attract more funds from new investors, not establish a true market price for the shares based on the value of the company or its prospective performance.

Once again, these are areas for government rulemaking because market discipline is unlikely to have much influence on the most abusive practices. In addition to causing harm to investors, these practices undermine the healthy development of the organized markets. Although street-corner markets have had a role to play in the early stages of development, they are fraught with dangers and, in the long run, they will do little to raise large amounts of capital for legitimate businesses.

A third area of policy concern is the future role of the banks in the securities industry. A number of banks have been involved in securities activity (such as acting as registrar or market maker), usually providing services to enterprises that are either a client or shareholder of the bank, oftentimes both. Those banks that have issued shares to increase their capital also use their securities departments to manage the distribution and trading of their own shares. Generally, however, Russian banks have not yet developed an active securities intermediation business in the same way brokerage firms have.

Despite the limited presence of banks in the markets to date, the more sophisticated specialized brokers are anxious about the potential domination of the securities industry by the banks once the markets start to look attractive. The larger banks are better capitalized, have access to financing through deposits, inter-bank instruments and the Central Bank, and often have important political mentors. Another source of potential conflict between banks and brokers is that banks are often the backers of securities exchanges, which transact little business but succeed in blocking other initiatives due to their greater financial and political staying power. Banks are also viewed with suspicion because of the interlocking ownership with industrial groups that are potentially some of Russia's most important issuers of securities.

Given the importance of a healthy securities industry for rapid capital markets development, the relative role of brokers and banks should be treated with care, especially because of the risks to the financial system presented by under-regulated universal banking structures. At the very least, policies should address issues such as protection of bank deposits from inappropriate securities market risk, controlling the most egregious forms of conflicts of interest, and levelling the playing field between banks and specialized securities firms.

Another area requiring emphasis is the investment fund industry. The rosy scenario for Russia's capital markets is driven by a shift in the attitudes and behavior of issuers and intermediaries in response to the interests of large investors. But healthy development in the long run will also depend on a growing appetite for investments by ordinary Russians, either directly or through collective investment vehicles. With the end of voucher auctions, the VIFs are entering a new stage of their business, and they can be either a positive force for market development or a source of difficulties. First, they should be encouraged to stop taking in new shareholders and become true closed-end funds, as required by law. The larger and more promising funds are obvious candidates for listing on trading markets. But this must be accompanied by disclosure of their portfolios and net asset value, as well as information on income and administrative expenses. Consequently, it is important that there be clarification of accounting and reporting requirements applicable to the funds industry which take into account the illiquid nature of much of the funds' current portfolios. Those funds with strong name recognition and good distribution networks should be encouraged to create new products, differentiated by investment policies and portfolio management strategy. The growing Russian financial press would certainly be an eager conduit for information on legitimate investment opportunities and market prices to the general public. Finally, the current process of consolidation of the more than 600 VIFs must be watched carefully. Although there are positive signs that the market is producing appropriate consolidation, scandals in large funds could cripple investor confidence to such an extent that the domestic demand for investments will dry up.

Russian policymakers interested in the development of the capital markets cannot limit their attention to specialized securities markets laws and regulations. The future shape of Russia's capital markets, and the degree to which they will be able to integrate with international markets and attract foreign capital, will also be affected greatly by fundamental legal reform initiatives, at the level of the Civil Code or other basic law. For example, in the area of securities ownership and transfer, the institutional superstructure must be built on a solid foundation of legal concepts, including the Civil Code definition of securities, certain principles in the general law on obligations, and the rules regarding finality of transfer, obligations and defenses of issuers and transferors, and relations between nominees and beneficial owners. Draft laws often try to use traditional concepts, which do not always serve as an adequate basis for a modern securities system, especially one involving securities that are uncertificated or immobilized in depositories. Similarly, in modernizing the Russian payments system, it will not be enough to adopt operational regulations and messaging formats that meet international standards for electronic funds transfers. Finality of transfer and allocation of risk are dependent on how basic Russian law will resolve such matters as the legal characterization of payment orders, principles governing netting, and arrangements for secured transactions and insolvency.

Only a year-and-a-half ago, Russia's mass privatization program began to create a critical mass of issuers, investors, and securities around which intermediaries have begun to organize market structures. These institutional arrangements are maturing at a remarkable pace. For market forces to continue to work, however, policies are needed to provide basic certainty regarding intangible property rights and payments, remove impediments or distortions to institutional development, and prune away the fraudulent and abusive practices that are damaging the credibility of the infant markets and making legitimate financial products uncompetitive. Development of Russia's capital markets will progress in zigs and zags, with moments of euphoria mixed with disaster. There are, however, grounds for optimism that the capital markets will begin to play their appointed role in supporting Russia's transformation.

Notes

1. A prime example of how quickly developments can take on importance is the collapse of the MMM A/O pyramid scheme, which took place between the conference at which this paper was presented and publication. Although MMM did not, in fact, involve the securities markets, it brought to the fore some important aspects of both financial products being peddled to the public and government regulation or lack thereof. Several points made in the original presentation have been expanded, given the potential impact of the MMM episode.

2. Decree of the President of the Russian Federation No. 1183, June 10, 1994. Decree of the President of the Russian Federation No. 1233, June 11, 1994.

3. Although the entire range of capital markets, from money markets through government securities to corporate debt and equity markets, will have important contributions to make to Russia's transformation, the balance of this paper will focus almost exclusively on the equity markets. The results

of Russia's mass privatization program have created a remarkable set of opportunities and problems that will occupy Russian bankers and brokers, enterprises, government policymakers, legislators, foreign investors, foreign financial institutions, and multilateral organizations for years to come.

4. Throughout this paper, unless otherwise specified, broker is used as a short-hand for a licensed financial institution acting as a securities intermediary, whether as agent or principal and whether a firm specializing in securities activities or the stock department of a bank.

5. The Commission on Securities and Exchanges under the President of the Russian Federation was formed by President Yeltsin with the appointment of its initial members in March 1993. Its eight members are representatives of various government bodies with some jurisdiction over securities activities: Ministry of Finance, State Committee for the Management of State Property (GKI), Anti-monopoly Committee, Central Bank, and Federal Property Fund. Its chairman is currently the Chief of the State-Legal Department of the President. The commission has limited authority and no independent staff.

6. Decree of the President of the Russian Federation No. 1769, October 27, 1993.

To understand securities infrastructure issues in the Russian context, a note on Russian vocabulary is in order. The term registrar is used in the RFCSE Regulations to denote an agent of the issuer, whether performing the functions (in U.S. terms) of registrar or transfer agent. The term depository includes any institution keeping securities accounts, directly or indirectly, on behalf of owners, whether the securities are held in the name of the owner or in the name of the institution as nominee. Thus, depository covers (in U.S. terms) a depository, a custodian, or a broker-dealer holding customer securities. Until the RFCSE's Regulations, the term depository was used in common parlance to describe any keeper of securities accounts, whether for the issuer or the investor. Needless to say, the regulations introduced critical distinctions in these different economic functions by defining different sets of legal rights and obligations. These distinctions are essential in any modern system for share ownership and transfer (other than those which combine registry and depository functions in a central book-entry institution, such as in the Czech Republic).

Securities Market Development and Privatization

Roger Leeds and Michael Harman

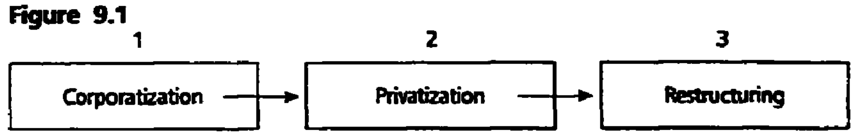
The extraordinary level of political and economic turmoil in Russia notwithstanding, the privatization program has defied the naysayers. Today, the country can boast an estimated 40 million private shareholders in companies once 100 percent state-owned. Tens of thousands of small enterprises have undergone privatization, and thousands of the larger enterprises are conducting primary share offerings and becoming publicly-traded companies in 1994. This rapid transformation has been possible largely because of the 1992 distribution of vouchers—which then could be exchanged for shares in privatized companies—to almost every Russian citizen. Despite a continuous array of roadblocks, the Russian privatization program has indeed become the catalyst for market-oriented reforms and it has established solid foundation for the development of a securities market. A widespread transformation of ownership has occurred and a new class of shareholders has been created.

With an incredible 35 percent of the Russian population suddenly transformed into direct or indirect shareholders, the importance of a viable secondary market cannot be overemphasized.

Although the voucher privatization program has been a success, a number of serious structural problems remain. Foremost among them is the absence of a functioning secondary securities market,that would permit these new shareholders to trade their holdings. With an incredible 35 percent of the Russian population suddenly transformed into direct or indirect shareholders,[1] the importance of a viable secondary market cannot be overemphasized. The public, so assiduously courted during the creation and implementation of the privatization program, will lose confidence in the process if the fundamentals for securities market development are not in place. Anatoly Chubais, Deputy Prime Minister and head of Russia's privatization agency (GKI), has correctly noted that the privatization program has been implemented so quickly because it is "understood, accepted and supported by the people."[2] However, this considerable achievement will be lost if this mass of nascent shareholders cannot soon trade their stock in a liquid, regulated marketplace. This is only beginning to happen.

The ultimate objective, of course, is to rapidly transform these thousands of enterprises into more productive, efficient assets for the benefit of their shareholders and the country-at-large. In Russia the process is well established and straightforward (figure 9.1). Although steps 1 and 2 are important prerequisites, enterprise managers must be induced to undertake the painful but essential restructuring measures that lead to enhanced enterprise performance. Herein lies the direct linkage between privatization and securities market development. Managers are most likely to change their behavior and actions to optimize enterprise performance when they are held accountable by an active, informed group of shareholders who have a vested interest in enterprise performance, and periodically have the right to vote for a slate of directors and managers who will act in their interest. Enterprise performance also is affected by access to capital at competitive rates. In large measure this depends on perceptions of future performance, which in turn is reflected by the price the public is willing to pay for the company's shares. Thus, restructuring is most likely to succeed when management is held accountable by a group of shareholders who are well in-

Figure 9.1



formed about the enterprise and have the capacity to efficiently buy and sell shares depending on their view of future enterprise performance.

As in all emerging economies, public participation on this level hinges on an active secondary securities market with a number of characteristics:

- *Information and public disclosure.* Information is of reasonably high quality, timely, and equally accessible to all market participants.
- *Intermediaries.* Market intermediaries (brokers and dealers, custodians) are well trained and handle client accounts fairly.
- *Trading.* Share trading and prices are not easily manipulated by any one party and networks of communication are sufficient to order and execute trades.
- *Registration.* Share ownership is registered to the party which actually owns the shares and that owner receives the rights to those shares.
- *Clearing and settlement.* Clearing and settlement of transactions is completed on a timely and accurate basis.
- *Regulation.* Prudential regulations governing standards of behavior for issuers, intermediaries, and investors are fair, reasonable, and effectively enforced.

When the Russian privatization program was launched in 1992, none of these conditions were in place. Assertive government intervention was required to create the basic conditions that would permit a secondary equity market to serve as a catalyst for enterprise restructuring, as well as an outlet for domestic savings. The government recognized a clear need to create an organized institutional infrastructure (that is, brokers and dealers, custodians, share registrars, clearing and settlement agents) that forms the core of the securities market. Of course, these institutional participants would require trained professional staff, technically able to record, transfer, and trade securities. And, as in all developed securities markets, there was a need for the physical infrastructure—a reliable communications network that would allow for trading to occur in a timely, inexpensive, and transparent manner. Absence of these fundamental conditions results in a predictable array of consequences, such as a lack of investor confidence, unacceptably high transaction costs, and a high incidence of fraud. In short, the system is inequitable and retards the essential task of enterprise restructuring and economic growth.

The share registry ultimately determines all shareholder rights...

To address these key problems a technical assistance program was created in 1993 by Russia's privatization agency.[3] In brief, the mandate was to rapidly create the institutional and regulatory infrastructure that would permit shareholders to easily gain access to and trade their stock, and to ensure that their holdings would be secure. This, it was hoped, would lead to broad public participation in shareholding and securities trading and would pressure the managers to undertake enterprise restructuring. Moreover, enhanced secondary market liquidity almost certainly would increase public confidence in securities markets, which, in turn, would encourage more of the public to entrust their savings to equity markets that would be channeled to capital-short enterprises. A secondary objective was to begin training a new generation of registrars, transfer agents, and other participants in the functions and operations of the securities markets.

The need for viable securities markets

A number of factors explain why Russian securities markets have not been effectively meeting the interests of either the potential suppliers or the users of equity capital. First was the nature of the privatization program itself, which inadvertently created disincentives for enterprises to raise capital through public markets, although now many have begun to do so. By mandating the sale of shares for vouchers through public auctions, a significant percentage of total equity value has been absorbed outside the markets. Moreover, most of the remaining equity, under the unique rules of Russia's privatization program, has been allocated to the enterprise employees at very attractive, heavily discounted prices. Thus, only a small fraction of total equity has been available for sale to outside investors, primarily through market auctions.

Share registration

In the absence of an efficient secondary market, once an enterprise is privatized most shares remain frozen in individual accounts because registration of ownership transfer is controlled by the enterprise managers themselves. Registration refers to the process of noting the owners of a company's outstanding shares in a registration book, or share register. The share registry ultimately determines all shareholder rights, including who should obtain dividends, updated information on the company's activities, and the right to vote for company directors and other corporate decisions at shareholder meetings. If the register is not controlled and operated in a manner that is independent from enterprise management, which is often the case in Russia, shareholders' rights are undermined. By controlling the register, the directors can effectively impede the transfer and trading of shares.

Given this role, registrars must have two important features. First, good operational and administrative procedures must be in place to ensure that share ownership is registered accurately and in a timely manner. If registration is not accurate, the wrong shareholder might be recorded and the correct shareholder's rights could be lost. Slow re-registration will reduce market liquidity by making it difficult for a new buyer of shares to quickly resell those shares to another investor.

Another key feature is that the registrar must not have a vested interest in the ownership and rights of any particular investor. If, for instance, the registration process is controlled by corporate management, the management may wish to avoid registering a shareholder who amasses enough shares to have significant control over the corporation, since that control poses a threat to corporate management. For this reason, in most developed securities markets, the registration book is controlled by an independent third party.

The Russian ad hoc system of share registration suffered from administrative problems in the early days of privatization which slowed equity trading. More importantly, there were serious problems concerning the independence of the registration process from corporate management when many corporations managed their own registration books. Several enterprise directors were said to take extreme measures to protect their own interests, such as refusing to record share transfers in the share register, physically threatening shareholders, tampering with proxy votes, and creating shareholder trust organizations to ensure that a majority of votes supported the positions taken by corporate management.

These problems were compounded by the absence of regulations and investor protection regarding the registration process. As a result, shareholders were without recourse when abuses occurred.

Clearing and settlement

While efficient share registration facilities are a necessary first step to the operation of any functioning securities market, modern markets go further. The absence of good clearing and settlement procedures, another prerequisite for a self-functioning securities market, also limited secondary market trading in Russia. These procedures assure that the contract entered into by two brokers who execute a trade results in the timely exchange of funds for securities between the two brokers. Clearing procedures ensure that the two brokers agree on the terms of the trade which is to be settled. Settlement procedures ensure that the two brokers actually exchange the funds for securities at an agreed upon time and place.

Many undeveloped markets do not have formal clearing and settlement procedures and the processes are done informally. The two counterparties to the trade review with one another the terms of the trade and then agree upon a time to exchange funds and securities. Such informal procedures increase the likelihood of settlement errors and delays due to clearing mistakes, particularly in higher volume markets. They also increase the chance of settlement failures since there are no mechanisms for sanctioning failures. If one broker fails to settle obligations, the trade is simply canceled.

In a market with low trading volume, settlement delays and failures do not sig-

Clearing procedures ensure that the two brokers agree on the terms of the trade which is to be settled. Settlement procedures ensure that the two brokers actually exchange the funds for securities at an agreed upon time and place.

nificantly upset market activity. But in higher volume markets, settlement delays and failures can cause a series of defaults by other market participants. Consequently, the likelihood of frequent settlement failures in a securities market can significantly reduce interest in share trading, particularly among foreign investors—and among domestic investors as well.

For these reasons, most developed securities markets have formalized clearing and settlement procedures that normally are operated through some type of centralized clearing and settlement organization (CSO). After a trade is completed, the documentation for the trade is forwarded to the CSO. The CSO then confirms the terms of the trade with the two brokers who executed the trade. It then makes certain that securities and funds are settled on time. In addition, most clearing and settlement organizations "net" trades—they calculate a net amount of funds or a net amount of securities that any one broker must submit to the clearing corporation to settle all of the trades contracted on any one date. Netting trades significantly reduces the volume of funds and securities that must flow from one broker to another. This, in turn, reduces settlement errors, delays, and defaults, and allows securities markets to handle higher trading volume, thereby instilling greater confidence in the market.

Funds and securities can be settled physically or electronically. The trend in funds settlement is for counterparties to settle their obligations electronically through the regular banking system. On the securities side, most developed securities markets are increasingly doing book-entry settlement. Institutions, called depositories or custodians, or the CSO itself, will store physical share certificates of shareholders and maintain a central book noting for whom they are holding certificates. To settle trades, the depository either debits or credits its book for a broker's holdings of certificates. This immobilization of share certificates significantly increases the efficiency and reliability of settlement and reduces the risk that certificates will be lost or stolen.

Not surprisingly, Russia had minimal if any formalized clearing and settlement procedures in the early 1990s. Until recently, most trades were settled on a cash basis, either privately or through brokers. There were no clearing or settlement institutions. Consequently, clearing and settlement were slow and often inaccurate, with many defaults. Moreover, there were limited facilities and procedures for efficiently clearing inter-bank credits, and there were no means for the safekeeping of share certificates. As a result, transaction costs were extremely high. These inconveniences created disincentives for broad-based public participation in the country's securities markets.

In addition to these problems, the physical infrastructure needed for an efficient securities market has been absent in Russia. Although intra-regional trading is possible if somewhat cumbersome, it is extremely difficult to execute inter-regional trades. Most importantly, telephone communication in Russia remains rudimentary, particularly between outlying regions. Moreover, there are limited facilities and procedures for efficiently clearing inter-bank credits, for settling trades or for providing for the safekeeping of traded securities. As a result, transaction costs can be extremely high and these inconveniences create disincentives for broad public participation.

Given this array of problems, coupled with the rapid emergence of a huge number of new shareholders, it is hardly surprising that pressure began to mount in Russia to improve the climate for trading securities. The loudest clamor came from the have-nots among the investing public, the small and medium-size shareholders and their government representatives. Equally dissatisfied were the growing number of investment funds that have become very popular with the public and are an increasingly influential force for securities market reform. To date, there are approximately 650 funds, and they control an estimated 40 percent of all distributed vouchers. And finally, pressure for reform has come from an emerging group of broker and dealer firms and other entrepreneurs who have gained substantial experience in the market and have a direct stake in expanding public participation. An inefficient securities market that dampens public enthusiasm is hardly in their interest.

Technical assistance for securities market development

This diverse combination of factors was the stimulus that led the Russian privatization agency (GKI) to accelerate implementation of a technical assistance program to promote the development of efficient securities markets. The immediate priority was to design and implement a program that would provide Russia with the necessary institutional and regulatory infrastructure for securities markets to operate more efficiently, and to protect the rights of the millions of new Russian shareholders who are struggling to understand and use the new markets. More specifically, the program was designed to:

- Support the development of an effective and efficient securities market regulatory framework and of government and quasi-government regulatory institutions.
- Accelerate the development of the securities market infrastructure—an essential prerequisite for achieving broad public participation in the market—through the creation of model frameworks and procedures for independent share registration, securities transfer and safekeeping arrangements, and guidelines for secondary market trading and settlement. All agreed that this reform must occur, not only in Moscow, but in other important regional centers across the country as well.
- Create specific institutions to serve as pilot organizations for security settlement and cash clearing operations. Such organizations are critical to resolving liquidity constraints and to building the public faith in the secondary market.

With these broad objectives, the privatization agency turned to foreign technical experts to rapidly undertake the design and implementation of a results-oriented work program. Overall, more than 100 foreign specialists and Russian professionals would be directly involved in this pioneering effort to stimulate rapid securities market development. Sequentially, the work proceeded in the stages shown in figure 9.2.

Strategic assessment: Addressing the needs of stakeholders

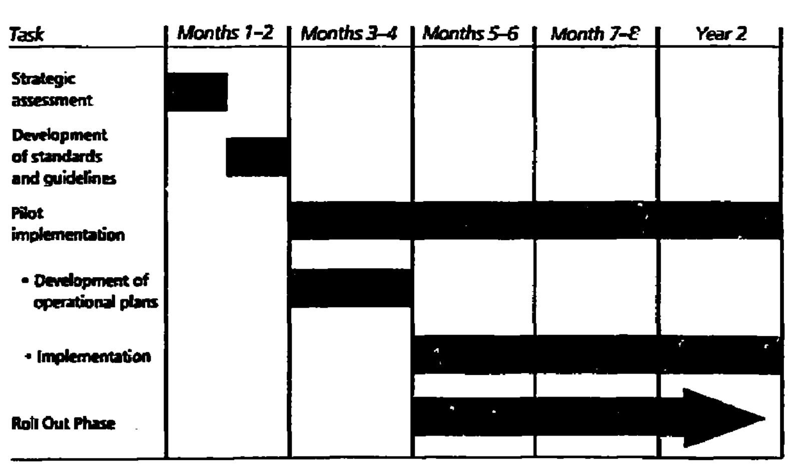
The strategic assessment portion of the assignment—the diagnostic phase—identified the specific nature of the constraints that were inhibiting the market reform process in Russia and recommended an action plan for implementing practical solutions to these constraints. Given the extraordinary regional diversity of Russia, interviews were conducted with officials and market participants from the geographically strategic cities of Moscow, St. Petersburg, Ekaterinburg, Novosibirsk, and Vladivostok. In each of these cities there is at least some financial infrastructure and a reasonably high level of voucher activity.

A representative sampling of institutional participants, such as banks, brokers, and investment funds, offered opinions about the most important constraints to the development of the market and made suggestions as to how they might be overcome. This preliminary stage focused on gaining first-hand knowledge from the key institutional stakeholders in the securities market and on mapping out an implementation strategy that would be practical, relatively simple to implement, and responsive to their needs.

Of all the institutional representatives interviewed, three groups play the most prominent role in the market, and hold the greatest stake in the development of a functioning securities markets: brokers and dealers, investment funds, and commercial banks.

The immediate priority was to design and implement a program that would provide Russia with the necessary institutional and regulatory infrastructure for securities markets... and to protect the rights of the millions of new Russian shareholders...

Figure 9.2 Work schedule



The influence of Russian investment funds also has grown very quickly.

Brokers and dealers. As members of the largest category of independent security registrars, brokers and dealers are key to breaking the control that enterprise managers have maintained over the registration of their firm's shares. If brokers can induce the enterprise managers to cede control of the registrar function, they are in a strong position to stimulate secondary trading.

For example, one of the more successful firms of brokers and dealers, located in the Moscow region, is OLMA. Originally an investment advising company founded in the late 1980s, the firm now employs over 100 people and maintains eight Moscow locations. Having convinced several large issuers of the importance of having an independent registrar, OLMA holds the registers of nine privatized enterprises. Through its affiliate organizations in thirty-five cities, OLMA has been involved in the issue of 200,000 shares via auction, and in the collection of over one million vouchers. In the secondary market, the vast majority of the firm's activities have been in transactions related to issues for which they hold the register. For example, OLMA is considered the market maker for both TsUM and Cosmos, two of the most significant issuers in Moscow. It is unlikely that the current volume of trading activity in these issues would have occurred if the share registrar had remained with the enterprises.

Investment funds. The influence of Russian investment funds also has grown very quickly. An estimated 40 percent of all vouchers are controlled by these funds, which quickly have become an important mechanism for Russian citizens to participate in the privatization process. The explanation for the popularity of the funds is clear—investors exchange the right to use their vouchers to obtain shares in one enterprise in favor of an opportunity to invest in a diversified portfolio, managed by well-informed professionals. Some of the investment funds—relatively large pools of investment capital, with strong market research—are considered to be among the first Western style investor groups to emerge in the Russian market. Due to their market knowledge and significant position, their views were an important input to the strategic assessment.

Alfa-Capital, for example, is one of the largest investment funds in Russia, with more than 1.5 million subscribers in their first closed-ended fund offering. Due to a strong initial performance, the firm has started to establish a position of influence in the marketplace. Alfa has significant blocks in twenty-two issues and sits on the boards of four enterprises. As with the other leading funds, as the management of Alfa Capital has gained control of select enterprises it has begun to use its influence to force restructuring. Recent publicity over the proxy battle to remove the management of the Bolshevik Biscuit Company, in which Alfa Capital maintains a large minority share, has brought the importance of investment funds to the attention of management and government alike. This is precisely how the architects of Russia's privatization program hoped it would work—a core shareholder with a significant financial stake in an enterprise's performance gains control and serves as the catalyst for much needed restructuring.

From the perspective of the securities market infrastructure, these investment funds can fulfill a very important role. With their own requirements for controlling sales and registry through national networks, Alfa Capital, for example, maintains relationships with 600 representative organizations in 200 cities. Their systems can easily be adapted to become clearing houses and third-party registers for other enterprises. The further development of the securities market will only contribute to the success of the investment funds. By taking advantage of low share prices and improved security and liquidity in the securities market, investment funds are expected to become significant players in the future Russian market.

Commercial banks. Starting several years ago from a centralized system with a single state bank, the commercial banking system now includes 2,000 banks registered in Russia. Although, the numbers are deceptive because most of these banks maintain less than 100 million rubles of capital

($60,000)[4] and therefore have little impact on the securities market. There are still a sizable number of larger banks with over 200 million rubles of capital that play a significant role in the market. Based on the German universal bank model, the commercial banks hope to develop in all arenas of the financial market. Some already are providing a full range of commercial and investment banking services to their clients.

As their wealth and influence have continued to expand, these national banks have become ideal candidates to fulfill the independent registrar function. The additional costs to the banks of providing these services are insignificant relative to the opportunity to broaden the range of services they can offer to their corporate clients. As a result, a new and significant provider of registrar services has emerged.

As another indicator of the growing interest in securities markets, some banks also are becoming partial owners of most exchanges. For example banks participated in the creation of the Moscow International Stock Exchange (MISE), the Russian International Money and Stock Exchange (RIMSE), and even in the Alfa-Capital Investment Fund. At the same time, as the attractiveness of banking has become more apparent, other securities markets players have begun to examine seriously the industry as a possible new line of business. Several brokers and dealers in St. Petersburg and Moscow, for example, have applied for banking licenses and some of the larger funds report that they too may petition the Central Bank for limited banking licenses.

The strategic assessment identified two fundamental problems that need to be addressed in the near term. First, the analysis clearly revealed that enterprises restricted access to the register for the re-registration of shares and used this control to limit share trading, which severely arrested the development of the securities market and impeded much needed enterprise restructuring. Second, the lack of a structured and transparent clearing and settlement mechanism greatly retarded the evolution of the markets. To correct these problems a series of concrete recommendations were made to the privatization agency.

Consistent with these recommendations in October 1993, President Yeltsin signed the Decree on Measures to Provide for the Rights of Shareholders. The decree made significant strides towards the establishment of a legal framework for a transparent securities market. These included provisions that all enterprises with over 1,000 employees would be required by law to use a third-party, independent register; that a shareholder's right to have ownership changes recorded in the company register in a timely manner would be protected; that there must be regular dissemination of information on investment funds and ownership issues; and that the concept of nominee ownership be introduced (by which a financial advisor is allowed to hold a single general account on behalf of clients). The decree was less successful in establishing effective enforcement mechanisms, a problem that continues to undermine the effectiveness of the established safeguards.

As another indicator of the growing interest in securities markets, some banks also are becoming partial owners of most exchanges.

Guidelines for independent registrars and a pilot program

The Russian financial institutions most affected by the October 1993 decree were the registrars. In order to provide technical support to this fledgling category of enterprises that were becoming increasingly important to the success of securities markets, the first task was to develop guidelines and requirements for share registrar operations. The documentation was extensive. For example, it included general descriptions of the function and purpose of registrars, procedural descriptions for manual operation of a registrar, the information to be tracked in the register according to international standards, and suggestions of appropriate methods and formats for future electronic communication between enterprises, banks, and registrars, domestically and internationally.

Pilot implementation: A national network of registrars

Once the operational guidelines were in place, the next task was implementation on a pilot basis. The immediate need was to put in place a set of institutions that would

National registrars are typically independent organizations created to service a single large issuer, usually a large investment fund, larger broker, or super-regional bank.

satisfy the functional guidelines and specifications and serve as an example that could be replicated by other institutions throughout the country. The first challenge was to rapidly create a network of independent share registrars. Once selected, each model registrar was provided with training, computers, and software to increase their shareholder capacity and to ensure compliance with the recommended guidelines.

After surveying a representative set of active registrars, pilot organizations were selected on the basis of an objective set of criteria designed to pinpoint those that had the potential to become model registrars. Three classes of registrars were identified, each with distinct characteristics. From each of these categories pilots were selected.

National registrars. National registrars are typically independent organizations created to service a single large issuer, usually a large investment fund, larger broker, or super-regional bank. These organizations maintain strong national reputations and are able to service and attract large national issuers. However, they do not become registrars to make a profit. Rather, they become registrars to strengthen their ability to control the trading activity in the market for specific issues. For banks, being a registrar also becomes an additional means of attracting new business and is another step along the road to becoming a universal bank.

Regional registrars. These are often brokers or smaller banks that provide registrar services to a few regional issuers who are quite active in the oblast's or larger geographic region's markets, but who raise little national interest. As with investment funds, these organizations become registrars in order to serve as the market maker on local issues. Constraints to growth are usually related to a lack of technical understanding of registrar operations and procedures. This could be remedied though the pilot program.

Community registrars. Community registrars are designed to support small issuers that are not large enough to warrant the attention of national or even regional registrars, but that are required to maintain their share register with an independent registrar. Because the profitability of running these local operations is questionable, community registers are usually associated with local or national government institutions that are able to underwrite the group's activities. A logical choice would be one of the institutions created to support the national voucher auction process. For most of these types of organizations, the education and implementation process begins at ground zero. There is little or no experience with or even exposure to the concepts and operations of a register.

Once the pilot institutions were selected, each was provided with technical assistance to ensure that they could operate according to the defined functional standards and guidelines. After an initial discussion and a review of the basic intentions of the technical assistance, a series of meetings were conducted to present the concepts and issues raised. At that point, a more detailed audit of the operating procedures was conducted for each pilot institution, including an investigation of the capacity to undertake both manual and electronic procedures.

After the current condition of the enterprise was determined, the business planning process began as an iterative process between expatriate technical experts, the enterprise management, and the local consultants. The result was a realistic work program for each pilot institution. A multitude of operational issues were considered, including the quantity of enterprise issues available in the region, the registrar's competitive advantage in the market, possible regional expansion, and projections on market growth. Detailed operating targets for the first year were agreed upon and a marketing plan was developed to achieve these goals. Finally computer hardware and software requirements were assessed and assistance was provided to install the appropriate systems.

The final portion of the registrar technical assistance program was to determine and resolve training needs. For the regional and local registrars the training needs were fairly straightforward and standardized training classes could be organized to meet their needs. For the national registrars the training needs were more sophisticated. Standard training programs ranged from the more pedestrian overview of registrar activities and functions, to more detailed courses on fee structures and marketing programs.

To ensure that this ambitious initiative would be sustainable after work on the pilots is completed by year-end, a Registrar Support Center (RSC) was created. Designed to serve as an information clearing house for issuers, registrars, and related organizations, the RSC is funded initially by donor financing, but eventually will become self-sufficient through member and user contributions. The RSC is expected to keep track of issues and legislation related to registrars, as well as to organize seminars and training programs and to test new software products. It is hoped that this type of self-sustaining support service will become the model of how an industry advisory organization can provide ongoing support effectively to the financial community and serve as a single source for timely and accurate information.

Roll-out phase

Based on the practical experience gained during the pilot stage, a "roll-out" was designed in 1994, to replicate the project throughout the nation. The roll-out will rely increasingly on the experiences of Russian consultants who have participated in the pilot implementations alongside foreign experts. Moving into geographic regions beyond the scope of the original project, these consultants will provide services to other organizations that wish to become independent registrars. A schematic of the registrar implementation program is provided in figure 9.3.

Clearing and settlement organizations

A similar progression of steps was followed to create formalized clearing and settlement organizations and depositories strategically located throughout the country.

The operations of the CSO are straightforward, as illustrated in figure 9.4. Assume that Investor 1 decides to sell shares to Investor 2. Investor 1 contacts his broker, Market Participant 1, who sends a sell transaction to the CSO. Likewise, Investor 2 contacts his broker, Market Participant 2, who in turn sends a buy transaction to the CSO. At the close of the trade day, all trades are matched and settled. Data (such as price, number of shares, and terms of settlement) are confirmed, and the trade declared matched. At that point, the CSO reduces

Figure 9.3 Registrar implementation plan

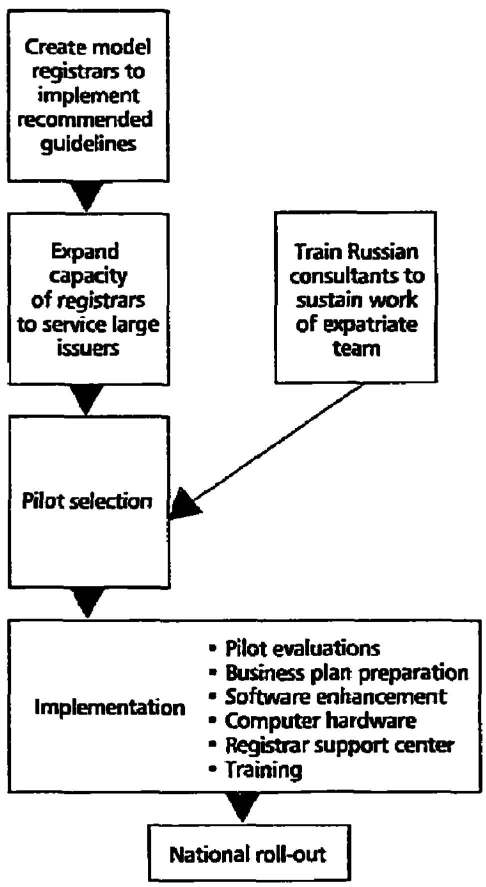
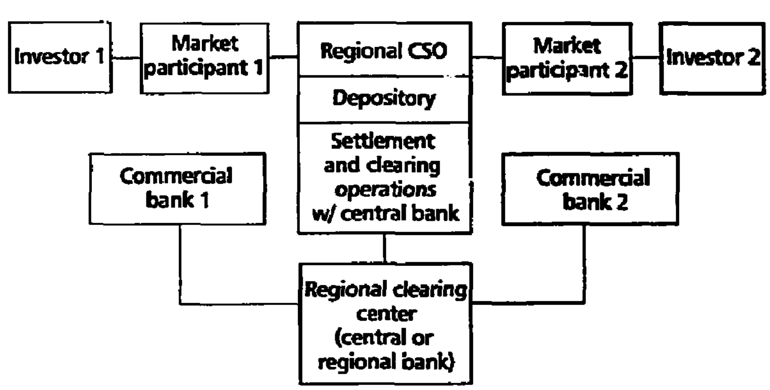


Figure 9.4



the nominee account for Market Participant 1 and increases the nominee account of Market Participant 2 by the number of shares indicated in the transaction. Once the day's batch processing is completed, a single consolidated financial adjustment notification is sent to the settlement bank to net the financial positions of market participants for that day. Since all accounts are held at a common bank, settlement of cash occurs very quickly.

This structure provides a much safer and more efficient method for the settlement of shares traded than does the current system of physically transferring cash and securities with each trade. The stocks never physically leave the CSO, and cash needs to be transferred only via electronic or paper transfer order. As a result, it is expected that members will be able to trade in higher volumes, with less risk of default on payment and reduced settlement costs. Demands on the banking system—currently overburdened by the volume of payment orders—also will be reduced by providing a single consolidated transaction for each member organization. And the common depository will provide a general safekeeping facility in various issues.

The implementation phase of the CSO project required the identification of possible pilot organizations in the selected cities and the establishment of ties with the prominent financial organizations in the region. Only after bringing these financial market players together in a common member agreement did the CSO start to evolve. In this way, the approach to CSO creation was developed specifically to address the needs of the Russian market.

The CSO framework developed for Russia will be feasible as long as the volume of trades remains low, which is likely to be the case for a significant period of time. Eventually, however, the CSO will advance from a paper-dominated environment to an electronic mechanism for matching and settling trades. As with the registrar portion of the project, a detailed technical evaluation of each region's potential trading volume was undertaken to determine the eventual computer configuration that would be required to support the organization. In both Moscow and St. Petersburg, the first two CSO sites, the programming effort already is under way and will serve as the model CSO system to be rolled out to other regions.

Regional versus national implementation

As with the registrars, CSOs will be established on a region-by-region basis rather than through a single national system. This is the only practical solution since inter-regional cash settlement can take months because of extremely poor communication links. Although somewhat more efficient, intra-regional transfers can require several days as well. The proposed regional approach to CSOs takes advantage of the stronger regional links and supports the expected heavy regional trading patterns. With the exception of a few strategic national issues, early evidence suggests that the public is interested primarily in securities trading on a regional level, and there is little likelihood of significant of cross-regional trading until the national communications networks undergo vast improvements.

By the end of 1995, the technical assistance project intends to establish a series of CSOs positioned in geographically significant locations across the Russian Federation. Each organization will function under identical governance structures and participant requirements, with identical computer or manual procedures. At some point in the future, once the national banking system and the telecommunications network become more efficient, there are plans to link CSOs' activities between regions, thereby establishing a seamless, electronically-linked national securities clearing and settlement system.

Until this more advanced system arrives, however, members that want to trade in the issues of another CSO must have correspondent bank accounts in that region. Trades then will be transmitted electronically between CSOs. But settlement of funds will have to occur locally to meet settlement timing requirements. An explanation of the interim solution is presented in figure 9.5.

Once the national system is functional and fully automated, settlement can occur through the central bank. This more permanent solution, projected for a time when the nation's communications infrastructure is modernized, will, in practice, resemble the schematic of the regional CSO itself. The only additional information required in the national system will be fields to track the location of the bank and the security accounts on trade transactions and bank settlement transactions.

Conclusion

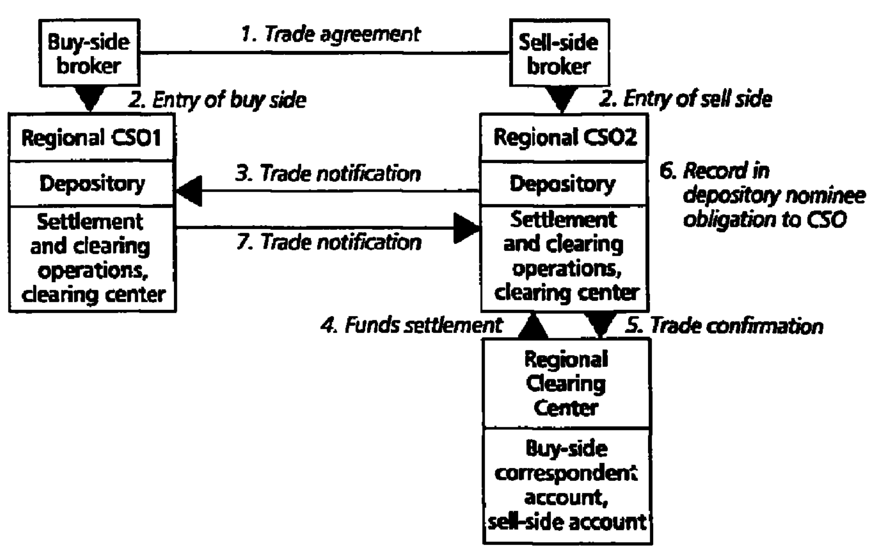
The creation of this basic institutional and regulatory infrastructure that provides the essential foundation for efficient securities market trading is inexorably linked to the ultimate success of privatization in Russia. If most medium-size and large enterprises are going to survive in Russia, they must undergo significant restructuring and they must expand their capital base. Both of these achievements hinge upon the willingness of segments of the public to participate in equity markets, which will occur only if they believe that the markets are reasonably safe, efficient and fair.

Attainment of this level of confidence, and therefore participation, requires that the marketplace satisfy a number of reasonable investor expectations. They must, for example, have access to reliable information about the enterprises on a timely and equal basis so that they can make investment decisions; they must have a high level of comfort so that trades can be consummated relatively quickly, easily, and safely; and, they expect their vote to count for something—they expect to be able to hold managers accountable for enterprise performance. When these basic conditions can be met, there is every expectation that broad segments of the population will be prepared to risk their savings to participate in the equity markets.

The recent experience in Russia provides encouraging evidence that a well-designed and adequately-financed program of technical assistance can make a difference. Close cooperation between the government (the privatization agency), a foreign donor (USAID), and a core of highly trained foreign specialists working effectively with Russian counterparts has led, in a reasonably short time period, to a set of tangible results that contribute to the dual objectives of securities markets development and enhanced private enterprise performance. By March 1994, after about eight months of work:

- The capabilities of fifteen registrars in seven cities had been enhanced, allowing them to meet the basic needs of more than 10 million shareholders;
- The Registrar Support Center that eventually will be self-sustaining was up and running, providing an institutional anchor for future training and other assistance to existing and newly-created registrars;
- A core of local specialists and consultants were trained and in position to continue the roll-out of new registrars in other regions;
- A network of four regional clearing and settlement organizations was established, each with identical governance structures and participant requirements;
- The initial securities market regulatory framework was put in place, although a considerable challenge remains to expand the scope of regulation (that is, information disclosure) and upgrade enforcement capabilities; and
- The fundamentals are in place for a gradual transition from a regional to a national securities trading system.

Figure 9.5 Inter-regional clearing and settlement operations trading



Know-how has been transferred, some new institutions have been created, and others significantly upgraded. The public is gradually gaining confidence in securities markets and the early evidence suggests increased market participation, directly or indirectly. Although, of course, there is much to be done before a single, electronically-linked national securities market is a reality, the fundamentals now are in place, which has given an immeasurable boost to the achievement of the nation's privatization goals.

Notes

The authors wish to thank Jonathan Bulkley and Alison Harwood for their significant contributions to this paper.

1. Compared to only 19 percent in the U.S.
2. *Wall Street Journal,* December 19, 1993, p. A5.
3. The project was funded by the United States Agency for International Development (AID), and executed by private consultants, including the authors.
4. As of May, 1994 the exchange rate was 1,800 rubles to the dollar.

Part Three

CORPORATE GOVERNANCE AND RESTRUCTURING

Ownership, Governance, and Restructuring

Joseph Blasi with assistance from Darya Panina and Katerina Grachova

In Russia, senior managers of enterprises implement privatization. Who, then, is better qualified to comment on the progress and problems of privatization? From August 1992 to March 1994, on behalf of the Russian Center for Privatization (RPC) and Russian State Property Agency (GKI), 150 interviews were conducted in 150 different enterprises, with general directors and senior managers of privatized firms—a small but significant sample of 7,000 medium-size and large enterprises that had participated in voucher privatization by February 1994. Interviews were also conducted with local privatization officials. Their insights on issues previously discussed with general directors provided the opportunity to cross-check observations made by the directors. The interviews covered 2.1 percent of the enterprises participating in the privatization program. Themes discussed were financial statistics, inter-enterprise relationships, current ownership patterns, desirable patterns, corporate governance, labor-management relations and labor shedding, plans and problems for restructuring, credit, needs for technical assistance, and general observations of the privatization program.

This paper distills from the interviews' basic concepts and trends and offers a textual analysis of these interviews. Our findings are based on a statistical analysis of the employment and current ownership information for 127 enterprises in thirty-three regions and on the analysis of the twenty-five most recent enterprises visited in seve -gions during February and March of 1994. As research is still in progress, and ten to twenty new enterprise interviews are being added weekly, it was decided to freeze the research in two recent periods. Where the answers to questions have been almost uniform across all 150 companies, the entire sample will be discussed.

The twenty-three interviews conducted before April 1993 were in enterprises in the process of considering or filing documents for privatization. Most had completed their closed subscription, but not their voucher auctions. The 127 interviews from April to March 1994 were carried out in enterprises which had completed their voucher auctions and were nearing the end of the first phase of the privatization process. The interview data provide additional quantitative information not examined in program-wide statistics and provide direct feedback about privatization methods and post-privatization developments inside the enterprises in the senior managers' own words. This information is of general interest. It is also of specific utility to officials at the GKI and the RPC to help with policy analysis, regulatory changes, and further planning and to serve as a basis for outside policy advice and analysis to the GKI and the RPC.

Most of the 150 interviews were in what Russians classify as medium-sized enterprises (that is, more than 500 employees) with an average of 2,800 (median 1,200) employees. Thirty-three or 38 percent of the eighty-eight regions in Russia were visited. The city of Moscow and the Moscow region were two of the thirty-three regions examined and no other enterprises within a three hour drive from Moscow were included in the study. The other thirty-one regions chosen were intentionally well-off the beaten path. Five were in Siberia or adjacent to Siberia, six were north of Moscow, ten were south of Moscow, five were due east, and five due west. The researchers repeatedly varied requests to local officials so

At the same time that managers and workers were making decisions, following the procedural rules put forward by the GKI, and filing the necessary documents, they or their representatives in trade unions, industry associations, and parliamentary factions... were bitterly denouncing the privatization program.

that they could not easily control the type of enterprise being presented. For example, the team requested specific enterprises focusing on a far away town or one industry group or they requested general directors unfriendly to privatization. Without exception, officials of every region and town chosen eventually responded positively to the fact that someone was sent from Moscow who was willing to patiently sit and listen to their ideas and those of their local industry leaders. This simple fact removed most barriers.

Did enterprises cooperate?

> The state must not have any ownership. The state must not be involved in the structures that make profit. In all countries with a developed economy, the state is financed only by taxes.
> —*Senior economist, steel plant for machine building, Moscow area*

Clearly, the answer is yes, because most firms rapidly corporatized, chose closed-subscription options, and went through voucher auctions. That they would do this was not initially obvious to observers inside or outside Russia. At the same time that managers and workers were making decisions, following the procedural rules put forward by the GKI, and filing the necessary documents, they or their representatives in trade unions, industry associations, and parliamentary factions, along with the communist and nationalist extremes, were bitterly denouncing the privatization program. Twenty-three interviews were conducted before voucher auctions began in December. These discussions contain repeated and strong denunciations of privatization, criticism that rules and regulations were unworkable, claims that the (short) schedule to complete privatization was unachievable, and talk of plans to change the direction of the program through political action. Yet, almost every enterprise completed the process, more or less on time. Indeed, even enterprises where respondents were most critical produced a detailed written privatization plan, which usually followed the outlines of the program as put forward by the government.

Why this contradiction? One obvious explanation is that those who feared the consequences of privatization and opposed any change from a state-owned system, nonetheless, saw that it was preferable to control the divestiture process rather than have it controlled by external agents. Thus, they condemned the program at the same time that they implemented it. It was a case of following the rules while trying to undermine them.

The litmus test of enterprise managers' support is their attitude toward state versus private ownership. Almost all enterprises still have the state as part-owner after privatization, since most property funds hold "golden shares" or are preparing "packets." Golden shares are stakes the local property fund held back in enterprises in the hope that they could be sold for a higher value later. Packets refer to ownership stakes that the local privatization authorities expect to sell at future voucher or cash auctions or at investment tenders. The average amount of the enterprises' shares still held in state hands (by the Federal Property Fund) after privatization was roughly 17.6 percent. The ownership stake held by the state is reduced by about 5 percent to 12.9 percent when one takes into account Fund Acktzionirovania Rabotnikov (FARP) shares that are as yet unpurchased, but reserved for workers. The Russian Parliament added to the privatization program the right of workers to purchase an additional 5 to 10 percent of shares using FARP. When asked to specify how much state ownership would be optimal, most senior managers answered zero; in fact, less than 5 percent of those 150 general directors interviewed defended any future ownership role of the state in their enterprises. Thus, despite continued criticism of privatization, almost all senior managers overwhelmingly support the basic principle. Nevertheless, most general directors expressed mixed feelings about the specific mechanisms of this particular privatization program by freely offering their ideas for redesigning the entire program.

Ownership results

According to GKI's 1992 report, 63.7 percent of all enterprises going through the program chose closed subscription, that is, majority employee ownership; 70.7 percent of medium-sized firms and 60.8 percent of large firms also chose that option. About 55 percent of the 127 post-privatization enterprises in our sample chose option 2; but a significant 45 percent went for option 1, which does not give employees and managers quick control of enterprises. Why? Part of the answer is that in larger firms it may be difficult for workers to raise the funds to apply option 2. But, it must also be realized that insiders can fairly easily achieve majority employee ownership no matter which closed-subscription option they choose due to subsequent opportunities to buy shares in various auctions. Instead of serving as two distinguishable forms of ownership (one majority insider and one majority outsider), the options have instead served as two mechanisms to achieve similar goals for insiders.

Thus, the initial decision on which option to choose is not motivated by majority employee ownership. The reason is that most of the enterprises achieved majority employee ownership anyway, no matter what option they initially chose. Rather, it is motivated by an evaluation of means. The decision is based on many aspects of the situation: whether majority employee ownership can be quickly and easily secured after option 1 by buying more shares in auctions or on the secondary market; whether employees and managers can afford to pay the higher price for option 2; the perception by the workforce that option 1 shares are a better deal because they get 25 percent of the shares free, a discount on another 15 percent, and pay only the pre-inflation enterprise value; how strong the desire is to gain immediate control of enterprises before other mechanisms for selling shares to outsiders kick in; and the perception (real or imagined) of immediate threats to the control of outside buyers of shares. Of the 127 enterprises studied after privatization, 90 percent achieved majority employee ownership. Of the thirteen enterprises or (10 percent) whose current ownership at the time of the interview was not majority employee ownership, seven had originally chosen option 1 and six option 2. The reduction in ownership in the six enterprises that originally chose option 2 reflects sales of shares by employees to outsiders.

Although the price of shares is a better deal under option 1, most enterprises still choose option 2. This is evidence that the overwhelming concern is for majority ownership. Of course, the more the liquidity or access to finance that insiders had, the greater the likelihood of enterprises choosing option 2. As inflation increased, insiders found they could use resources in enterprise accounts to make a cash purchase, and this is precisely what they did. Indeed, many enterprises reported that they easily effected the purchase and had resources left over for participation in voucher and cash auctions.

What was the ownership pattern after privatization? Enterprise managers were asked to describe the current ownership of their companies. The average total employee ownership in the interviewed firms, including FARP (which is essentially a supplementary employee share ownership opportunity) is about 65 percent; without FARP it is about 63 percent. As noted, few enterprises that had chosen option 1 or option 2 failed to achieve majority employee ownership. In the case of firms that chose option 1, insiders bought more shares on the voucher or cash auctions and repurchased shares from outsiders who participated in voucher or cash auctions.

Among the 127 post-privatized firms, the average equity stake owned by top management is about 8.6 percent (median 5 percent). The average outsider (nonstate) ownership stake is about 21.5 percent (median 20 percent). A significant number of enterprises (57 percent) achieved sizable outsider stakes (20 percent on average) and individual citizens acquired meaningful stakes. Blockholder stakes are defined here as those comprising of more than 5 percent of stock. It is the 43 percent of enterprises without blockholder stakes where there is a potential for consolidation of shares in the coming months (tables 10.1 and 10.2).

What do these numbers say about the results of privatization? They provide a powerful explanation of how, with a seventy-year history of communist control of enterprises and state ownership, the GKI managed to privatize 7,000 medium-sized and large enterprises in less than two years. Indeed, insider ownership incentives seem to explain why the grass roots of Russian society across most regions cooperated. Senior managers favored majority insider ownership, over any kind or structure, as the initial form of ownership because they favored separation from the state.

Privatization equals mafia ownership, said Ruslan Khasbulatov, former Speaker of the Russian Parliament...

Privatization equals mafia ownership, said Ruslan Khasbulatov, former Speaker of the Russian Parliament, who repeated it frequently on Russian television before his arrest in October 1993. Careful study of the data, however, suggests that sweeping claims that privatization has been hijacked by the Russian mafia is open to serious question. In our interviews, enterprise general directors were asked to identify major outside buyers of shares. In more than 90 percent of the cases, they were investment funds registered with the government, companies with previous ties to the enterprise, identifiable specific Russian or foreign investors, or individuals in the local community. The assertion of mafia ownership or control was never made by enterprise managers. While mafia interests may be lurking behind some ownership agents, the data does not reveal such an involvement.

What accounts for the gap between claims of mafia involvement and the facts on the ownership distribution in the enterprises? In interviews where the word mafia was mentioned, it became clear that many senior managers consider this a catch-all phrase to describe any unknown, unwanted, or unpredictable outside buyers who might threaten their control of the enterprise. This desire to tightly manage change is understandable given the decades of state ownership and control and the acute uncertainty of what will happen after privatization, but it is inconsistent with an efficient market economy.

Substantial employee ownership in the majority of enterprises also disproves the claim that insider ownership was a goal of the privatization program that no one intended to achieve. That is, throughout 1992, many enterprise directors and supporters of employee ownership said that the government's claim that the program was in the interests of workers was a fraud, because it did not provide employees with sufficient access to credit for shares, and because employees and managers would never be able to buy a controlling stake. Some Western supporters of employee ownership took up this issue and repeated the claims. This criticism was featured prominently in the pre-privatization interviews (before the spring of 1993). While insiders in some bigger enterprises could not fund 51 percent of the shares under option 2 immediately, there were very few where a dominant insider stake of 40 to 51 percent was not easily achieved after the voucher auction.

The real argument about employee ownership is whether the 7,000 largest nonmilitary enterprises in a big economic power like Russia should be closely held companies, controlled by small groups, or open, public corporations with potential for investor involvement and ownership stakes by all citizens of Russia. Enterprise managers saw 100 percent ownership as a way of ensuring that their firm would not become

Table 10.1 Distribution of share ownership
(percent)

	Average	*Median*
All insiders	65	60
Top management	8.6	5
All outsiders (nonstate)	21.5	20
State	12.9	12

Table 10.2 Distribution of outsider stakes
(percent)

Enterprises with blockholder stakes	57	
Enterprises without blockholder stakes	43	
	Average	*Median*
All enterprises in the sample		
Blockholders	11	6
Individual citizens	4	1
Only enterprises with blockholder shares		
Blockholders	20	15
Individual citizens	7.2	5.7

a public corporation easily open to unwanted investors. When they did not succeed in making the privatization program equal, 100 percent inside ownership, they used a variety of methods to make sure that they achieved majority employee ownership and insider control. Despite the fact that they served as straw men in the arguments about the ownership format of privatization, the opposites of the ownership spectrum—closely-held companies with many owners—do not represent the only options for these firms.

The issue of management support for employee ownership is more than academic. A purported government plot threatening employee interests and ownership motivated the Russian Parliament to consider radical changes to the program in February 1993, and again in October 1993. In February, a wide-ranging public discussion took place on a fourth closed subscription option that would allow 90 percent of all enterprises to be purchased on state-given credit at purchase prices that were not adjusted for inflation. This option would virtually eliminate the voucher program by allowing only 10 percent outsider participation. Large blocks of stock would have been put in trusts whose dividends and votes were controlled by senior managers (Blasi 1993). This proposal failed to win approval after a tough public fight was waged by the Deputy Prime Minister Anatoly Chubais and the GKI.

In October 1993, in an attempt to "recover the good features of option 4," there was a proposal patterned on the American ESOP (the Khasbulatov proposals) that would allow employees and managers to borrow money from the Russian government to repurchase the shares bought by outsiders (Rutgaiser 1993). Again, these shares were to be held in trust and voted by the general director. The proposed law would eliminate outside ownership entirely and destroy the voucher program; but the bill was never introduced because it was overtaken by the other events of October 1993.

A most surprising fact arising in the interview is the low percentage of top management ownership in the enterprises, an average of 8.6 percent. This is hard to explain given the overwhelming desire of managers to control their firms. Frustration over the low level of top management ownership is a major message in almost every one of the 150 interviews. Most managers that discussed this problem pointed to four reasons for low top management ownership. First, they lacked personal funds to participate in closed subscription, voucher, or cash auctions to the desired extent. Second, nonmanagement workers would have been upset if managers acquired large stakes. Third, managers felt that the government undercut them by not providing them with special deals in order to acquire equity. And fourth, a few senior managers felt that tying up their money in a firm's shares was less important than controlling shares by marshaling their influence with workers or getting a friendly investor they could influence.

There is no question, however, that general directors expect to consolidate and expand their holdings. A small survey of twenty-five enterprises in seven regions of our sample showed that 52 percent of senior managers had plans to repurchase employee shares (two general directors did not answer the question posed). Moreover, 32 percent of the senior managers had plans to organize a trust to collect and vote the employee shareholding, use proxy voting to maintain control over the shares (one-third of the general directors refused to answer this question).

Privatization has achieved more employee ownership than in the U.S. stock market, which has more employee ownership than any Western stock market...

Privatization has achieved more employee ownership than in the U.S. stock market, which has more employee ownership than any Western stock market (Blasi and Kruse 1992). In the U.S., 7,000 firms in the market have less than 5 percent broad-based employee ownership. But employee ownership has been growing with an average of about 15 percent employee ownership in roughly 1,500 of these corporations, and the set of firms with employee ownership greater than 20 percent is rapidly growing. Some defenders of more insider ownership in Russia claim they are emulating widespread employee ownership in the U.S., which is, of course, incorrect. The senior managers gave inaccurate and exaggerated statistics about U.S. employee ownership that provided their argument with the necessary legitimacy and to cover their desire to have significant ownership stakes for top management.

Optimal ownership

Top management was asked how they would design the ownership of the firm to maximize the efficiency of the enterprise. The results are revealing (table 10.3).

...enterprise managers... believe that substantial top management ownership is necessary for the efficiency of an enterprise... and that, in Russia at the present, outside investors cannot or will not play this role.

Top managers' main complaint with post-privatization ownership structures is that they have a small stake. Managers universally want to increase their stakes (and gain control) and drastically reduce broad-based worker ownership. The percentage reduction in employee ownership, managers propose, is on average 33 percent (median 26 percent). The proposed percentage increase in outsider ownership is on average 5.5 percent (median 10 percent). Management would like to see its own ownership stake increase by an average of 31.4 percent (median 25 percent). This data tends to confirm the widely held notion that general directors wish to personally control their companies. Indeed, they wish to control most of the top management ownership stake, although data on the general director's optimal ownership for himself (or herself) was not available for each company. When asked what the total optimal rank-and-file employee stake should be, general directors indicated roughly 15 percent. This is an interesting coincidence, given the U.S. average for rank-and-file employee ownership stake is 15 percent in public companies with employee ownership.

This data calls into question the sincerity of intensive campaigns by managers, ostensibly in support of expanding employee ownership in general, and making it easier to secure employee ownership through state-provided credits in particular. Clearly, ownership agendas (such as the option 4 and the Khasbulatov proposal) were simple attempts to cloak managers' self-interest, (which the public would have had a hard time swallowing) with the mantle of almost complete employee control through near total insider ownership; the ultimate result would have been the end of the voucher program by giving additional credits to employees to repurchase all the shares that had been awarded to outsiders.

In both option 4 and the Khasbulatov proposal, the general director of the firm would be the sole trustee of employee-ownership shares, with full voting control over these shares. Option 4 also gave managers income over the dividends of many of those shares. As noted, many enterprise managers are designing share buyback programs to repurchase employee shares and to consolidate and expand top management holdings. It is too early to tell, however, whether management-dominated trusts or simply purchases of shares from workers will be the dominant method of attempted top enterprise manager control over these corporations. Against the back-drop of these agendas, it is an impressive achievement that the government's program managed to hold top management ownership to such reasonable levels and to introduce substantial levels of outside ownership. In addition, the program resulted in small levels of state ownership, and the government succeeded in holding back legislative proposals to expand insider ownership even more in 1993.

In their part, enterprise managers offer an economic analysis to support their claims. They believe that substantial top management ownership is necessary for the efficiency of an enterprise on the reasoning that large enterprises need single or core groups of influential owners, and that, presently, outside investors are unwilling to play this role. There is some logic to this argument. Managers do not, however, generally know or appreciate the role that stock market investors and independent boards play in developing a well-functioning firm.

Table 10.3 Optimal ownership of post-privatized Russian enterprises according to the senior managers.
(percent)

	Average	*Median*
Optimal employee ownership (excluding top management)	32	35
Optimal top management ownership	40	30
Optimal outsider ownership	27	30
Optimal general director ownership	31	20

Note: A textual analysis of all 150 interviews confirms these trends. An updated analysis of all data will be available in March 1994. Top management is defined by the general director as the top five to ten members of the executive team.
Source: Summer 1993, January and March 1994 samples of 74 enterprises.

More than three-quarters of the interviewed enterprise managers say that they truly believe the largest Russian companies should optimally be more than a third owned by the top five to ten managers. Witness these statements:

> The problem is not with private ownership but with the ability to control employees. It is possible to have 51 percent owned by employees and the rest given to managers in a voting trust that gives management the possibility to control the enterprise. Managers must persuade the state that they can really manage and if managers run the enterprise properly the state should sell them shares at nominal value. Managers would work hard for their ownership in order to get shares from the state. I think that almost all would support that the government would sell them shares under this method. And there is one more feature. Shares should be owned by management professionals. Now they are bought by people who have nothing in common with production who got their money from trade operations. This is a negative feature that prevents the development of production.
> —*Textile factory, Kursk*

> The optimal distribution of ownership would be for top management, employees and the outside investor who brings a lot of money, for each have a third of the company.
> —*Electronics plant, Yaroslavl*

> Managers should get at least 25 percent of the shares. By this I mean the top ten people. The employees should have 25 percent of the shares and the rest should be in the hands of citizen, preferably equal amounts to two to three suppliers of the firm.
> —*Food-processing plant, Nijny Novgorod*

> The optimal structure is for 40–50 percent to be in the hands of suppliers and customers who supply raw materials and buy our machines. Our enterprise would be open to foreign and domestic investors and we would reserve 20 percent for them. The rest 30–40 percent would be distributed among the employees of the enterprise but top management should get the majority of this, say 30 percent.
> —*Metal products plant, Voronezh*

> Look at the situation we have today. The top management has only 5–10 percent of the shares and the labor collective has 30–40 percent. They are shareholders but they are not ready to consider themselves as owners. The enterprise needs a real owner. It is evident that those who feel themselves responsible for their enterprise and interested in increasing profits will concentrate big amounts of shares in their hands in order to control the company.
> —*Clothing plant, Tver*

> In reality, we want at least 60 percent to be concentrated in the hands of the top managers and the rest to belong to small outsiders. Employees are interested in dividends but not investments but managers are more interested in big programs for the development of the plant. It is better when all shares are accumulated in the hands of several owners.
> —*Steel plant, Vologda region*

Top managers were almost uniformly negative in their evaluation of broad-based employee ownership. They consider majority employee ownership to be a transitional phenomenon. In general, many top managers have plans (or hopes) to develop employees into responsible shareholders. This is somewhat disingenuous given their own spirited attacks against the government's motives for including employee ownership in the program and how it operates. The private opinions of enterprise managers are interesting, given the respectful public tone surrounding both the option 4 and the Khasbulatov employee ownership initiatives:

> We want to create a controlling shareholder group and we have a strategy to accomplish this by the end of the year. We will start buying shares sold to our

employees through the closed subscription and sold to them on the voucher auction. The optimal ownership structure is for the top managers—fourteen people in our firm of 1,100—to have a majority of the ownership of the enterprise. Now all employees are shareholders but not an owner. Employees you see are not the same thing as an owner. I would say that top management would have no more than 60 percent while the general director himself should have 33 percent of the shares.
—*Department store, Nijny Novgorod*

Attitudes about management ownership favor sole proprietorship and closely-held companies whose shares are not traded on exchanges.

Nothing changed with employee ownership. The ownership of every employee is too small and we do not suspect there will be significant dividends. Employees started working better but it is not because of employee ownership but because of unemployment.
—*Steel plant, Cherepovetz*

Such enterprises should belong to one person, but our employees will not understand this. They are interested in their salaries but not in the management of the enterprises. They do not want to have a headache because of the problems of the enterprise since they have a lot of their own problems. But our tradition of equal rights influences the process of privatization and a lot of time will pass before everything is made property.
—*Food-processing plant, Riazan*

Regarding employee ownership, employees do not understand what ownership means to them. The only advantage of employee ownership is that the state now has no right to interfere in the business of the enterprise.
—*Textile factory, Ivanovo region*

Anyway workers did not become owners. Employees just stay to be hired people. And now they spit and swear. We need dozens of years to change people. It seems surprising but people steal and drink even more. I think that those employees who want to have shares for profit should have nonvoting shares.
—*Household appliance plant, Novosibirsk*

Attitudes about management ownership favor sole proprietorship and closely-held companies whose shares are not traded on exchanges. Senior managers have trouble recognizing that several 5, 10, or 20 percent shareholders can own shares in their enterprise and influence its direction through a board of directors or through contacts with management. They believe that day-to-day executive control by management is not possible without an ownership stake in excess of 30 percent and further stakes in the hands of investors chosen by top management.

Further study is necessary to understand the extent to which general directors in Russian firms expect to control most of the top management ownership block personally.

How does this data on top management ownership and expectations compare with the West? Management ownership is widespread in the U.S. and has recently been studied in detail (Blasi, Gasaway, and Kruse 1994). Average top management ownership is 10.9 percent in the 7,000 public U.S. companies; considerably less in Fortune 1,000 companies (usually under 2 percent) and somewhat larger in smaller public companies. There is no relationship between the size of top management ownership and superior economic performance in the U.S. stock market. Russian general directors often claim, wrongly, that they are emulating Western management ownership practices. The more central questions are whether a widely held public company with numerous small shareholders is what Russia's emerging capitalist firms need to restructure and to operate efficiently; and whether existing management can or should play the historical role of the capitalist entrepreneur—the core owner or investor. Examining issues in corporate governance will facilitate a closer consideration of these problems.

Corporate governance

The trends in corporate governance in the interviewed enterprises were uniform. Top managers have engaged in actions that essentially turn the firms into closed corporations, take them out of the market of corporate control, emasculate employees as shareholders, restrict outsider access to information, and tightly control boards and shareholder meetings and registries.

Most senior managers reported putting off the first general shareholder meeting for as long as possible. Often, a reason (or excuse) was that the 10 to 20 percent of shares held by the Federal Property Fund had not been sold. Once the meetings were held, less than 10 percent of interviewed firms allowed confidential voting of shares. The typical pattern is for shares to be voted by a show of hands. In larger enterprises, representatives of employee shareholders are chosen and given proxies to attend the meeting—that is, all employee shareholders do not participate. Almost all senior managers who discussed a shareholder meeting in detail reported that they could predict with confidence that the main decisions they supported would be voted in before the meeting. Frequently, the managers reported that this was due to their implicit control of the employee shares—"because I have good relations with the labor collective"—their explicit personal control of the votes in a trust, or a public method of employee voting of shares at the meeting that rendered unlikely disputes with management's position.

How are the boards of directors structured in the 127 post-privatized firms? Top management members numerically dominate the boards in over 90 percent of the firms with a majority of the members. Most Russian general directors come to a board meeting with other managers who are their direct report. Fewer than 5 percent of the boards include more than one outside citizen or commercial or foreign shareholder. In almost every enterprise visited before February 1994, insider shareholders usually controlled a majority of the shares, and used the traditional method of board selection to elect a board entirely composed of insiders. The "traditional" method of board election (as practiced in most U.S. corporations) involves a nominating committee controlled by the existing board and the chief executive officer. Management determines a slate of nominees and can usually garner 51 percent of the votes necessary to elect the entire slate from passive shareholders and institutional investors spread across the country who generally vote the management slate. In Russia, this traditional method is made easier because the general director does not have to guess about collecting the votes of diffused outsiders. A majority of shares is usually held by insiders, most if not all of the nominees are insiders, and the result is more predictable. Despite the predominance of insiders, the wariness of rank-and-file employee shareholding is clear in board structure; less than 5 percent of the companies have nonmanagement-employee representatives on their boards.

Nevertheless, a closer analysis of the outside board representation issues indicate some ferment:

- In November and December of 1993, general directors were asked whether they would support a mechanism such as cumulative voting for boards that would allow minority shareholders to attain board seats. The sample was small but there was a growing willingness to accept cumulative voting. Perhaps, this can be explained by a recognition that potential large outside investors will demand board seats.
- In January 1994, President Yeltsin mandated new shareholder meetings before the end of April 1994 with cumulative voting. In February and March of 1994, interviewers tried to ascertain specifically whether the Yeltsin decrees on cumulative voting were being implemented. The general directors were exceedingly unwilling to discuss this issue and many expressed strong disagreement with the law mandating cumulative voting. There is little evidence that cumulative voting has been implemented except in a very small number of firms. In several of these cases, we discovered that cumulative voting had been redesigned by the enterprise to appear to abide by the new

Top managers have engaged in actions that essentially turn the firms into closed corporations, take them out of the market of corporate control, emasculate employees as shareholders, restrict outsider access to information, and tightly control boards and shareholder meetings and registries.

Clearly, management entrenchment regarding boards, shareholder meetings, and shareholder registers leaves the door open to abuse...

regulation while giving insiders firm control over the new voting mechanism.

- To further complicate these findings, a substantial percentage, 32 percent or eight out of the twenty-five firms visited in seven regions in February and March of 1994 were found to have nongovernment, outside shareholders on their boards of directors. In three of the cases the outsiders outnumbered the senior managers. In the eight cases, outsiders ownership stakes were 53 percent (voucher fund), 47 percent (commercial firm), 28 percent (commercial firm), 20 percent (businessman), 16 percent (commercial firm), 10 percent (voucher fund), 10 percent (voucher fund) and 0 percent (local expert). Unfortunately, in none of these cases was there evidence that the outsiders elected as a result of the new cumulative voting decree. All total in the twenty-five firms, there were forty-four outside government and nongovernment board members out of 187 board members. Only twenty-one of the forty-four board members were not government representing government ownership stakes. Of these twenty-one board members, could be considered members of commercial firms that had an alliance or kereitzu arrangement with the general director. This pattern is further reflected in examining the top outside shareholder of the twenty-five firms. 36 percent of the top outside shareholders could be considered to be commercial firms that had an alliance or kereitzu arrangement with top management. And 60 percent of the general directors have a positive attitude towards associations or holding companies in their industries that could potentially play this role.
- The average outsider stake of 21.5 percent (20 percent at the median) in the 127 post-privatized firms can be further analyzed for blockholders who have more than a 5 percent holding. In 46 percent of the firms there is no blockholder. Among the 54 percent of firms that have blockholders, the average stake is 19.63 percent (15 percent at the median). To the extent that rights for minority shareholders can be expanded, blockholders already have an ownership foothold in this significant number of privatized firms. And an important future agenda for Russian privatization is policies that encourage the sale of the shares that remain in government hands to new blockholders in firms that do not have large outsider stakes.

These disparate impressions do not lend themselves to a clear conclusion. But they do suggest that outside board representation may be more widespread than originally thought. They suggest that private arrangements with outside shareholders, not the government decree, seems to be the initial explanation for this phenomenon. They suggest that industry group alliances (kereitzu) may be a better explanation for a lot of emerging outside board representation relative to independent outsiders. A more definitive statement on the incidence of cumulative voting will only be possible in the mid-summer after many of the 127 enterprises have been revisited and that data is analyzed.

If there were an inquiry regarding the shareholder register, almost all senior managers would say that shareholders can see only the number of shares they personally own in the register. In every firm interviewed, the shareholder register was maintained by management, although this was due to a change by government decree. There is inconclusive evidence about how many firms are honoring the decree.

Clearly, management entrenchment regarding boards, shareholder meetings, and shareholder registers leaves the door open to abuse, including decisions by management to dilute outside shareholder interests by sales of new shares to insiders, changes in the corporate charter which enhance the rights of insiders, and attempts to have the insider-dominated board of directors take decisions that should be taken by the shareholders meeting. It is not possible, however, to ascertain the extent to which such violations of shareholder rights were taking place. In October and December of 1993, President Yeltsin issued regulations to secure shareholder rights, with a decree on shareholder registers and the 1994 privatization program. These regulations produce a set of simple rules:

- Changes in the corporate charter, the charter capital, or major transactions affecting 25 percent or more of the charter capital require a majority vote of 75 percent of shareholders in general meeting.
- There is cumulative voting for the board of directors. Employees cannot comprise more than one third of the board, which must have at least seven members or nine members where companies have more than 10,000 shareholders.
- Annual shareholder meetings must be held within 120 days of the end of the fiscal year with basic rules of financial disclosure.

These regulations begin to address some shareholders' rights problems, but many more remain. Further research is needed to clarify the level of awareness of these new regulations and the extent to which they are being followed. Initially, it does not seem that privatization has a big impact on corporate governance. But this should be put in context; there is growing discomfort of investors in Western economies with management entrenchment and its impact on corporate performance. Independent directors staged coups in few major U.S. corporations in 1992 and 1993. Even so, management-dominated boards are the rule in most Western economies (Oxford Analytica 1992). Since the goal of privatization is not simply to change from state to private ownership, but to create private incentives so that the companies can be rationally restructured and improved, where are the implications of our findings for restructuring prospects?

Restructuring

Almost every enterprise manager had extensive plans to buy machinery and implement capital investment to rebuild, expand, or renovate. Few general directors envisioned shrinking the business (that is, sales of units), reducing product lines, or focusing on clear high-margin products or services. Every general director wanted to expand and had a strong bias towards more production. Unfortunately, this echoes the Communist past, where production volume was more important than profits and competitive markets. It was impossible to objectively clarify whether the general director's restructuring plans were naive hopes or whether they resulted from careful business planning. Few general directors, however, provided evidence that they had an objective analysis.

Almost every general director said that their biggest problem was shortage of cash to carry out large capital projects. Only one firm, a supplier to the Siberian oil industry, had readily available capital inputs. Every other firm was receiving state credits, but these were, in almost every case, a mere fraction of those needed for capital investment. This may suggest that firms are borrowing to pay wages and buy raw materials and that even continued cheap credits at increased levels would not succeed in restructuring the enterprises. Before the resignation of key government reformers in January 1994, the government was reportedly debating whether it could manage to continue existing credits.

It was impossible to objectively clarify whether the general director's restructuring plans were naive hopes or whether they resulted from careful business planning.

Another major problem for enterprises was high taxes that curtailed their ability to use internal financing. Unfortunately, from the perspective of the enterprise, even a government that chooses to offer extensive state credits may still impose high taxes on profits, thereby eliminating the ability of firms to meet their capital requirements. High taxes on profits are seriously discouraging capital investment through retained earnings. A preliminary conclusion would be that real enterprise restructuring will not take place without substantial outside investment. This is an objective barrier to restructuring.

There are also some subjective barriers. The main problem is the expectations of senior managers about their power and ownership. Enterprise directors were asked to estimate the total investment capital needed to restructure the enterprise. They were asked for the total ownership they wished to have for top management and for outsiders. They were asked who they preferred as outside investors. And they were asked for their attitudes about majority outside investor ownership.

Moreover, most of the enterprises are receiving state credits through commercial banks that are supplied with credit by the Central Bank.

Consider a hypothetical case where an outside Russian or foreign investor comes to the enterprise ready to invest the capital top management believes is necessary. The first problem is that the total capital needed for restructuring, translated into share capital, represents a far greater percentage of outside ownership than management has allotted in their minds. The second problem is that even if management is prepared to reduce the stake of insiders in general, they want to reduce it in their own favor. This would not be a bad idea if managers put real capital into the firm, based on the real value of assets (in a firm with good prospects). But managers universally say that they lack cash. Thus, managers want to increase the ownership stake of a small group (themselves) who lack cash. Since an outside investor's infusion will dilute not only the stake of employees, but also the current small stake of top management (5 to 10 percent), then management generally opposes, or at least is deeply suspicious of, their involvement.

The third problem is that 60 percent of top managers oppose majority investor ownership for reasons of control. There is a lack of data about what employees think, but the general directors' adoption of this view is certainly troubling. The fourth and final problem is that a third of general directors feel that outside investors should be related suppliers, producers, or customers with whom their enterprise currently does business. Yet, many possible partners are like the enterprises in a difficult situation seeking their investment.

To these attitudes of management, one must add a number of technical problems in arranging restructuring through capital infusions. General directors are so fixated on arranging the ownership, that some are selling stakes at "bargain basement prices" to related suppliers, producers, and associations, as well as making plans to sell more equity to other suppliers, customers, and producers. This scarcely answers the question of who will put significant amounts of money into the firm. While it is true that arrangements of sweetheart equity deals for friendly outsiders contradicts the notion that management is fixated on retaining ownership, it should be noted that management's main concern is to retain control in order to direct the firm as they see fit. Personal ownership, trusts, employee proxies, kereitzu, and domination of the board are the various means used to implement this desire. Moreover, most of the enterprises are receiving state credits through commercial banks that are supplied with credit by the Central Bank. These credits are presently supplied without any attempt to evaluate their end-use, the expected profitability of the (purported) investment, or the firm's ability to repay the credits. Keeping enterprises afloat through cheap credits simply magnifies the fairy-tale environment in which top management lives, and gives them another incentive to avoid making rational decisions.

There is insufficient information, too, on what the shares of enterprises are worth. One reason is that the selling price of most enterprises in the closed subscription and the voucher auction was based on pre-inflation valuations of fixed assets, and does not take into account current prospects. Also, the lack of a stock market further restricts the ability of the enterprises to raise capital at realistic prices. Moreover, there is little data on which to base an objective analysis of the expansion and restructuring plans of general directors. And finally, the corporate governance structure and predilections of general directors prevents them from getting input from anyone other than members of their board. Thus, any policy to restructure enterprises will have to tackle each and all of these problems.

Senior managers were asked what kind of "knowledge-oriented" technical assistance they would require, if it were provided for free. Responses reveal an interest in detailed information about equipment and technologies in their industry and certification of products, operating in foreign markets and preparing documents for exporting (in terms of laws, currencies and technical arrangements), marketing, preparing business plans and managing the finances of the entire enterprise, stock markets, the laws and legal norms of joint stock companies, and likely investment partners overseas. Many enterprise managers have specific questions about how banks, suppliers, producers, and consumers operate in other countries.

It was surprising that many general directors, who were generally willing to speak for hours on many subjects, had cryptic or no answers regarding technical assistance needs. One general director said that he felt as if he was being asked to choose foods in a cafeteria, without knowing the menu. In fact, enterprise managers in our sample have only a sketchy, impressionistic, and incomplete idea of their technical assistance needs.

Several needs which—in the opinion of the interviewers—were evident from managers' discussions of their problems and operations were never clearly identified:

- Managers appear to need more understanding of how to negotiate with a domestic or foreign investor, price a proposed investment, and establish the rights and responsibilities of both parties;
- They lack information on accounting systems that would allow them to carefully discern the components of the real cost of products and which ones are high- and low-margin;
- Managers do not have the names, telephone numbers, fax numbers, and basic information about major world competitors, potential major suppliers, and potential customers outside the former Soviet Union, various sources for technology, research, and machinery, and internationally known investors or financial organizations that invest in their industry.
- They do not have enough information on measuring productivity and how their performance compares with competitors in Russia and worldwide;
- They do not have enough training in financial analysis to compute a reasonable estimate of the stake of their firm they would have to sell to an outside investor (and at what price) to turn around the business.

There is an interesting relationship between the technical assistance gaps, the objective and subjective barriers to restructuring, and the closed system of corporate governance the general directors favor. Most of the technical assistance gaps limit the achievement of "perspective" in their factory, their industry, their products, and their own performance. This perspective is exactly what they need to deal with boards that are incapable of giving technical blunt criticism, capital investment plans that may not be objectively correct, and preferences for managerial ownership that may be unrealistic.

The evidence is not all bad news. There are preliminary signs of restructuring. From a sample of forty enterprises surveyed, 58 percent reported new product development. Fifty-eight percent of enterprises also reported contacts with foreign investors and about one-third reported specific discussions about joint ventures with foreign investors. Fifteen percent of the enterprises surveyed were already involved in joint ventures with domestic or foreign investors. There is also some evidence that general directors wished to decrease enterprise obligations regarding social assets such as housing, kindergartens, and so on. Only one-third of the general directors wanted to expand social assets or keep existing services, while two-thirds had given or planned to give the social assets to the municipalities to manage.

Managers do not have... basic information about major world competitors, potential major suppliers, and potential customers outside the former Soviet Union...

The role of employees

One might assume that all these majority employee-owned enterprises are in fact behaving just like the employee-controlled firm which Western theoretical economists have been discussing for the past twenty years. Each general director interviewed was asked to comment on the role of the labor collective or the trade union, the level and growth of wages and benefits after privatization, the enterprise's plans for continued funding in the social sphere (such as for housing), and trends in employment. The findings were uniform.

Some economists have predicted that employee-controlled firms would divert profits into wages and benefits for workers and away from capital investment, that efficient management would be interrupted by worker control exercised by a worker-dominated board of directors, and that employee ownership would exist as a threat to outsider shareholder ownership. Looking at the surface, one might be tempted to conclude that in present-day Russia, after seventy years of Communism, the employee-controlled nightmare of theoretical economists was coming true and that employee ownership is the central barrier to restructuring firms privatized to insiders.

We argue differently. First, in our view, these post-privatized enterprises are not employee-controlled as defined by theoretical economists. The senior managers interviewed report that the collective bargaining relationship between the union and management has totally broken down in the post-privatized enterprise. General directors report that they are unilaterally making decisions on wage increases and the norm is to increase wages every few months based solely on inflation. But they report that they are either decreasing benefits to workers, charging workers for benefits they once received for free (such as housing), or planning to withdraw the firm from serving social welfare functions. While managers report that they think workers are only interested in salaries and dividends, they do not report any significant worker voice in the determination of salaries or dividends. Thus, these firms are more management-dominated than worker-controlled.

Second, it would be easy to conclude that post-privatized enterprises lack cash and money for investment because they are putting it into salaries. A more detailed statistical analysis is required, but there is little evidence that salaries, which are not excessive, bear any significant relationship to capital investment needed by the enterprise. This begs the question about who is setting salaries. It is not the workers. Most managers are raising salaries periodically to keep pace with inflation, but they indicate that they make the decision about the timing and the extent of the raise based on business and social considerations. Many general directors are engaged in a tenuous balancing act as they try to maintain capacity, deal with massive receivables, and get enough credits to buy raw materials and pay salaries. Aside from other factors weakening worker influence, this does not seem to be fertile ground for worker control.

Third, the boards of directors are not at all worker-controlled. There are nonmanagement employee representatives on these boards in fewer than 5 percent of the cases. Most board members are top managers who report directly to general directors—who also control the shareholder register, the agenda of the board meeting, the by-laws of the joint-stock company, and credit relations. Workers in the jobs studied are passive as both shareholders and trade union members. There are very few firms where workers can confidentially vote their shares, and so take a big risk opposing management. Top managers interviewed tend to view the employee shareholder in the same way that entrenched managers of American firms often see the little old lady in Wisconsin who owns ten shares—they are a technical nuisance, a problem to be effectively managed through the manipulation of board meetings and shareholders meeting.

Fourth, managers also report that the trade union in most companies is a perfunctory organization. Indeed, the overwhelming conclusion about employee ownership is near complete passivity on the part of the Russian worker. This is not surprising since it is entirely consistent with fifteen years of social scientific research on employee shareholders in many other countries.

One might expect that the Russian majority employee ownership firm had at least protected workers by stabilizing or increasing employment. Even this turns out to be incorrect. Since 1991, post-privatized firms have cut employment by 21 percent. Indeed, some general directors said that firings and layoffs, not employee ownership, are among the reasons some workers are being more careful about the way they work. This does not mean that employment preservation is not a priority. When asked how many additional employees could be cut if there were no social considerations, senior managers said about 20 percent. There is no evidence that employee ownership is the reason for this restraint; it is probably related more to the lack of a comprehensive social safety net in the Russian Federation. If a social safety net existed and new business development picked up in Russia, it is unlikely that employee ownership would give workers enough control to prevent large reductions in employment.

Is worker ownership a threat to outside shareholder rights if the firm is not employee-controlled? Not on the basis of the information obtained in our interviews. On the contrary, management entrenchment in enterprises that are legally majority employee-owned, but not employee controlled, is the major threat to outside shareholder rights. In fact, entrenchment is the major threat to the rights of insider shareholders, too. It might be healthier for corporate governance if employee shareholders could confidentially vote their shares at shareholder meetings, with the results audited by outside accountants. Employee shareholders might elect outside professionals to serve as independent monitors of management on the boards of directors. And it would be healthy for corporate governance if trusts, holding companies, partnerships, joint stock corporations, and the like are used to collect employee shareholder votes that could not be voted by top management. Rather, all votes should be passed through the legal entity to the individual employee shareholder.

While employee ownership played an important role in providing an incentive for workers to participate in privatization, the role of employee ownership is not the central issue in determining the future development of Russian privatization. The crucial question is who will play the roles of core owners, capital providers, and monitors of management in the restructuring post-privatized firm? Can it realistically be inherited by existing managers, simply because they are there? While they desire this role, they do not have the financial means necessary to bankroll their firms. Can it be external shareholders who face daunting resistance by managers to their entry into the power structure, unless picked by management? The policy challenge now is to assess whether there are any levers to simultaneously encourage shareholder rights and corporate governance input for outside providers of capital, appropriate rewards for retaining skilled management, and a modicum of reasonable employee representation.

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The crucial question is who will play the roles of core owners, capital providers, and monitors of management in the restructuring post-privatized firm?

Corporate Governance during the Transition to Private Ownership

Leroy P. Jones and Natalia Tsukanova

Who governs Russian enterprises according to whose interests? Prior to 1987 the interests of the state were dominant; after full privatization, the interests of the shareholders should reign supreme. This paper deals with the transitional intermediate period, asking who will control the enterprises in the absence of concrete policy measures, who should exercise that control, and how can policy bridge the gap?

These are important questions since the performance of an economy ultimately rests upon the responses of economic agents to their environment. Privatization is simply a fundamental change in corporate governance. Since full privatization will take years under the best of circumstances, the question of transitional governance mechanisms becomes central to economic performance. If the pace of liberalization is an inverse function of economic performance—as recent events suggest it is—then transition governance is central to the whole liberalization effort.

Evolution of corporate governance

The evolution of corporate governance in Russia is a five-year story of a remarkable transformation from one of the world's most centralized governance structures (in 1987) to one of the most decentralized, with virtually complete autonomy given to the managers and workers (by 1993).

The classical Soviet corporate governance model

The classical Soviet system (pre-1987) is well known. Under Soviet socialism, two parties exercised primary governance rights over state assets: state bureaucrats and, to a lesser extent, managers of firms. There existed a complicated hierarchy of state bodies, staffed by the infamous *nomenklatura*. Their power resided first of all in their responsibility for appointing the chief executive officers (CEOs). This, of course, is the key corporate governance issue and, as a result, the nomenklatura had great power over decisions ostensibly in managers' hands. Other notable powers included making investment decisions and setting quantities and prices under the planned economy system.

Firm managers also enjoyed significant discretion. First, they exercised operational control over production. Second, they had some control over employment and wage policy. Finally, they had an information advantage over the other parties that provided them with bargaining power in investment and production decisions. Still, they were fully dependent on the branch ministry both because they could be dismissed by the branch and because the ministry provided them with inputs and effectively bought the outputs.

1987 to 1992

In 1987, the Law on State Enterprise (Association of Enterprises) was passed in accordance with the proclaimed policy of more democratic socialism. It stated that the CEOs "should be elected by the conference of the workers' collective for a period of five years." The appointment then had to be confirmed by some higher body (usually a branch ministry). If an appointment was not confirmed then new elections had to take place.[1]

While this measure eventually dramatically increased the powers of managers and workers, the process was an evolutionary one. Initially, when workers' collectives and branch ministries disagreed, the bureaucrats very often managed to appoint their

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candidates because they still had many levers to pull. Over time, however, these powers eroded and in recent years there is virtually no evidence of successful attempts by higher bodies to appoint or dismiss a CEO. Interviews at dozens of enterprises revealed only a handful of managerial changes and these were all precipitated by death or near bankruptcy. Managers seem to have mastered the art of reappointing themselves.

The erosion of control of the ministerial bureaucrats was manifest in other areas as well. One of the key functions exercised by the branch ministries in the classical Soviet model was to provide firms with inputs and to allocate outputs to customers. This system collapsed with the disintegration of the Soviet Union. Firms were thus forced to assume this role, making the period of 1990–91 very difficult, as they sought to develop their own complicated network of relations with partners. Though prices were liberalized in 1992, the centralized allocation of resources was replaced much earlier by these quasi-market mechanisms.

Control over the distribution of surplus also shifted. The ministries used to have almost complete discretion in allocating the firms' revenues. An attempt to restrict the discretion of the ministries was made in 1987–89. Over this period two famous models called hozraschyot (self-accounting) and self-management were developed and introduced in most of the Russian industries. According to these models the revenues or profits obtained by the firm were to be distributed according to certain fixed norms (percentages). After transferring a certain percentage of the budget to the ministerial fund, the firm was free to use the rest of the money for investments and wages. One important consequence of this new order was the transfer of some control over investment decisions from the ministries to the firms' managers. At the same time, ministries still retained a lot of control, as they were responsible for determining the mentioned norms for each individual enterprise.

The 1991–92 "Budget System" and "Tax on Profits" laws further eroded the powers of the branch ministries. These provided that all firms were subject to the same taxes and were free to use the rest of the surplus at their discretion, subject only to control by the State Revenue Service. There was little room left for the branch ministries in control over the distribution of surplus.

In sum, as the ministries lost their control rights, managers increased their powers by default. Some of the control rights were in theory gained by the workers, but in practice the bulk of essential governance rights came to be exercised effectively by managers.

Post-1992: Corporatization and privatization

In 1992, privatization was introduced, with corporatization as a first step. The ultimate goal is to shift corporate governance to an entrepreneurial class. The critical question is how long this will take. There is room for concern on this score because in Russian medium-sized and large enterprises, the initial step has, in most cases, only legitimized worker and manager control, merely converting it from *de facto* to *de jure*.

The initial distribution of shares (after corporatization but before true privatization) is spelled out in the 1992 privatization program[2] with two primary variants.[3] Under option 1, workers and managers receive 25 percent of the shares for free but the shares are nonvoting (preferred type A). They can also buy up to an additional 15 percent of common shares carrying voting rights. The balance of the shares is initially held by the government, but only 20 percent (of total shares outstanding) will be voting, with the remainder (40 percent if workers and managers take their full 15 percent) being nonvoting (preferred type B). Accordingly, even where workers and managers buy all available optional shares, the government will have a 57 percent majority (20 out of a possible 35 percent voting shares) in the stockholders meeting.

Option 2 is considerably simpler. Workers and managers buy 51 percent of the shares, with the balance held by the government. Under this scheme all shares are voting from the outset and there are no preferred shares.

Since the majority of firms chose option 2, workers and managers will initially have a majority vote in most corporatized firms. Furthermore, government shares are likely to be sold for vouchers, thereby further reducing the government share under option 2 on a one for one basis. Under option 1, however, voucher sales come from the preferred type B stock (which becomes common on sale) and thus dilutes both worker and manager and government voting rights. For example, if 10 percent of the shares are sold to voucherholders, voting rights would be: government 44 percent (20 out of 45 percent); workers/managers 33 percent (15 out of 45 percent); and voucher-holders 22 percent (10 out of 45 percent).

In sum, shortly after corporatization, managers and workers have a majority of shares in the vast majority of enterprises. The only exception is where firms which have chosen option 1 and either fewer than 5 percent of the shares go to voucherholders or larger voucher sales are offset by workers and managers taking up less than the maximum 15 percent of common stock.

Even in cases when they do not hold a majority of shares, workers and managers will still control the board of directors, which consists of the general director (with two votes), representatives of workers, an appropriate legislative body, and a relevant property fund (with one vote each). Shareholder percentages are irrelevant until, for example, a vote needing a three-quarters of the common shares arises (such as a vote to change the charter to some other board composition).[4] This will be difficult to obtain, but is at least mathematically possible under option 1.[5] However, this change must be approved by a two-thirds vote of the workers holding type A preferred stock, and this is unlikely. Accordingly, workers and managers will control three-fifths of the board under most foreseeable circumstances. Leaving the legislative vote aside as an unpredictable swing vote, any vote for capital via the board must be exercised through the single vote from the property fund appointee or the general director. The latter is appointed by the shareholders, who, as already noted, are the managers and workers themselves in most cases.

In those cases where workers and managers are not the majority, generating a voice for capital will require cobbling together a majority coalition between government and private shares. This, in turn depends upon the ability of private shareholders to concentrate their voice. In other Eastern European privatization plans, this has been accomplished through the vehicle of mutual funds or their equivalent. By combining their votes into a single voice, individual shareholders can achieve the economies of scale necessary to make it worthwhile to invest in acquiring the information required to play a significant role in governance. In Russia, this role has been attenuated by a provision limiting such pooling to 10 percent of the voting shares of any one company by any one investment fund. Still, several such funds could accumulate to a significant voice.

Unfortunately, the experience of voucher auctions to date suggest that this may be a futile hope in many cases. A survey of auction consequences in seven provinces is the only hard evidence available, and it is discouraging. The typical pattern is for an option 2 firm to offer twenty-nine percent of its shares for sale at auction with the remaining 20 percent of nonworker or manager shares remaining in government hands. The result has generally been that workers and managers buy up to 80 percent of the shares sold. To the extent that this study is representative, voucher sales have thus not diminished worker and manager control, but enhanced it.

The scope for a voice for capital is further reduced by the efforts of almost every industry to create a holding company for shares of privatized members of that industry. The phenomenon was so wide-spread that GKI had to develop a specific policy towards such proposals. As a result, some of the holdings were created with the permission of the GKI, some of the plans were rejected and never implemented; and, in certain cases, holding companies were formed even without GKI approval.

An additional corporate governance problem occurs for those enterprises that are not subject to privatization. This is by no means an insubstantial list. The 1992 privatization plan identifies three categories of firms that are not to be privatized or that are to be privatized selectively. The following list gives some of the more economically important entries in each category.

1. Enterprises not to be privatized in 1992
   - Energy enterprises and facilities
   - Pipeline enterprises and facilities
   - Water-use and amelioration systems and structures
   - Television and radio broadcasting centers
   - Port facilities
   - Electricity, thermal energy, and gas supply

2. Enterprises to be privatized only with government decision
   - Mining enterprises
   - Fuel and energy enterprises (coal, oil, and gas)
   - Communications enterprises
   - Commercial banks

3. Enterprises to be privatized only with GKI decision
   - Enterprises included in the Register of Monopolies
   - Large enterprises with more than 10,000 workers and more than 200 million rubles in assets
   - Railroad, air, maritime, and river transport enterprises
   - Medical equipment and pharmaceuticals
   - Alcohol, liquor, wine, and tobacco enterprises

It is important to note that list 3 is restricted primarily on the demand (for privatization) side rather than the supply side because in practice, GKI has encouraged privatization wherever possible. Being on the list does have two important effects, however. First, because of the importance of such enterprises, GKI pays more attention to proposals from them. Second, there is much less pressure on such enterprises to be forthcoming with proposals. Still, some very important list 2 and 3 enterprises have already been privatized by mid-1993. The oil industry and the huge Uralmash (heavy equipment) and Zil (automobiles) concerns are prominent examples. Nonetheless, many economically important activities remain outside the current privatization process. The more important ones may be broadly characterized as public utilities or natural monopolies.

What has happened to corporate governance in the firms for which privatization is not mandatory? As with enterprises scheduled for privatization, there has been considerable devolution of power to managers as the enterprises have taken advantage of the 1987 and 1988 laws to form autonomous legal entities. Compared to the others, however, parent ministries retain larger governance rights.

Why worry?

Are there any reasons to be concerned with legitimizing worker and manager control?

A vote for capital

The first reason has to do with providing a voice for capital. Left to their own devices, rational workers and managers will be motivated by self-interest to extract a maximum of surplus in the form of higher wages and benefits, and pass a minimum through to profit where it is subject to double leakage from taxes and dividends. The arithmetic is simple: 100 rubles of benefits taken above the line is worth 100 rubles to managers and workers; for 100 rubles of benefits taken below the line, 32 rubles leaks to corporate taxes and 33 rubles to the government shareholder as dividends. Unless Russian workers and managers are narrow-minded—which they are not—they will run the company so they get the full 100 rubles rather than the residual 35 rubles.

Rational workers and managers will, of course, pass some surplus through to profit since some retained earnings will be necessary for investment to maintain the company in the long run. However, this investment will still be suboptimal because of the first round leakage to taxes and because future changes in corporate governance may be expected to reduce their ability to pay high wages and thus further diminish their share of future returns to the current sacrifice required for investment. If workers are irrational, the situation is considerably worse. A number of managers whom we interviewed argued that workers were short-sighted and would not undertake even the (already suboptimal) level of investment required by self-interest.

The first evil of inaction, then, is an inappropriate functional distribution of value added. Too much will go to workers and too little to government and capital. The result will be too low levels of government services, savings, and investment. Since we are talking about enterprises which constitute well over half of the Russian economy, the resulting macroeconomic impact would be devastating to the growth prospects of the economy. Note that this will ultimately harm the working class as a whole as low investment precludes the creation of real jobs and the capital accumulation that makes real wages rise.

Accordingly, the first task of corporate governance during the transition is to provide a vote for capital. Without pressure for return to capital, the whole economy will suffer.

A vote for managerial change

A case can be made that the foregoing evil is no great evil because the real problem in Russia today is to get enterprises to generate surpluses in the first place. If this can be accomplished by giving the bulk of the benefits to workers and managers, then the efficiency goal will have been reached and functional distribution is a second-order question. There are two classes of response to this argument. The first is that some enterprises (particularly those involved in resource extraction for export) are already very profitable. For example, the average monthly wage in mining in Sverdlosk in June 1992 was 40,000 rubles, compared to an average wage in the region of 6,000. Why should the surpluses of mining be used for consumption by well-placed miners rather than for investment which benefits the working class as a whole?

The second class of response is far more important, because it questions whether the desired increase in efficiency and surplus will in fact take place without the vote of nonemployee shares. Thus far, this paper has assumed that the Coase Theorem[6] holds and that if workers and managers can appropriate the bulk of the surplus, they will act to maximize the surplus to be so appropriated. Sadly, there is considerable reason to believe that this does not hold in Russia, at least in the short to medium term. As is argued below, managers and workers have in fact been in this position for several years, and the response of the state sector to market forces has thus far been considerably less than dramatic.

...the first task of corporate governance during the transition is to provide a vote for capital.

To understand what is going on, it is useful to consider the results of one detailed available study of enterprise response. One of many puzzles in Moscow today is the proliferation of street-side kiosks which provide an abundance of varied consumer goods. The question is, why have these retail outlets prospered in competition with established former state stores which have been privatized? More generally, why have other privatized small establishments in Moscow—notably restaurants—exhibited so little entrepreneurial response after privatization? At least part of the answer is suggested by a fascinating study of 452 establishments in seven cities. The study confirms the lack of response in Moscow but finds considerable response in the other cities. The difference is attributable to the method of privatization. In Moscow, enterprises were simply turned over to the previous workers, who continued to do things the same old way. In the other cites, auctions were used, which resulted in control being shifted to an entrepreneur who was both capable of initiating change, and motivated to do so as well. Eventually, control of the Moscow establishments will be transferred to true entrepreneurs through bankruptcy or simple recognition of the self-interest of current owners. Until then, however, inertia dominates, with patterns established over seventy years of socialism triumphing over the profit opportunities provided by property rights in markets.

The same phenomenon is occurring in many of the larger state enterprises. To be sure, there is wide variety in managerial response, at least as exhibited in interviews.

For the health of the enterprises and the economy, protection for the interests of capital must be added.

Some managers are aggressively pursuing new business opportunities, but many—perhaps most—seem merely to be bewailing their fates and crying for government to bail them out. The point is that enterprise reform requires management to profoundly change its ways, and many managers are not ready or able to do so. Some will have to be fired and others will have to face a real threat of being fired before widespread change occurs. This has not happened to any significant extent thus far, and is unlikely to happen soon with continued control by managers and workers. One distinguished observer of the Russian economy has argued that given a choice between massive infusions of new capital with existing managers and no capital with new managers, he would predict a higher growth rate with the latter. This may be something of an overstatement, but the sentiment should be applauded. Thus, we have a second and critical role to be played by corporate governance—to use the hiring and firing and incentive power of the shareholders to ensure that managers either change or are changed.

A vote for exit

The third evil of inaction is straight-forward. In a market economy, firms that outlive their usefulness must die. If they are to die, sooner is better to avoid wasting additional resources. The interest of workers and managers do not promote this end. They would prefer to suck every last resource from the firm and its creditors in the form of wages and benefits. Once again, their wage gains outweigh their dividend losses and their role as employees dominates their role as owners. The interest of capital does promote this end, since a timely shut-down can at least preserve some of the assets or preclude additional losses before more and more money is poured in. A voice for capital is therefore required to ensure appropriate exit rates.

A vote for the small shareholder

Another perspective on the evils of inaction is provided by recognizing that during the transition a significant portion of the shares in many companies will be in the possession of voucherholders and other small investors. Because these shares will be widely desired, small investors will not be able to bring their collective voice to bear on the operation of the enterprise. Their interests can be protected only by the vote of the single large strategic investor—the government. In the absence of such a role for the government shares, Russian citizens are likely to receive little return from their vouchers and will be rightfully disenchanted with the privatization program.[7]

The bottom line

None of this should be taken as an attack on managers and workers. Their interests are fundamental and must be promoted vigorously. The point, however, is that in a market economy, an enterprise must be run to benefit the providers of both capital and labor. If either is neglected, the enterprise will decline. Some workers and managers—raised under seventy years of socialism—may not fully appreciate this point at first, but in the long run their interest is inextricably linked to that of capital. An enterprise that does not protect the interests of capital will not attract capital, and without capital the productivity gains which raise real wages are not possible. The current system protects only labor interests. For the health of the enterprises and the economy, protection for the interests of capital must be added.

To argue that governance could be improved is not to say it will be improved. Reforming corporate governance in a way which reimposes the old form of state control in a new guise will not be a step forward. Thus far we have only argued that there is room for considerable improvement in corporate governance. It remains to be seen whether there is a scheme for accomplishing this which is likely to do more good than harm.

Policies to improve corporate governance

The arguments thus far may be succinctly summarized:

- Empirically, the period 1987 to 1993 saw a revolution in corporate governance as the bulk of powers were decentralized from state organs to the managers and workers of largely autonomous enterprises.
- Normatively, the change was undoubtedly a major step forward for both static and dynamic efficiency.
- Nonetheless, serious governance problems remain. In the context of monopoly output markets and near monopsony in the provision of (largely state) credit, manager and worker control results in an inadequate voice for capital, change, and efficiency.

This analysis is hardly unique. Within Russia, there are many who share at least some of the major tenets. A distinguished Commission under Professor Yasin has recently compiled a draft report on *Basic Provisions of State Enterprise Reform*. They say that at present, the enterprises are "controlled neither by the market, which has not been put in place,... nor by the State as the owner." Rather than looking to markets for revenues, these entities "put pressure on the Government with a view to receiving privileges and subsidies...."

The challenge, then, is to develop measures that promote better management and financial discipline of enterprises in a manner that is consistent with, and that hastens rather than retards, the transition to a market economy. The balance of this paper asks how this might be accomplished.

Governance regime

A useful first step in this direction is taken by the commission in abandoning the hope of having a single governance regime for all enterprises and instead identifying different structures as appropriate for different types of enterprises. This paper follows this lead, but extends it, identifying four (rather than their three) regimes. Three regimes are specified based upon the nature of the markets in which they operate and the last is subdivided according to progress on privatization. Briefly, the regimes are:

1. *Monopoly government suppliers* who derive the bulk of their operating revenues from the budget through sales to the government rather than through sales to a market, and the goods are produced by only one or a few suppliers so supply is not competitive.
2. *Utilities, and other services* who sell to consumers and producers. There is little actual or potential competition in their core markets and, therefore, they may be expected to remain in government hands for some period of time.

In contrast, the last two regimes produce for markets that are actually or potentially faced with competitive pressures, whether from domestic or foreign sources. They are distinguished as follows:

3. *Transitional firms* are those slated for privatization, but for whom the process is not complete.
4. *Mixed enterprises* are those where corporatization has been completed, but in which the government retains significant share-holdings.

Note that this last definition is considerably broader than the official Russian definition which classifies an enterprise as private if the government's share is less than 25 percent.[8] The government definition is useful because it encourages firms to go through voucher auctions to achieve special privileges accorded to those who pass the 25 percent trip wire. One such privilege is the right to bid for and hold shares of other companies, including the right to participate in voucher auctions. Passing this threshold is, therefore, necessary for achieving the formation of holding companies.

Nonetheless, for reasons explained above, it is clear that even a 24.5 percent government shareholding could be so voted to improve the efficiency of the firm. Therefore, regime 4 has consciously been defined as including mixed (public and private) firms rather than only those that are not officially privatized.

Table 11.1 provides a matrix linking governance regimes (the columns, representing types of enterprises) with the essential defining characteristics of each regime (the rows). As such, it provides both a summary of recommendations and a disciplining analytic device which ensures that major issues are not left unresolved for particular types.

The challenge... is to develop measures that promote better management and financial discipline of enterprises in a manner that is consistent with... the transition to a market economy.

Regime 1: Monopoly government suppliers

Pure government suppliers include such list 1 organizations as the National Archives; assets of the Armed Forces (geological and meteorological surveys); agencies concerned with hygiene, epidemiology, and plant protection; and patent, standards, and machine testing facilities. It is difficult to distinguish such entities from the government itself. Like the government, they produce important public goods, whose value is impossible to determine in any practical way. One can therefore not conduct the sort of cost-benefit calculus possible for true enterprises. Further, structuring them as independent entities does not suffice to create a market, for they are then monopolists facing a monopsonist, but the monopsonist is in control because it has the money.

If such entities are indistinguishable from government, to the extent that market mechanisms do not operate, then there is no great harm in treating them as part of the government apparatus. That is, they are part of a hierarchical chain of command, their employees are state employees, and they are funded as part of the regular budget process.

Table 11.1 Corporate governance regimes of different kinds of enterprises

	Government suppliers	*Utilities, and other services*	*Transitional*	*Mixed public and private*
Examples	Weapons research and design institutes, patents and standards, meteorology	Railways, telecommunications, electric utilities, pipeline operators	Enterprises undergoing corporatization	Consumers and producers; actual and potential domestic and imports competition
Market (main buyer of output; competitive conditions)	Government; near-monopolistic or strategic industries	Consumers and producers; little potential core competition	Consumers and producers; actual and potential domestic and import competition	All companies that have undergone corporatization but are still partly government-owned
Role of government finance	Dominant	Carefully selected and structured subsidies and credit guarantees	Selected finance for restructuring in anticipation of privatization	Prohibited (reliant on capital markets)
Corporatization	No	Yes	Ongoing—to be expedited	Done
Privatization	Not now	Not necessarily now (but encouraged where feasible)	Ongoing—to be expedited	Done (less than 50 percent government-owned) or partially done (more than 50 percent government-owned)
Legal form	Departmental enterprise (state law and public employees)	Joint stock company (or public corporation with special law)	Existing laws	Joint stock company
Board	None	State-controlled majority; minority representation of workers, experts, banks, and so on	None	According to shares
Entity appointing CEO	Government	Supervisory board, with approval of interdepartmental commission	Workers collective	Shareholders board
Control devices to mimic markets	Competitive bidding procedures to be developed where multiple suppliers exist	Performance contract carefully designed and signed by interdepartmental commission	None	None
Price-setter	Government	Autonomous commission for each industry	Market	Market
Entry	Restricted	Encouraged wherever technically feasible	None into regime, free into industry	Free
Exit	Explicit government policy needed	From industry, policy; from regime, okay	Explicit government policy needed	Free

An intermediate category of enterprises occurs in industries where economies of scale are such that many suppliers are possible. Now the government monopsonist can use competitive bidding procedures among government-owned firms in strategic industries and bidding among private suppliers in nonstrategic sectors. Armaments may fit in the first category and producers of stamps, state insignia, and the like in the second. The former could, and should, in the long run, be placed in regime 2, and the latter in regime 4.

Regime 2: Utilities

How should utilities and other services be governed? There are three options. First, they could be managed like regime 1 organizations. Second, they could be managed using the fiduciary mechanisms described above. Third, they could be run along the lines of public enterprises in mixed economies. This paper rejects the first option but sees some merits in both of the other two alternatives.

International experience demonstrates convincingly that direct government control is not appropriate. Instead, utilities should be corporatized as semi-autonomous bodies. Reasons include the following:

- *Consumer needs should dominate.* Management of such enterprises should be psychologically oriented to look first to the market for policy guidance and then to ministries. Direct government control reverses this orientation. Quality of service and efficiency suffer as a result. Managers must be given a commercial orientation, meaning they look first to the market for solutions to their problems. Returning them to direct state control encourages the traditional mentality; corporatization helps transform that mentality and fosters a new market orientation.
- *Government rules are inflexible.* Management of such enterprises must be free to respond quickly and effectively to changing market conditions. They must also be able to quickly acquire necessary inputs at market prices without cumbersome administrative requirements. Illustratively, but most importantly, is the status of workers. If they are state employees, then management is restricted in hiring, firing, and promoting according to the needs of the enterprise and the consumer rather than according to dictates of law. For example, most enterprises need trained cost accountants, a commodity that is in scarce supply in Russia and available only at a premium wage beyond government standards. Managers must be given the freedom to manage in response to market conditions and this is almost impossible under state regulations.
- *Direct state status inhibits the transition.* Russian utilities have extremely large capital needs. Multilateral and bilateral lending and grant-giving institutions, to say nothing of private bankers and investors, are highly [illegible]ikely to provide funds to direct state s[illegible]res. Furthermore, corporatizatio[illegible]acilitates privatization in the lon[illegible]d competitive restructuring (f[illegible]mple, privatizing electrical generation while maintaining a public grid) in the short to medium run.

In sum, regime 2 is much more like regime 4 than regime 1, because both serve independent customers rather than the government. This similarity is reflected in the fact that many of the enterprises in regime 2 are already well into the planning stage for privatization (communications, airlines, and ports). There can be no question that regime 1 mechanisms of direct state control are simply not appropriate. The choice between the remaining two mechanisms, however, is not so simple.

In addition to the obvious definitional distinction based on the share of government ownership, regime 2 differs from regime 4 in two principal ways:

- *Limited competition.* Regime 4 firms face actual or potential competitive markets. This competition may be from domestic production or imports (once a modicum of stabilization is achieved, the dollar ceases to be a store of value, and the exchange rate falls). Regime 2 firms, in contrast, largely produce nontradables which are natural monopolies in at least their core activities. The number of such activities is smaller than generally thought, and competitive restructuring can reduce the realm still further, but there remains a core of activities for which prices will have to be regulated.

- *Finance.* As an instrument of social policy, the government may want to subsidize consumption of some regime 2 commodities in a selective and carefully-structured fashion. To meet their capital needs the government may, on a case-by-case basis, decide to provide additional equity capital or guarantee loans. No such facility should be available to regime 4 firms.

The above reasons have led the majority of the world's mixed economies to run these activities, as public enterprises owned and controlled by the government. In these countries the public enterprise sector generally generates around 10 percent of GDP. The United States and followers such as the Philippines have, however, largely followed the alternative approach of regulated private operation. Here, the public enterprise sector amounts to only about 3 percent of GDP. In the presence of monopoly, both forms of governance have proven highly imperfect. However, during the 1980s the weight of world preference clearly swung towards regulated private enterprises. Wholesale privatizations in the United Kingdom, Chile, Mexico, and Argentina, as well as partial privatization (selling minority shares to diversified shareholders) in Japan, and small-scale privatizations in numerous other countries clearly illustrate this change. It must be noted, however, that despite pronouncements to the contrary, privatization has been of significant magnitude (reducing the sector by more than 10 percent) in only a handful of mixed economies. Furthermore, these have all been the more advanced mixed economies, characterized by developed capital markets and legal institutions. Which governance mechanism is the lesser evil for Russia at this stage is a tough call, as the choice is between two highly imperfect alternatives.[9] Whichever choice is made in the long run, many of these activities will remain in government hands for the short to medium term and, if this is the case, we examine two alternative control mechanisms.

Under both options, there will need to be an independent authority or authorities to regulate prices. This subject will be left for others to elaborate, but there is an immense volume of international experience to be tapped.

In an earlier memo on this subject for GKI, Robert Anderson surveyed international experience with controlling public enterprises and identified two broad patterns:

- *Informal control via board of directors.* Following the pattern of private enterprises, shareholders appoint a board of capable and experienced individuals who then represent shareholders, pursuing their interests through whatever means seem appropriate to the board given the circumstances of the company.
- *Formal control via performance contracts.* Other countries judge that part-time boards are an imperfect control on full-time managers. They rely instead on formal performance contracts with management which specify goals to be achieved and provide explicit monetary incentives varying with the degree of attainment.

If the first mechanism is chosen, however, there is a major danger to be avoided. In most countries where the board method has been attempted, board members are part-time political appointees who have neither the time nor the experience to effectively contribute to governance. Stereotypically, they receive a packet of material a few days before the meeting, and peruse it in the limousine on the way to the meeting. In such circumstances the enterprise plays them like a fiddle and, except as a check on the more egregious forms of managerial malfeasance, the enterprise is controlled by the CEO.

If the board method is chosen, therefore, the private fiduciary method recommended below for regime 4 should be adopted. This provides the essential incentives for the fiduciary to do his or her job well. We confess a fondness for the symmetry of thus privatizing the fiduciary role, but recognize that it may not prove feasible on a wide enough scale to cover all applicable firms. Accordingly, we go on to consider the alternative.

While performance contracting is central to the proposed regime 2 governance, it is by no means the only element. The broad question is what should the government shareholder do when it controls a majority of the shares? As an aid to answering this question, it is useful to begin with a distillation of the literature on multidivisional or multinational firms, which face the same class of hierarchical problem. Lessons from this literature suggest that the head office should:

1. Appoint the General Director;
2. Provide resources (including reallocation of surplus and major investment decisions);
3. Set objectives;
4. Monitor performance according to those objectives;
5. Reward or penalize according to achievement of those objectives;
6. Plan and coordinate across subsidiary units; and
7. *Do nothing else.*

Performance contracting is carrying out activities 3, 4, and 5. It is essential to providing motivation and guidance in its own right, but is also essential if the other functions are to be carried out. Perhaps the most essential item on the list is the prescription "Do nothing else." However, if the government does not set targets and incentivize performance, then managers are likely to pursue their own set of interests. It makes sense for the government to look over their shoulders on day-to-day activities to prevent abuses. In short, if the government does not control results through performance contracting, then the alternative is to control the processes through which results are achieved. Performance contracting is thus central to the governance of public enterprises. South Korea provides a model of positive experience to be tapped if this option is adopted.

A capstone governance institution is needed to carry out governance activities on behalf of the state. This could most efficiently be done by making it responsible for both regimes 2 and 4. The general structure of its responsibilities was given above. Priority activities include the following:

- Preparation and commissioning of detailed studies on governance issues with attendant policy recommendations.
- Development of computerized databases developed on a priority basis with attention first to critical information (for example, subsidies) on the largest firms using readily available data.[10] This would evolve over time into a more comprehensive performance information system.
- Negotiation, monitoring and evaluating the performance contract system for regime 2 where this method is adopted.
- Recommending appointment and reassignment of managers in regime 2 based on assessments of performance.
- Selecting and monitoring regime 4 fiduciaries.

The other important governance function is finance and while the capstone institution should be involved in this activity, its principal locus should probably be elsewhere in the government. The creation of a new and independent body to carry out these activities is urgently needed. This institution would require both a senior policy board and a secretariat to provide information and analysis and carry out day-to-day activities. Further, the secretariat must be autonomous from government rules and regulations so that it can attract the necessary highly qualified staff.

Regime 3: Transitional firms

Regime 3 is for transitional enterprises. Inclusion in this sector is precisely as defined in the Yasin Report, namely:

> ...enterprises in Federal ownership which were not included in Type I and for that or some other reason did not undergo corporatization or privatization, but which are capable of operating in the market independently on a commercial basis.

To promote interim efficiency in this sector it can be argued that they should be subject to the governance structure which we will propose for regime 2. There are clear benefits associated with this idea.

The property funds and GKI share a fundamental limitation on their ability to exercise the corporate government function.

There are, however, also two offsetting costs to this approach, both of which impede the speed of transition to a market economy.

- Conversion to the new form of governance will consume considerable scarce human resources at both the enterprise and government levels. These resources could be better employed in developing means to adapt to market forces.
- Psychologically, it will reorient managers to look backward to the state, rather than forward to the market for solutions to their problems. The pace at which regime 3 withers away will accordingly be attenuated.

The costs of building a new governance structure greatly outweigh the benefits.[11] Governance for the transitional enterprises should therefore be status quo. There is no escape from their current plight other than privatization. In an effort to put further pressure on these firms to privatize expeditiously, the state should not render any financial assistance to the enterprises of regime 3, except in the context of a concrete restructuring plan leading to privatization. In sum, the transitional regime should be just what its name implies. All policies towards enterprises in this regime should be explicitly designed to minimize the transition period.

Regime 4: Mixed enterprises

How can a voice for capital and change be introduced in regime 4 enterprises? Given the crippled board and minority status of outside shareholders, the scope seems limited indeed. Most observers, therefore write these firms off as a done-deal. Before abandoning the board, however, we should note that it is only crippled and not quadriplegic. Even one board member can make a difference if he is trained to ask the right questions. People are willing to do some things in private but not in public, and a board member can get things discussed and thus put in the public record of the meetings. If well-qualified, the same person could presumably perform the same function as the government's minority representative to the shareholders meeting. Where the government has minority status, the impact will be limited to the sort of informed lobbying previously described for the board. In cases where the government shares constitute a controlling majority, or where such a majority can be had in conjunction with the proxies of private shareholders, considerably more can be accomplished. How can these votes be exercised effectively? We propose privatizing the governance function through the use of private fiduciaries.

The people are the principal—the ultimate owner of the shares in question. The problem is how to get the ultimate agent—the enterprise—to act in the interest of this principal. The people are a rather diffuse group, and consequently one or more intermediate agents must represent their interests. As we have seen, one such intermediary will be some representative of the RSFSR, institutionalized in the property fund, GKI, or perhaps other bodies. But, one additional layer is needed to act in the default capacity.

Who is the default agent? It is widely recognized that after a company's corporatization and privatization by GKI, government shares are transferred to the appropriate federal, regional, or municipal property fund, making them the default agent. What is not so widely recognized is that the GKI is entitled to keep controlling blocks of shares for up to three years in large enterprises, enterprises that dominate markets, or those engaged in natural resource-based activities (list 2 and list 3 firms).

The property funds and GKI share a fundamental limitation on their ability to exercise the corporate government function. Both are subject to limitations on salaries which make it impossible for them to attract—or at least keep—the highly skilled people necessary to do a sophisticated job. There are other limitations as well, involving the bureaucratic inheritance of the old system, but the salary constraint alone is sufficient to indicate that the governance function should be delegated to some autonomous body or bodies not subject to bureaucratic constraints.

Fortunately, this seems to be a noncontroversial conclusion. Representatives of the Federal Property Fund assert that, with only eighty employees and no plans to hire more, they intend not to exercise the governance function, but to delegate it. The same principle lies behind the joint decision of the property fund and GKI to form the Russian Privatization Center (RPC) to exercise privatization functions. The same sort of thing needs to be done for the governance function.

We shall refer to this third party or parties as a fiduciary, to emphasize that it is acting on behalf of the property fund and GKI, who in turn are acting on behalf of the Russian people. Who should the fiduciary or fiduciaries be?

The most obvious candidates for the fiduciary role are the old branch ministries and their offspring associations and apex corporations. As we saw above, there is considerable support among the industrialists for the branch ministries to be the primary fiduciaries, and, in some cases (such as oil), they have already been empowered in that role. They have one powerful asset: knowledge. The apex organs are repositories of information about the industry and its managers, technology, suppliers, and buyers (especially in former CIS republics and Eastern Europe). These strengths can and should be utilized, at least in the form of consulting firms, selling their services to autonomous members of the industry according to the needs perceived by autonomous enterprises in light of alternative means of providing such services (whether internal or external).

Another issue is whether or not they should also be given shareholder rights over the associated firms putting them in a hierarchical position of dominance. There are a number of ways of answering this question. One is to look at the list of jobs to be done (evils to be avoided) by the fiduciary as laid out above. The goal of providing a vote for capital would be promoted by this structure, since their income would partially be a function of the dividends of the subsidiaries. With regard to the other goals, however, the picture is less sanguine.

The job of avoiding consumer exploitation would not only not be accomplished but would be retarded. One would essentially be creating a super-cartel where the usual constraint on cartel behavior (self-interest of members in cheating on their production quotas) would be precluded by the holding company's power to appoint and reward the general directors. The leaders of the associations are smart enough to assure interviewers that they have no intention of doing any such thing, but would encourage competition among their member firms. They are also smart enough to know that in such a situation it would be contrary to their self-interest to do so and that in a market system the primary guiding light is that of self-interest.

Another major goal is the promotion of change. Would the old leadership force the replacement of incompetent management upon the enterprises? Would their response to poor performance be to expedite change or delay it through cross-subsidization of losing enterprises through transfer pricing and the use of captive banks? Similarly, would they promote the goal of promoting exit, or delay it out of (expensive) loyalty to old friends?

The answers to all these questions are self-evident to those whose self-interest is not involved, and accordingly the old branch ministries should be rejected as fiduciaries. It would be the same old people doing the same old things. These individuals should be encouraged to use their critical knowledge as consultants to the industries, but with the relationships intermediated by markets rather than hierarchies.

Another possibility is to appoint independent private financial or management specialists as fiduciaries. Their interests would be linked to that of the nation through an appropriately structured set of incentives to be described in the next section. In essence, this would mean privatizing the government's corporate governance function in addition to privatizing the company itself.

Who might these fiduciaries be? At one extreme—perhaps representing wishful thinking—is Singapore Airlines (a public enterprise and arguably the world's best airline) as trustee for Aeroflot shares. Such a trustee would not only vote the shares, but provide management consulting services and play an active role in the search for a private buyer or partner for the enterprise. At the opposite extreme, a purely domestic financial-management company might take on a portfolio of smaller companies, but play the minimalist role of appointing the general directors—signing incentive contracts with them that promote the trustees' interests (and therefore, because of the trustee incentives, promote the public interest) and taking one seat on the boards to monitor and promote performance. Many intermediate possibilities exist. A particularly appealing one involves a partnership between domestic and foreign financial-management consultants.

How would such a trustee be selected? Competitive bidding is the obvious market-based answer, with the award going to the bidder willing to accept the lowest payment[12] to do the job. However, the lowest bidder might simply be the least intelligent or the one least able to do the job. To avoid this, two things would have to be done. First, bidders would be prequalified (in terms of their ability to do the job). Second, each would submit both a price and a plan as to how they would exercise their fiduciary responsibility. The selection committee would consider the quality of the plan and the bidders' ability to implement it, in addition to the price in determining the winner.

This scheme has considerable merit in that it uses market mechanisms and is thus consistent with the current reform philosophy and that it also places the shares in the hands of those with the skills most needed in Russia today. The enterprises have considerable engineering and technical skills, but are woefully lacking in the entrepreneurial, financial, and market management areas.

The critical question, of course, is whether or not there is a potential supply of such trustees. This will depend in part on the incentives to be offered. First, however, we consider cases where no private fiduciary is forthcoming.

Even under the most optimistic assumptions it is doubtful that the supply of trustees will be sufficient to handle all of the important regime 4 entities. Most significantly, it is unlikely to work when government and private shareholders are in a minority. Some firms may have such bleak prospects that no trustee will take them on. Others may have difficulty specifying an incentive scheme that adequately links the interests of the trustee to those of the nation. Most importantly, it will take time to find and contract trustees, and corporate governance will still have to be exercised in the interim.

Accordingly, it is imperative to establish a fiduciary of last resort (FLR) to take on all trusts not dispensed using the above scheme. There are two critical distinctions. First, the FLR would be a publicly-owned body while the trustees of first resort would be private. Second, the FLR would not be compensated primarily through a share in the profits of the firms whose shares it was voting. Rather, it would be an autonomous body wholly owned by the state and compensated primarily by fixed payments (ideally, with funds provided by some international or foreign donor). Performance incentives could and should be provided, but these would not be the primary form of funding, precisely because the bulk of the firms involved would be those for which such incentives were deemed inadequate by the market.

What we have in mind is something structurally equivalent to the Russian Privatization Center (RPC), which is jointly owned and operated by the Federal Property Fund and GKI with foreign funding. In fact, since the property fund and GKI are the concerned shareholders, the RPC (or its twin) would be a prime candidate for the FLR role. Wherever it is located, it would have two functions: first, it would select and monitor the fiduciaries of first resort; second, it would appoint, train and supervise those selected to vote the government shares in residual enterprises.

The urgency of governance reform

Many informed observers—both Russian and foreign—believe that reform of corporate governance is not a priority. Their arguments may be summarized as follows:

- At this critical juncture in Russian history, the government simply has too many higher priority concerns (democracy, macroeconomic stabilization, privatization) and too few skilled economic managers to divert resources to another difficult and controversial reform.

- Any attempt at reforming corporate governance would slow down the privatization program as the possibility of an alternative governance structure would reduce the pressure on many enterprises to privatize quickly.
- Any reform effort would be likely to reimpose a semblance of the old state governance structure. This would be worse than the current evils of pure worker and management control.

There is much wisdom in these arguments and any proposed reform must explicitly address these concerns.

The counter-argument rests on two propositions:

- The state sector is going to remain large for several years. For the sake of illustration, assume that regime 2 enterprises will account for 20 percent of GDP. Assume further that regime 4 enterprises will produce another 30 percent.
- Corporate governance can make a difference, most importantly, by providing a voice for changing managers. Again by way of illustration, assume that it can produce a 5 percent annual increment in efficiency (defined simply as the ratio of real outputs to real intermediate inputs).

If these premises are accepted, then implementation of corporate governance reform will add 5.5 percent to the annual growth rate of GDP. The calculation is simple. If the relevant enterprises produce 50 percent of value added, then their output will be on the order of 120 percent of GDP. Increasing this by five percent while holding inputs constant will then make real GDP 5.5 percent (0.5 multiplied by 120) higher than it would have been without reform. These numbers of course only represent broad orders of magnitude. Note, however, that they are conservative in at least one critical respect. They assume that the only gain is in static operating efficiency and ignore the dynamic impact on investment and innovation.

If some variant of the foregoing argument is accepted, then how are the three earlier objections to be met?

- We are not in a position to assess the extent of limited economic reform capacity, but would suggest that getting a GDP boost of approximately 5 percent annually would seem to warrant expenditure of scarce resources.
- To minimize the impact on the pace of privatization, two features would be necessary. First, a quick and definitive decision would have to be made assigning a limited number of enterprises to regime 2. Second, nothing should be done with regime 3, and they should not be eligible for even the limited financial assistance which might be accorded to regime 4.
- To avoid returning control to the old state structures, the apex organization of the new governance regimes would have to be outside of those structures. A new and autonomous body would have to be created to exercise strictly limited functions (specified in the section above) for regime 2 firms and to appoint and monitor fiduciaries for regime 4.

Whether or not these counter-arguments carry sufficient weight can only be decided at the highest levels of the Russian government. If, and when they are accepted, then this paper has provided some preliminary suggestions on how the reform of corporate governance might proceed.

Conclusion

Since this paper was written in 1993, the GKI has made extraordinary progress in completing privatization transactions. The question here is how quickly this remarkable change in structure will translate into changes in behavior. It is of course much too soon for definitive conclusions, but the useful papers by Blasi and by Webster in this volume provide some fascinating insights. On the question of who controls the enterprise, Blasi reports two results which will not surprise readers of the foregoing: first, insiders dominate outsiders in terms of board representation and decisionmaking power and second, among insiders, managers overwhelmingly dominate workers.[13] This corresponds to our earlier observation that the immediate impact of privatization would be conversion of *de facto* managerial control to *de jure*. How has the resulting managerial control been exercised?

Of particular importance is the observation that "Since 1991, post-privatized firms have cut employment by 21 percent."[14] If this were the result of concrete actions by managers it would be impressive evidence that they were capable of rapid change and were pursuing the interests of capital and not merely labor. There is room for concern as to whether this is the correct interpretation. Consider Uralmash, the famed heavy equipment producer in Yekaterinburg. In 1991 it had 62,000 employees, but at the time of our visit in 1992 it was down to only 48,000. Further enquiry revealed that none of this was due to layoffs or restructuring—all had been voluntary departures for better opportunities elsewhere. As of 1994, employment had been further reduced to only 23,000 workers and only 3,000 of this decline represented action by management (subsidiaries hived off in the process of privatization). Voluntary departures of such magnitude are of course wonderful news for proponents of rapid reform because it shows the creation of many new jobs in the private sector. As evidence of changes in managerial behavior, however, they are less than convincing. How much of the 21 percent average reduction was voluntary (as in Uralmash), how much was active labor-shedding by management? Our own interviews suggest that, at least through 1993, voluntary departures dominated. Until further evidence is in, one should not equate cuts in the labor force with management-induced restructuring.

It has also been reported that after privatization, management was changed in about 10 percent of the cases. To the extent this represents the ascendancy of modern market-oriented management, this is impressive. However, some part of it presumably reflects the retirement or death of old-style managers and their replacement by like-minded fellows. Learning how much of the 10 percent falls in each category is crucial to interpretation.

Survey evidence for active restructuring illustrates that 58 percent of managers engaged in new product development, 58 percent had contacts with foreign investors, 33 percent had specific discussions about joint ventures, and 15 percent were already involved in joint ventures.[15] This is certainly encouraging, but one needs to know how many of these contacts will be brought to fruition. Talking about doing things is better than not talking, but actually implementing them is something entirely different. Similarly, in interpreting the 15 percent involved in actual joint ventures, one wonders how many were begun prior to privatization.

In sum, there are two extreme caricatures of Russian managers.

In sum, there are two extreme caricatures of Russian managers. One says that the best people rose to the top in the old system and the capabilities learned there will allow them to excel in the new market economy as well. The other extreme says that the capabilities necessary to succeed in a bureaucratic system are totally different from those required in a market system and true change will come only when management is changed. The truth is presumably somewhere in between. If experience reveals that the latter extreme is closer to the mark, then real change in the large and medium-sized industry sectors in Russia will come only with further changes in corporate governance.

Notes

This is a condensed version of a much longer paper. Copies of the complete paper are available from the authors.

1. Article 6 of the Law, passed by the USSR Supreme Soviet on June 30, 1987. The procedure of elections was further elaborated in the Regulation of the Central Committee of the Communist Party and the Council of Ministries of February 8, 1988.

2. Resolution of the Supreme Soviet of the Russian Federation N.2 980-1, *State Program of Privatization of State and Municipally Owned Enterprises of the Russian Federation for 1992*, June 11, 1992.

3. A third option is available, but has been chosen by few enterprises and is therefore ignored here.

4. Followed by another vote to actually fill the newly apportioned seats via a simple majority vote of common shareholders.

5. For example, change would be possible if workers and managers buy only 6.5 percent of their optional shares (20/26.5=.755). Alternatively, change could also occur if workers and managers buy the full 15 percent, but government sells all its preferred shares to independent investors who are induced to vote with the government [(20+40)/75=.80].

6. As long as someone has the property rights, it doesn't matter who.

7. Some would argue that there is a fifth evil of inaction, namely continued managerial usurpation of surplus and assets through a variety of sweetheart deals with private companies which kick back a percentage to the managers' accounts. While agreeing that this is a problem, we do not see it as one whose primary solution lies in actions by the government as shareholder. There is a much more direct solution: relying on a third party which has both the self-interest and potentially better information, namely the workers. In the previous cases, the interests of workers and managers overlapped and government action was essential. In this case, their interests diverge, since any diversion to managers is in large part at the expense of workers. Accordingly, the most efficient solution is to educate workers to the potential for abuse and perhaps provide them easy access to a remedy (perhaps a regional ombudsman). The government representative on the board might also play a role here, but this is not central. While we would not object strenuously to there being five evils of inaction, we are content with four, which seem more than sufficient to justify our conclusion.

8. Article No. 9 of the Law of Russian Federation "On Privatization of State and Municipal Enterprises."

9. To avoid misunderstanding, note that this statement applies only to the last 10 percent or so of GDP. World experience convincingly demonstrates that privatizing the other 90 percent is unequivocally a good thing.

10. We understand that the first steps in this direction are under way at the Ministry of Finance.

11. There may be an exception for a very small number of very large enterprises which it is impossible to privatize for a very long time. If so, they should be placed in regime 2.

12. The "x" in the incentive scheme described below.

13. Joseph Blasi, "Ownership, Governance, and Restructuring" (this volume, pp. 125–139)

14. Ibid.

15. Ibid.

Restructuring Large Enterprises in Preparation for Privatization: A Case Study

Håkan J. Wilson

The essence of transition, from planning to the market, is that Russian enterprises must change and adapt to a new and continuously changing environment. Much has been accomplished in privatization, but it is the success (or failure) of enterprise restructuring that will ultimately determine the speed of transition to a market economy. This case study illustrates the daunting difficulties facing large manufacturing enterprises in Russia, what remedial actions are needed, and how they can be carried out. The objective of the chapter is to present the measures necessary for successful restructuring.

Background

The chapter draws from an actual case of enterprise restructuring, but some specific enterprise information is concealed for competitive reasons and to provide anonymity to participants. The firm will be referred to as "Enterprise." Enterprise was created in the 1950s as an amalgamation of six separate manufacturing enterprises, some of which dated back to the 1920s. In 1990, the company had 32,000 employees and made a range of products for both the military sector and civilian industries. It had developed consumer products to balance its military order book and to exploit its technologies. Due to its strategic importance to the military, Enterprise was not explicitly targeted for privatization in 1991, but a new management team and strong foreign interest came at a time when the company faced an uncertain future as a military contractor. Thus, it took the opportunity to identify viable strategic directions, including how to privatize quickly. In mid-1993, Enterprise succeeded in getting cabinet approval for privatization, and it went through the voucher auction process in early 1994.

From 1992 on, a French investment group and an investment bank (referred to henceforth as Investment Bank) worked with management to create joint ventures with international firms. Some global competitors were interested in cooperating with Enterprise and a Korean multinational provided sophisticated technology and machinery for more advanced production. With more than 250 product groups, a weakening military demand, uncertainty over potential partner objectives, and a rapidly deteriorating economy, management found it increasingly difficult to identify a corporate direction with which it could feel confident. Management also recognized the need for restructuring to deal with the complexity of Enterprise's structure, with inevitable layoffs, and to create a legal structure to allow for joint ventures at the subsidiary level.

Consultants (a management consulting firm) and Investment Bank were hired to assist Enterprise in assessing its strategic position, and to undertake necessary restructuring. Investment Bank's interest was to create and financially support a joint venture, take an equity position in the company, or both. To this end, Investment Bank would help finance new investments, if guaranteed an equity stake and if selected for financing a future deal. Consultants recently decided to expand their European operation outside the United Kingdom, and were willing to invest both in learning and in building a reputation in Russia. They were financed partly by Investment Bank and partly by themselves. Later in the project, Bilateral Donor would come in and provide additional financial support.

Structural organization until 1991

In the early 1990s, Enterprise's productive capacity was split more or less equally between military and civilian production. On the military side, the development and production of a small series of specialized applications was dominant. Most civilian production was based on the same technology but had been developed separately. There were three main nonmilitary products and the most important end-users were industries, hospitals, and schools. Recently, some products had been developed to target the consumer market.

Altogether, there were more than 250 product groups, ranging from toys to advanced military hardware. Many civilian products were made only by order (a reflection of how military production operated). Moreover, there were many development projects in the pipeline, originating both in the central research and development department and in individual production units or complexes.

To meet the requirements of 250 product groups, the organizational structure emphasized specialization according to functional expertise (figure 12.1).

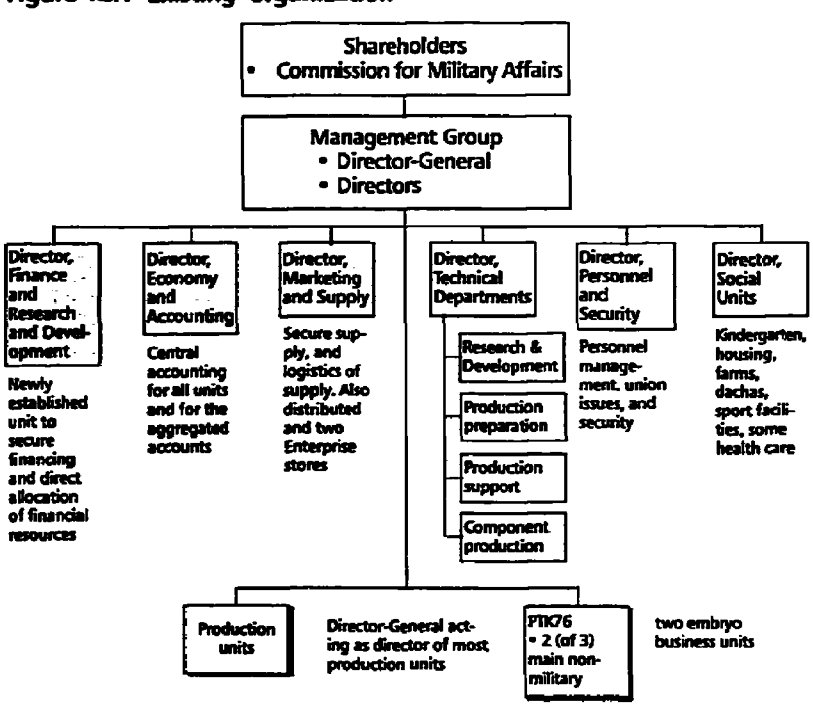
The technical department had been responsible for applied research and product development, prototypes, preparation for serial production, development of production tools, and maintenance. Roughly 6,000 employees worked in this department (including over 2,000 skilled engineers in research and development). Production of individual parts, processes, and assembly was allocated to individual production units. Assembly would always go to those units responsible for assembly of similar products. The marketing and supply department obtained external raw materials and parts. Specially tailored components were produced by the components parts unit in the technical department.

Production unit 76 was an exception. It assembled two of the more profitable nonmilitary products, and provided parts and processes to other units. Unit 76 was also responsible for elements of product development, production preparation, maintenance, and supply. All production units, including 76, reported directly to the director general, who, in addition to other duties, assumed direct responsibility for production, partly because he had been manager of 76 during its creation, before being promoted to director general. Overall, the production units employed almost 16,000 workers and engineers. Production and development decisions were taken by the management group—that is, the directors of the central units.

The department of economy served individual units, as well as the whole corporation, with accounting and cost calculations. Costs for complete products or parts were calculated based on the use of resources, estimated when the product was originally developed, and current resource costs; inventory accounting was based on the first-in, first-out method. With limited computer capacity, bookkeeping and cost accounting were done manually, employing several hundred economists.

The department of marketing and supply handled the major and difficult task of securing inputs. Marketing (to the extent that it was done) was carried out through contacts with government-controlled distributors in the former Soviet Union. Two exceptions were the stores in the city in which Enterprise was located and in

Figure 12.1 Existing organization



Moscow, where consumer products were sold and some industrial products ordered. The two stores also provided minor repair services and served as reception and delivery points for products to be repaired at the main factory.

The personnel department not only covered management of 32,000 employees, but also supported the workers' council and internal security. The finance and innovation department, which had been created in 1992, oversaw financing and cash-flow issues, as well as directed investments to promising developments. It also attempted to function as an internal trouble shooter or consulting service.

Finally, the social department, employing 5,000 workers, provided housing, kindergarten, limited health services, and basic food and groceries at the company cafeterias and stores (produced at a nearby farm). It also offered sports facilities near the factory and two *dachas* for employee vacations—one next to the farm outside the city and one in Crimea.

Flow of information

There were two distinct information flows—bottom up, from individual units to production units (or from central departments) up to management and top down, from management (or individual directors) to departments, production units, individual units, or even to individual employees. The first flow (bottom up) provided basic performance data—production volumes, resource use, worker attendance, cost of inputs, maintenance needs, development results, and so on. The second flow (top down) provided decisions—on product mix and production targets, resource allocation, personnel, suppliers, inputs, maintenance, development, schedules, and so on. Even trivial decisions were often referred upward, as senior management directed all aspects of the operation.

This resulted in a centralized organization with rigid operating procedures. Major decisions were communicated through executive memorandums from the director general, and all decisions required formal documentation. For example, Enterprise staff working with Consultants had contracts drawn up to establish their terms of reference and guarantee them their old jobs at the end of the project.

There were major gaps in the functions performed because, for decades, directives from Moscow had largely replaced the need for market information. Basic research was provided by central laboratories in Moscow, St. Petersburg, and in the city of Enterprise, and the military took an active part in supervising the development of military applications. Supply was organized nationally, and some key supplies came from other monopoly suppliers and from other republics in the Union (figure 12.2).

The most critical deficiencies were in marketing, sales, distribution, and after-sales service. Enterprise had almost no contact with end-users, and did not have real marketing, sales, or service capabilities, nor its own distribution channels. Isolated from strategic decisions on production and product development and from customer access and contact, Enterprise, in the early 1990s, was a large, centralized, overstaffed, incredibly complex, bureaucratic production and employment organization.

Structural changes in the early 1990s

The shocks experienced by the Russian economy from the early 1980s on are common knowledge. Less well-known were the

Figure 12.2 Existing business system

	Market research	Research and development	Supply	Production	Marketing	Sales and distribution	After-sales service
Performed by Enterprise:		Emphasis on • applied research • applications • development • production machinery	Extensive organization to secure supplies	• Production preparation • Production of components, and production machinery • Assembly	Limited arrangement for export	Two sales offices in St. Petersburg and in Moscow. Limited arrangement of distribution	In sales offices (for small repairs) or if sent to factory in Samara
Performed external to Enterprise:	Directives from central ministries	Basic research by central laboratories. Guidance by central directives.	Organized and guided by central directives.		Allocated according to central directives. Some consumer products sold direct	Centrally coordinated sales and distribution	

The external shocks most relevant to Enterprise were a drastic fall in demand of military products, the political chaos combined with the disintegration of the Soviet Union, hyperinflation, elimination of central planning, drastic reduction of soft credits or subsidies, foreign competition, and privatization of both suppliers and customers.

effects of the shocks on an organization such as Enterprise. They had a huge influence on the need for the scope and pace of restructuring. The external shocks most relevant to Enterprise were a drastic fall in demand for military products, the political chaos combined with the disintegration of the Soviet Union, hyperinflation, elimination of central planning, drastic reduction of soft credits or subsidies, foreign competition, and privatization of both suppliers and customers (figure 12.3).

These external shocks led to significant changes in the industrial structure in which Enterprise operated. Military orders, representing half of turnover, dropped rapidly, whereas industrial and medical demand for core products remained relatively stable. With increasingly independent and cost-conscious consumers, demand became more quality- and service-oriented. Consumers also seized the opportunity to buy newly available foreign products, and, as a result, Enterprise's consumer goods fared badly with their old design and limited features. To make matters worse, the payment system proved inadequate to absorb the rapid increase of transactions. It was not unusual for cash payments (from customer to their local bank to Enterprise's bank in the City to Enterprise) to take 60–90 days. Inflation and an increasingly hard budget caused further problems for Enterprise, its clients, and suppliers. And for the first time in Enterprise's history, customers would sometimes default on payments.

Enterprise experienced important changes in both up- and downstream supplies. As privatization gained momentum, many traditional suppliers changed their product mix, volumes, customer base, and prices. In particular, energy prices rapidly approached world market levels, and the local energy supplier quickly evolved into the largest provider of medium and long-term finance. Limited and irregular availability of key supplies reduced capacity utilization, even for goods still in demand. Moreover, downstream activities suffered severe disruptions. Local distribution organizations quickly went through privatization, and Enterprise suddenly had to deal with many profit-oriented private firms. The most critical input, labor, also experienced drastic changes as many skilled and entrepreneurial workers and engineers either left for better opportunities or spent their time at Enterprise working for themselves. Those who remained became dissatisfied with their shrinking real wages and reduced benefits.

Idle capacity, caused by reduced and shifting demand and limited availability of key inputs, was further aggravated by increased competition. For example, the transistor radio market was an easy target for cheap Far Eastern and Chinese consumer products. While some imports did not offer the same technical quality, their designs were more attractive, and they rapidly gained market share.

Enterprise's hospital products, on the other hand, were in a rapidly growing segment of the increasingly important medical equipment industry. This relatively new product group offered good-quality products to both hospitals and patients, with lower costs to all. A few big international companies had come to dominate the world market and many more wanted to enter. The Russian market was quickly becoming important, and Enterprise, among a few local suppliers, became a target for acquisition itself.

Structural changes adversely affected the performance of Enterprise. By the early 1990s, Enterprise experienced severe supply shortages and a marked departure from its healthy financial position during the late 1980s. Although the situation was kept under control through soft credits from Moscow, it was becoming more and more difficult to obtain these subsidized loans. Nevertheless, there were some products that were highly profitable, especially the few export earners. The trend toward a streamlined product range alleviated some problems, but the shift in product mix and volumes was painstakingly slow.

Further aggravation was caused by the lack of internal financial information, especially short-term cash-flow analysis. Accounting could not provide relevant and timely information in a changing environment with high inflation. Consequently, although the books may have balanced, there were frequent liquidity crises caused by the volatile payment system, defaulting customers, changes in demand, and sudden input price increases.

Operationally, all this had three major effects. First, inventory of less attractive product groups was piling up quickly, and production could not adjust accordingly. Second, at the same time, many workers were underutilized, causing poor morale and lower product quality. Many qualified workers left. And third, due to lack of funds, lower overall activity, and a sense of lethargy, the deterioration of the machine park and buildings accelerated.

These developments prompted substantial changes in conduct by Enterprise—and by its increasingly private and active competition. Enterprise reacted to the fall in demand by reducing its work force from 32,000 to 25,000 by the end of 1992, partly through retirement and resignations. Moreover, there was a stronger emphasis on revenue-generating products and on research and development focused on consumer goods, both of which had further cost-cutting effects.

To retain key staff and survive in this new environment, Enterprise began to pay important employees better, increasing the salary spread considerably. The company also began to delegate greater authority to managers and to create units to handle the missing functions. For example, production unit 76, with its small product-development, economy, and sales functions, was an attempt to create the embryo of a strategic business unit.

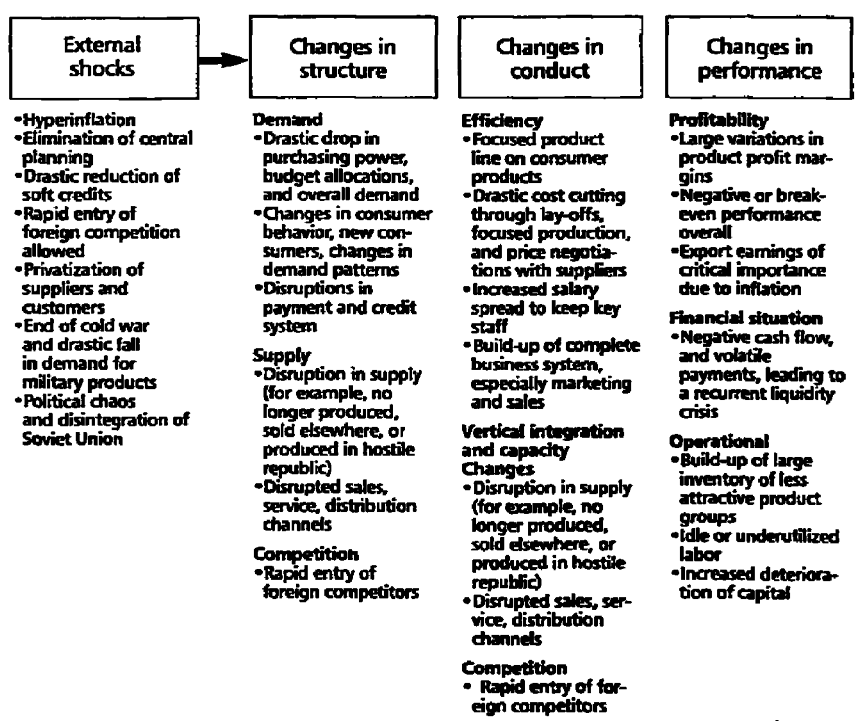
Externally, Enterprise began to link up with key suppliers (formally and informally). Upstream, the company secured long-term contracts with some parts suppliers by providing some financing as an incentive. Downstream, the race was on for control over distribution channels. Established contacts allowed Enterprise to continue to use much of the existing distribution networks, but this did not provide the necessary direct customer contact. The textbook solution would be to create a new distribution set-up, but Enterprise's international competitors were already working on this in the service-intensive hospital-product market.

Restructuring

The joint effort to restructure Enterprise began at the end of 1992 with discussions between management, Investment Bank, and Consultants. It was agreed that Consultants would field a team starting January 1993 to perform a diagnosis and generate preliminary recommendations. Enterprise would further strengthen the team by adding its own members as needed. Given positive results, the agreement would be extended beyond the initial three months. The first task for the consulting team was to get to know the client. There was little information available on Enterprise or its markets, merely brochures for some civilian products. The consulting team had four objectives:

- To make a rough assessment of the fundamental viability of Enterprise, its products, markets, and capabilities
- To assess management's willingness to change and its ability to implement tough recommendations
- To build trust and a relationship with client team members and key managers and be accepted by the organization
- To create a common platform for generating preliminary recommendations and

Figure 12.3 Structural changes early 1990s



to agree on a detailed work plan, scope of the engagement, and time frame

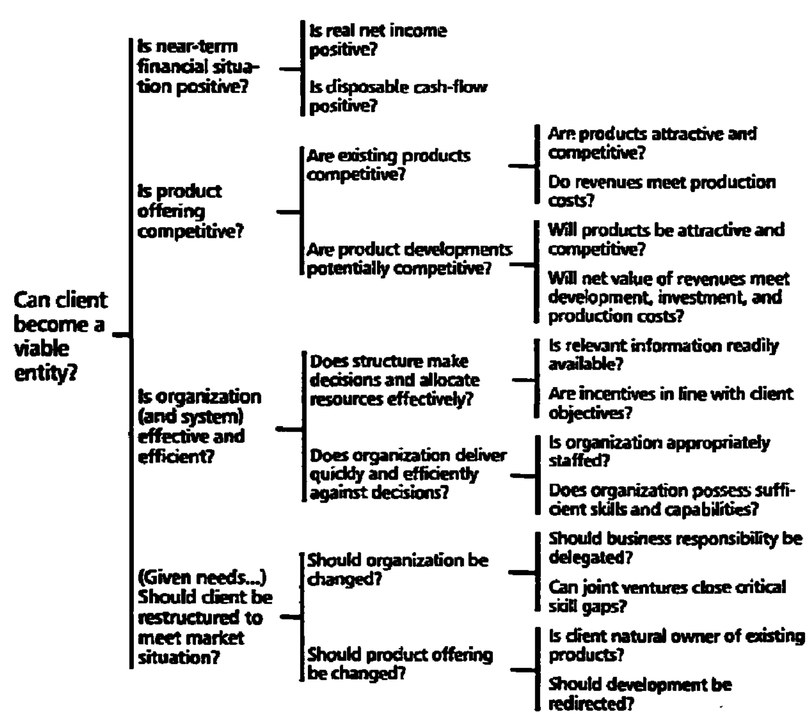
A mock annual report was drawn up, and the team set about designing draft organization charts to be filled in based on information generated by the client team members. This initial six-week exercise also served to demonstrate the effort and quality of information required to perform a fact-based restructuring.

The first critical need was to understand the short-term financial situation of Enterprise.

Was the restructuring of Russian enterprises qualitatively different from that of typical western clients? Clearly, the history and tradition of Enterprise were different from those of any western company, as were the degree and the types of external shocks it faced. On the other hand, the mandate was to help transform this company to a profitable business competing directly with large multinational corporations in a market economy. The obvious conclusion: restructuring is much more complex for a Russian enterprise, given the greater effort required, power of old habits, and cultural sensitivity. But basic business conditions still apply.

Having successfully created the mock annual report, the team designed a structural approach to help Enterprise become "sustainably competitive." To keep matters simple and focused, four key areas of analysis were identified (figure 12.4).

Figure 12.4 Structural approach to restructuring



Financial situation

The first critical need was to understand the short-term financial situation of Enterprise. Was there need for immediate defensive actions to sustain the company in the short run, or was cash-flow positive? The answer was inconclusive. The emphasis was on cash only and the team took great pains to eliminate revenues not readily available to the company. It seemed that there was enough liquidity to meet short-term demand, but even this was uncertain. Some soft credits were also anticipated, but it was unclear whether they would materialize. The analysis revealed that pricing did not reflect cash production costs, and that a set of price changes and production stops would improve liquidity. The short-term cash issue resurfaced several times in 1993, causing much turbulence for Enterprise and the project team.

Products, organization, and partners

Second, it was thought that product analysis would identify winners and losers among Enterprise's products and determine the future of its product portfolio.

The "annual report" outlined Enterprise's products and estimated the volume of production. With an improved understanding of the economic importance of the broader product groups to Enterprise, the consulting team brainstormed with management to determine where production should be focused. Based on existing industry understanding, supported by western market information, the team and management decided to concentrate on two industrial products as the most promising business areas and also look closely at one consumer product (because of its relative importance to Enterprise).

Organizational analysis aims at creating a structure to support the production and sale of the most promising products. The goal was to change the organization from monolithic and centralized one, to a set of product-oriented business units with delegated authority and profit responsibility. Another important objective was to reduce the complexity of the organization, as well as to train managers and workers to close skills gaps.

The assessment of potential partners was based on the strategic position of each sub-unit and its investment needs (in systems, skills, and capabilities, as well as capital). It also perceived partner aspirations and the value to both parties (Enterprise and partner) of cooperation. The assessment covered direct competitors with complete business systems and world market presence, suppliers of key functions, and capabilities in important markets only.

Progress

The initial diagnosis began in January 1993 and took about three months, with an additional three months to generate preliminary recommendations. The plan was that management had to accept the results and be willing to push ahead before the team could continue. Initially, the Consultants expected to move more quickly and either finish the engagement by late summer 1993 or increase the scope of the project. In reality, it took longer, for three reasons. First, the process was expected to be a series of iterations—starting broadly, then gradually zeroing in on key issues. But lack of information and the inevitable unanticipated situations caused delays. Second, as trust started to develop and personal relations were built, Consultants and management engaged in time-consuming, but productive and frank technical discussions. Third, management asked for assistance on items not included in the original terms of reference. Managers, including the director general, increasingly requested day-to-day help with operational issues.

By early spring 1993, the team had achieved a rough understanding of Enterprise, its products, its capabilities and the market situation and had devised a preliminary strategic plan for product focus, business unit organization, and joint venture arrangements. The team then began implementing and modifying the plan. A major effort was made to increase knowledge and understanding of both former Soviet and international markets. Since international market information was readily available, the issue was how to analyze the domestic markets. It turned out that Enterprise's managers and engineers had a wealth of information on other producers in the former Soviet Union because of their previous contacts. The team was able to put this information to use and suggest a marketing strategy. For example, the research and development department had rough segmentations of end-user markets, which the team broke down by purchasing power and geographic location to identify test groups. Data were then collected through in-depth interviews with representatives of the test groups, and some information was available from GOSPLAN in Moscow. This provided a deeper understanding of market size and share, the development of competitor products and distribution, and Enterprise product attributes.

...top management was still inclined to cross-subsidize and continue making products judged "important to society"...

As better-quality information and analyses became available, Consultants began to spend considerable time with management implementing the improvement plan. Not surprisingly, as soon as one problem was solved, new obstacles and questions would arise. For example, the need to merge profit responsibility with key business systems highlighted the concern of top management that it would lose control. Would sub-unit managers perform as expected, or would they retain the benefits at their units? Corporate governance had to be clearly defined and control mechanisms put in place. If sub-units were organized around good products only, how would the rest of the product groups be organized? The obvious answer, to eliminate most of the product range, met considerable resistance. In the consultants' view, it was reasonable to insulate viable products from loss-makers, but top management was still inclined to cross-subsidize and continue making products judged "important to society," if only to retain the option to produce these products at a later stage when the economy had developed. Eventually, new, more business-oriented sub-unit managers would force the issue, and as privatization became a real possibility, top managers increasingly emphasized profit generation over societal commitments and questionable long-term options.

Discussions on how to organize company-wide support functions focused on three elements. First, managers pointed to solutions of international competitors, especially those with centralized research and development. It could not easily be shown that those companies had gone through a period of decentralized research. It was only when synergies of central research and development outweighed the cost of removing direct control from profit centers that it made sense. The conclusion was that the returns from investment on research were insignificant (for the time being) compared with the value of instilling market behavior.

A second discussion centered on how to deal with social units. The social commitment to workers and their families was deeply ingrained in top management, and they only reluctantly agreed to divest these services. The third discussion concerned the links between functions. The team spent considerable effort describing to management how information could and should flow, how decisions could be made, and how future units would interact. The proposed sub-unit managers became invaluable allies, and many worthwhile ideas were developed and tested in the two pilot business units. As the new organization and core products were established, the focus of the consulting service shifted to implementation.

The transition phase was the most taxing—both for enterprise employees and for consultants. The emphasis of the work shifted from analysis to process, and the pressure on individual team members and managers intensified. One reason was that many middle managers got involved as the focus shifted from strategic design to implementation. The team was thus temporarily augmented and two consultants were assigned to each pilot sub-unit management unit while the project manager and another consultant supported the director general and corporate center. Groups were set up to work out details of the structure and functions of the corporate center and sub-unit organizations, including staffing, resource needs, transfer pricing, and myriad other details. The working groups reported frequently to top management and to each other. After a short teething period, the working groups generated momentum that quickly pushed changes through. The change process, however, caused tension to build between established operations and the proposed changes until it became clear that a resolution was required. The conclusion was that gradual transition was not only costly (as products were eliminated without subsequent layoffs and asset reductions), but could actually jeopardize the whole restructuring program. Management decided to give itself one month to create a functional new organization while temporarily shutting down operations, giving all nonessential staff leave. An important byproduct of this month was the identification of the staff (and resource) needs of each business unit, based on projected sales of profitable products.

In the final analysis, that one month of concentrated implementation of the proposed changes proved critical to the success of the transition. The clear deadline provided top management and consultants with a sense of now-or-never and pushed them to a massive effort to finalize key pieces. By the end of the month, the new organization was more or less in place—resulting in the immediate elimination of over 10,000 workers.[1] The new, redimensioned product market sub-units had the ball and were starting to run with it.

Results

There were five concrete results from the restructuring project:

- The nonmilitary product range was cut from well over 100 to 3 core groups, representing more than a 50 percent (and increasing) share of turnover, 80 percent of profit, and 45 percent of employment (direct and indirect). Of the original 250 product groups, only 90 remained, and those were mainly in the military sector.
- The new organization is considerably smaller and simpler, and the size of the organization continues to decrease as more products are judged nonviable or

unsuitable for Enterprise. The new sub-units have not yet begun to expand their staffs, but are likely to as output and product sophistication increases. There has been some limited recruitment to fill key functional gaps, but the emphasis has been on finding suitable staff internally and retraining them. The present corporate structure is that of a holding company, with incorporated strategic business units to stress formal accountability, to increase flexibility, and to facilitate foreign investments (figure 12.5).

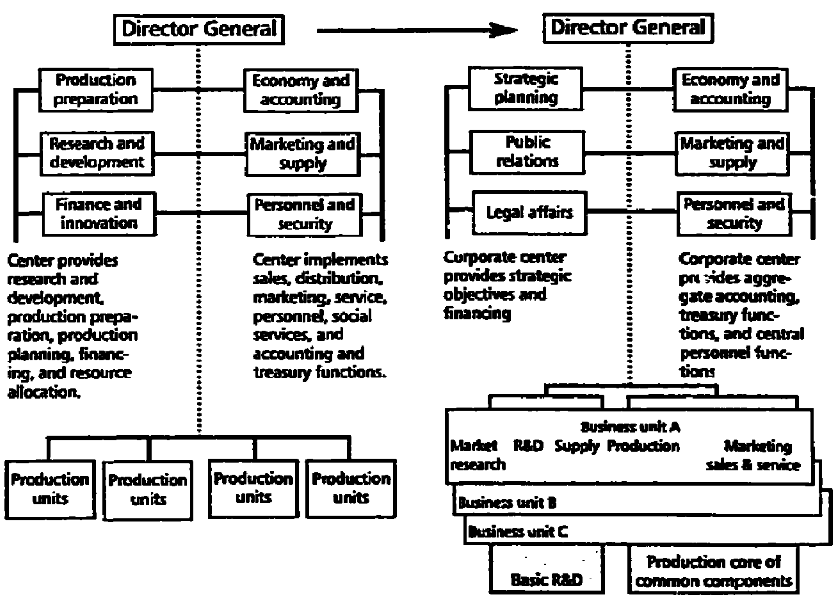
- Enterprise was successfully privatized in a voucher auction in November 1993, with strong interest from Moscow-based investors and brokerage firms. Almost all workers, including those terminated, invested their vouchers in the company. Once privatized, Enterprise was free to pursue an equity injection from Investment Bank in two of the business units, or subsidiaries.
- Due to lower costs, concentration on viable products, and improved marketing, distribution, and sales functions, Enterprise has returned to positive net earnings in 1994. More important, cash-flow is positive, and the company has begun to reduce its debts to the energy company. In addition, with hard-currency injections in two business units, these sub-units have begun to invest in three areas—equipment (to improve quality and process control), employee training, and creation of computer-supported management information and accounting systems.
- The working mode of Enterprise has changed dramatically. The orientation and skills of both managers and workers have already improved considerably, as measured by output and more qualitative assessments, and there is greater emphasis on horizontal interaction for information and decisions. Activities are increasingly driven by profit, and customers are, if not paramount, considerably more important than ever before. When mentioned (and they are mentioned often), they represent not abstract end-users or intermediaries but important individuals who cannot be controlled or ignored. A gradual understanding has emerged that the decisions of these consumers, rather than the decision of a few bureaucrats in Moscow, determine the fate of the Enterprise.

Conclusions

- *Corporate restructuring requires much effort and time,* often years of intensive, single-minded concentration of resources. It cannot be imposed successfully from the outside (by shareholders, governments, or the public). *It can only be instigated from within by managers* able to carry the organization with them. Any restructuring must therefore be undertaken with full cooperation of management and the understanding of employees, customers, and suppliers. Restructuring in the former Soviet Union is certainly no less difficult than it is elsewhere, and probably more demanding in intensity and quality of effort. After one year this particular restructuring effort had stopped the financial bleeding of Enterprise and set the stage for implementing a new corporate strategy. It will be another two to three years before Enterprise is fully restructured.
- *Basic business practices still apply.* The basic advice provided by consultants advising management in Russia was the

Corporate restructuring requires much effort and time, often years of intensive, single-minded concentration of resources, [and] can only be instigated from within by managers able to carry the organization with them.

Figure 12.5 Organizational change



same as anywhere else. Given the limited time available to management and lack of long-term capital, it is *important that the advisors focus on the fundamental aspects of the business, with a view to changes that are self-sustaining and that create a momentum of continuous positive change*. Rather than fine-tuning market strategies, which is time-consuming and requires considerable local knowledge, concentrate on getting the basics right.

- Two key limiting factors that must be addressed early on: *the complexity of large functional organizations and the lack of relevant skills for a market-based economy and profit-driven organization*. Both factors are to a large degree a function of the organizational structure of typical Soviet-style enterprises. This complexity can be reduced only through drastic reorganization, simplification, and down-sizing. The greatest lever for self-sustainable and continuous building of skills is to create a new structure for which both managers and workers are responsible that gives them authority over cost and revenues, quality and product decisions, production, sourcing, and marketing.
- *At the outset of a restructuring effort, advisors and financiers should perform a quick diagnosis of the enterprise* focusing on its current financial status and the attitudes of management. The abilities and willingness of top managers to change, which will decide the outcome of the project, can be assessed only by working directly with them. Equally important is to evaluate the potential viability of the company, the attractiveness of products, the cost situation over time, and the competitive structure of the market in which it operates. No doubt there will be many basket cases (and only a few shining stars). *If managers are unwilling or unable to implement tough changes, or if the company is not potentially viable, consultants should withdraw from the situation*. In addition, it makes good sense to begin the study with an analysis of the current financial situation. Often, cashflow will be negative and immediate attention must be given to near-term solutions of the liquidity crisis. Moreover, the diagnosis provides a foundation for trust-based relationships, without which advisors cannot help management accept and implement difficult changes.
- What must be clearly emphasized is that managers in formerly socialist countries find themselves in uncharted waters. Not only is the transition to a market economy new and confusing, but the interaction with international organizations, financiers, donors, and advisors can give rise to misunderstandings and suspicion. The value of patience and long-term perspective on behalf of foreign parties cannot be overstated. *Financiers must know that returns on investments, even if potentially significant, will take time to materialize—and often will not*. Participation in restructuring could well be viewed as a long-term option, and valued accordingly. Equally, *bilateral donors must permit advisors and management sufficient time to turn the company around and great freedom of operation*. Most important, however, *advisors should not expect any substantial impact until trust has been established between the consultants and the managers*, another aspect of the process that will take time. The ingredients of a trust-based relationship are no different in the former Soviet Union than elsewhere, only more pronounced. Honesty, integrity, long-term perspective, personal relationships, and high international standards of quality—these are everywhere the building blocks of change.
- The restructuring effort will often change direction during the project, partly due to what the consultants learn, but also as the client develops an understanding of the company's situation. Although much hard strategic thinking and analysis are required, there will be substantial tactical elements in working with managers. Often, the biggest discussion will center not on the strategy or even the organizational structure required, but on the less tangible interaction between units in the organization. The topics of debate will include anything from suppliers, customers, tech-

nology changes, competitors, and market behavior, to the soft link between units and functions within units, incentive schemes, information flows, and decisionmaking in a rapidly changing market environment. In the final analysis, this is where the success or failure of restructuring will be determined.

Note

1. Even though workers were immediately eliminated, legally they could not be fired that quickly. The solution was to retain the eliminated workers on a separate payroll where they would receive their current (nominal) wage indefinitely. With inflation, the cost of this payroll bill would soon be insignificant. In addition, management assumed a great deal of responsibility to actively outplace workers. In many instances, ex-employees would acquire or even be given individual assets, and continue to supply Enterprise and other companies as subcontractors. Others would receive short-term training for other employment opportunities. Some would be employed in private companies of top managers. Many, however, would have to fend for themselves.

Newly-Privatized Enterprises: A Survey

Leila Webster with Juergen Franz, Igor Artemiev, and Harold Wackman

Project objectives

The primary objective of the survey was to document the characteristics, problems, and needs of medium-sized and large privatized enterprises in Russia. The survey was carried out during the preparation and pre-appraisal of an enterprise restructuring operation. Findings from the survey were utilized in the design of a subsequent operation. Specific areas of interest included:

- The characteristics of medium-sized and large privatized firms as regards ownership, governance, labor and capital management, finance, post-privatization behavior, and future strategies;
- Firms' main problems in demand, inputs, finance, and labor;
- Firms' potential demand for credit in terms of use (working capital or investment), nature (debt or equity), term (short, medium, or long), currencies (rubles or foreign); and their relationships with major actors in the financial system (banks, domestic and foreign investors);
- Technical assistance requirements and potential design of this assistance;
- Firms' general capacity to stay afloat in the near term, undertake necessary restructuring in the medium term, and evolve into viable companies in the future.

Method

Two oblasts close to Russia's capital were selected for sampling—Moscow oblast (which excludes the city of Moscow) and Vladimir oblast (located about 200 kilometers from Moscow). The total area of the two oblasts is 75,000 square kilometers (twice the area of the Netherlands) with a combined population of 8.4 million (6 percent of the Russia's total population).

The survey was carried out from October 18–28, 1993 by a team of Western and Russian interviewers. Two-person survey teams spent two to three hours with each enterprise manager, completing a questionnaire made up of quantitative and qualitative questions and visiting their factories when possible.

The sample was based on lists of all privatized firms provided by the oblast property funds in Vladimir and Moscow (table 13.1). In each oblast, two lists were obtained: one for enterprises privatized through the mass privatization program (MPP) and one for privatized leasehold companies (PLCs).

Firms were to be evenly distributed between the two oblasts. Half were to be privatized leasehold companies and half should have come through the MPP. In addition, half of the sample firms were larger than the average privatized Russian firm (which has 1,100 workers) and the other half smaller. Small firms with fewer than 250 workers were excluded if possible. The sectoral distribution was to focus mainly on manufacturing with 70 percent of sample firms drawn from manufacturers and 10 percent each from construction, services, and transport (table 13.2).

The final sample was fairly representative of privatized firms in the two oblasts

Table 13.1 Privatized firms by oblast and origin

	Mass-privatization program	*Privatized leasehold companies*	*Total*	*Percent*
Moscow oblast	105	351	456	61
Vladimir oblast	194	96	290	39
Total	299	447	746	100
(percentage)	(40)	(60)	(100)	

with two exceptions. Because the survey included numerous large firms, the average sample firm size is almost twice that of the average firm in the population. Stratification by sector also resulted in a disproportionate number of manufacturers in the sample.

The firms

Half of the firms moved into the private sector in bits and pieces under leaseholds and half came through the mass privatization program. In both cases, there was little evidence that managers had sorted through assets, chosen the best, and discarded unwanted parts. This was particularly surprising for privatized leaseholds where it was thought that these managers have been active in asset stripping. More than 60 percent of the firms had been private for over a year and only 5 percent had been privatized in the previous six months.

Almost all former leaseholds were either closed joint stock or limited liability companies and, as required by law, all mass privatization enterprises were open joint stock companies. Among mass privatized firms, a quarter had chosen option 1, whereby workers could claim 25 percent of shares free of charge with the option of purchasing an additional 10 percent at a price established by GKI. Managers could purchase 5 percent of shares, and the remaining 60 percent were to be sold to the public through voucher auctions and investment tenders. Almost three-quarters chose option 2, wherein workers and managers could collectively purchase 51 percent of shares, 10 percent of shares were held back by the property funds for later sale to workers and managers, and the remaining 39 percent were sold to the public through voucher auctions and investment tenders.

Managers owned an average of 17 percent of their firms, 21 percent in leaseholds and 13 percent in MPP firms. On average, employees owned 61 percent of shares, 75 percent among leaseholds and 50 percent among mass-privatized firms. Among leaseholds, the small portion of shares not yet purchased belonged to the Russian state. Among mass privatized firms, owners other than managers and workers were oblast property funds (average 20 percent), institutional investors (average 19 percent), and individuals (average10 percent).

The average labor force was 1,518 employees, but the median was 752, reflecting a cluster at the small end and relatively few firms with more than 2,500 workers. Average monthly sales in September were $1.04 million but the median ($266,000) was considerably less, again due to a cluster of firms at the small end. At an average of $400,000, sales of former leaseholds were a third the size of mass privatization firms. Sectors with the highest sales included fabricated metal products and paper products, the lowest sales were in services and construction.

Manufacturing firms operated in all major sectors. Sixty percent were producing basic consumer goods. Nonbasic consumer goods such as porcelain and art products were the main products for 10 percent of firms. Twenty percent manufactured nonconsumer goods such as electric cables, water pumps, and locomotives, and 10 percent produced construction materials. Forty-five firms derived all revenues from one activity. Among those that had diversified, thirty-two began manufacturing a second product, ten started up trading activities, sixteen were involved with services (usually repair), and four took on minor leasing activities. In general, enterprises diversified to make up for shortfalls in revenues. For example, a number of specialized construction companies broadened their scope to all forms of construction. Manufacturers of auto-parts offered repair services.

Table 13.2 Characteristics of the sample

	Population	*Objective*	*Actual sample*
Number of firms	746	100	92
Moscow (percent)	61	50	52
Vladimir (percent)	39	50	48
mass privatization program (percent)	40	50	48
Privatized leasehold companies (percent)	60	50	52
Number of employees			
Less than 250 (percent)	51	few	12
Less than 1,100 (percent)	89	50	58
More than 1,100 (percent)	11	50	42
Mean	880	—	1,518
Median	280	1,100	752
Sector			
Manufacturing (percent)	48	70	76
Construction (percent)	18	10	10
Transport (percent)	13	10	8
Services (percent)	20	10	7

Some cross-investment was apparent. Among the two-thirds of firms that invested in at least one other business, most bought shares in a bank. Other investments were mainly in trading companies, raw material suppliers, and other manufacturing companies. One in five PLCs made other investments, compared with one in ten of mass privatized firms. Forty-five percent of large firms owned shares in three or more companies compared with 7 percent of medium-sized and 8 percent of small companies.

The major problems affecting businesses were delayed payments from customers, high taxes (managers claimed they were paying profits taxes of 80–90 percent), insufficient working capital, weak demand and falling orders, inadequate funds for investment, and inflation (table 13.3). These problems were inter-related. Working capital was eroded by high taxes, falling orders, and inflation. Delayed payments, particularly with high inflation, exacerbated the problem. Managers were hamstrung in their efforts to move into new, more profitable products by lack of residual funds for investment. Few managers complained of problems associated with government regulations, except for tax.

Capital

Fixed assets. Most firms (95 percent) owned all of their buildings and equipment. Former leaseholds purchased their assets in stages over the previous 3 to 4 years and mass privatization firms bought them as part of the privatization package. Ownership of land was less clear because of legal uncertainties. Half of managers said that they had a long-term lease from the state, 27 percent were simply using the land with no legal agreements, and 20 percent claimed they owned the land and had formal title to it.

Forty percent of enterprises had sold (mostly old) machinery or buildings in the previous 12 months to new private firms. Most manufacturers, however, were hesitant to sell off unused equipment, even though much was idle. Some wanted to hold on to their equipment because, in their view, its value was rising daily; others hoped to resume former levels of production in which case they would need what they had.

Finance

Working capital. Managers reported that inadequate working capital was their biggest problem with financing. Problems mainly were due to delayed payments from customers and high interest rates. Managers could not get paid by their customers and could not borrow to cover gaps at a price they considered reasonable. Revenues were critically influenced by demand uncertainties and input and payment problems. More specifically, cash flow reportedly did not cover operating costs (inputs, salaries, overhead, interest, and taxes) in 35 percent of enterprises. Comparisons across firm groupings yield a profile of firms with the most severe problems covering their operating costs. These tended to be:

- Producers of goods such as plastics, glass, fabricated metal parts, and some textiles (68 percent of all sample firms producing intermediate products) more so than producers of finished goods (13 percent of all such firms).
- Construction firms (five out of a sample total of six) and manufacturers producing construction materials (four of nine).
- Mass-privatizaton firms (47 percent) more frequently than among leaseholds (21 percent).
- Fairly equally distributed by size, with about a third each of small, medium-sized, and large firms failing to cover their costs. Among large firms, one in five adequately covered costs, compared with only one in twenty-four small firms and one in fourteen medium firms.

Payments. Receivables were up to date (or late by 30 days or less) in about half of firms, but late by 90 days or more in a quar-

The major problems affecting businesses were delayed payments from customers, high taxes..., insufficient working capital, weak demand and falling orders, inadequate funds for investment, and inflation.

Table 13.3 Largest problem affecting sample firms
(percentage of firms)

Delayed payment	*High taxes*	*Insufficient working capital*	*Weak demand*	*No funds for investment*	*Inflation*	*Other*
13	12	12	10	10	10	33

Note: Managers were asked to name their three largest problems in order of importance.

ter of companies. Half of receivables from private firms were up to date, compared with a quarter of receivables from state enterprises. For transport and construction companies with mainly in-state customers, almost all receivables were late. The worst offenders were in other CIS countries. Managers had little formal recourse against those who delayed payments, and most relied on informal means of collection. Personal harassment, including persistent telephoning and threats to cut off (or cancel) further shipments, was the most common approach. Only 15 percent of firms filed claims in courts—a procedure that took 6 to 8 months during which time no interest was paid on the debt. Extracting payments from large, powerful customers, upon whom many managers relied for future contracts, was difficult.

Obtaining a short-term loan from a bank was easy...

Prepayment. Requiring advance payments with orders was a widespread practice. This approach did appear to lower arrears, and may also have dampened demand in the industrial sector as managers delayed production until they could obtain prepayments from customers, which were needed for prepayments to suppliers. Others had the opposite problem wherein customers paid in advance (at current prices) while producers, who could not afford to stock raw materials, ended up paying higher input prices due to delays in procuring their raw materials. Textile and clothing producers who pre-paid for supplies of cotton from Uzbekistan were particularly disadvantaged. Locating solvent customers and extracting payment from them was an important key to success.

Use of institutional credit. Obtaining a short-term loan from a bank was easy, and 77 percent of sample firms obtained one or more loans with terms of fewer than 12 months in the previous year. Many obtained four or five such loans, typically with terms of three months or less. Loans were secured with equipment and inventories. Managers of smaller firms demonstrated a greater reluctance to take loans (62 percent, compared with 83 percent of medium-sized and large firms).

A few banks dominated in both oblasts: Unicom Bank in Moscow oblast and Moscow Industrial Bank and Rosselkhozbank in Vladimir oblast. On average, enterprises paid nominal interest rates of about 190 percent, with a range of 150 to 250 percent. Short-term loans were used mainly to pay for inputs (69 percent of firms) and employees' salaries (23 percent). Among the relatively few managers who had difficulty obtaining short-term loans, the main problems were reportedly that their banks didn't have enough money to lend or they preferred favored clients with large accounts.

Only 12 percent of enterprises received long-term loans (longer than 12 months) in the previous year. Most long-term loans were soft loans from the government, some through association with agricultural concerns and others in the name of reconstruction or imminent bankruptcy. Almost all had been obtained more than 6 months previously, and managers had little expectation of receiving additional soft loans.

Relationships with banks. Forty percent of managers had no problems with their banks. Those who did, complained about delays in transactions between different banks and different cities and across the network of former republics. Many managers claimed that banks delayed financial transfers intentionally to maximize their earnings. Other widespread complaints included lack of confidentiality, focus on short-term profits, and high fees for routine services such as cash withdrawals, opening of new accounts, and exchange of foreign currency.

Some managers described improvements in banking practices over the previous year. Firms were reportedly no longer required to conduct all transactions through the banks. Accountholders were free to withdraw unlimited cash from their accounts if they had a good explanation for its use, their bank had sufficient funds on hand, and they were willing to wait a few days for delivery. Intermediating transactions across the borders of former republics was a prominent area in which financial services worsened. Managers reported waiting months for payments, unable to ascertain whether the delay was the fault of the customer or of the respective bank.

Two-thirds of firms owned shares in banks, usually 1 percent or less in the local branch. Not surprising, the larger the firm, the more likely it was to be a shareholder in a bank (87 percent of large firms, 44 percent of small ones). Ownership appeared to confer several advantages, including relatively easy access to short-term credit facilities, marginally lower interest rates; and ongoing relationships between managers and bankers.

Managers

Most managers were middle-aged, well-educated men with long management histories. The youngest were in their early thirties and the oldest were in their early sixties, with an average age of forty-nine. Only 16 percent of managers were under 40. Fully 85 percent had university degrees and an additional 9 percent had post-university education. The continuity of management from pre- to post-privatization periods was clear from the fact that half of the managers interviewed had been general managers and 30 percent had been managers of technical departments in their enterprises before privatization.

Estimates were that about forty of the ninety-two firms surveyed were led by highly competent managers who appeared able to bring their firms through the transition successfully—assuming the business environment did not entirely hobble their efforts. Nineteen managers were judged to be poorly-prepared to make the transition, and the remainder were rated as average with a mix of strengths and weaknesses.

Many managers maintained their powerful positions with privatization, but interviews made it clear that the combination of economic crisis in Russia and the speed of privatization radically altered the content of managers' jobs. The difficulty of acquiring scarce raw materials had been replaced by the difficulty of paying for inputs in the context of high inflation and falling revenues. Production quotas were gone, but in their place had come pressures to find markets where production could be sold and strategies formulated by which to collect payments—both in the context of a devastating recession. Keeping enterprises afloat depended far less on lobbying ministry officials for subsidies than on making profits in the marketplace—after paying numerous high taxes. Provision of basic social services for workers became problematic for many managers, most of whom were caught in the dilemma of feeling responsible for these services but recognizing that they could no longer afford them.

The data suggest a strong network among managers of privatized firms. More than half belonged to at least one industry association, many of which were descendants of sectoral ministries that formerly coordinated production among state enterprises. Typically organized as joint stock companies, these organizations offered their shareholders and members bulk purchasing of raw materials, assistance with distribution, technical information, and a voice in Moscow politics in exchange for equity. Forty-five percent of enterprises invested in other companies (almost 20 percent in three or more companies) conveying the impression of a fairly dense network of cross-investment. Many managers continued to rely heavily on former suppliers and customers.

Most managers were middle-aged, well-educated men with long management histories.

Labor

The average and median numbers of workers per firm in October 1993 were 1,518 and 752, respectively, down from an average of 1,591 and a median of 800 twelve months previously (a 6 percent drop). Most managers reported their employees were working full-time, although about 15 percent said part-time work was often cut back due to falling orders and insufficient cash flow for payrolls.

Sixty percent of managers had laid off workers in the previous 12 months—on average, 10 percent of their labor force. Three-quarters of enterprises engaged in construction, chemical products, and textiles laid off workers, reflecting the severe demand problems faced in these sectors. A quarter of firms had not made significant changes in the size of their labor force, and 15 percent of firms hired additional workers—on average, 8 percent of the labor force.

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More layoffs can be expected, particularly among large firms. Just over 40 percent of managers acknowledged they had more workers than they needed. Moreover, fewer large firms laid off workers than small and medium-sized ones, and large firms were more likely to report excess labor than other firms—particularly in the nonmetallic minerals and the fabricated metals sectors.

Nonetheless, over half of the managers said they had difficulties holding on to their skilled workers, in part because of their inability to pay competitive wages. In some cases, the most talented employees left to work independently as private entrepreneurs in their own companies. The exception was among companies in small towns in which they were the primary employers in the area. These firms had not lost workers because their employees had few other options. Most managers were taking active measures to hold on to their best employees. Some initiated binding, long-term contracts. One firm selected a few of its employees for contracts, offering them access to low-priced cars at the end of two years if their performance was good. In another, 20 out of 1,300 employees had been singled out for individual contracts. Many managers took steps to raise labor productivity by linking employees' salaries and performances more closely.

The average monthly salary for a skilled worker was 110,442 rubles ($90) in September, 1993, up from 26,374 rubles in January 1993—an increase of 420 percent in the nine-month period. Monthly salaries for unskilled workers grew from an average of 12,208 rubles in January 1993, to 42,529 rubles in September 1993—an increase of 350 percent. Thus, the ratio of average salaries of skilled and unskilled workers changed from 1 to 2.2 to 1 to 2.6 in the first 9 months of 1993. Moreover, almost all enterprises (89 percent) offered social services to their employees, typically a mix of housing and associated utilities, health and child care facilities, vacation locations, transportation, and farming plots.

Provision of housing represented by far the most critical and knotty problem in the area of social services. Eighty-seven percent of sample firms provided housing for most of their employees. Fifty-seven percent maintained ownership of the housing facilities, with 28 percent transferred to municipal governments, and 14 percent transferred to employees. But regardless of ownership—even where employees purchased their flats—the financial burden of maintaining housing facilities and providing utilities remained with the enterprises.

Production and sales

Average monthly sales in September were $1.04 million with a median of $266,000. Forty-seven percent of firms had monthly sales below $417,000 (annual sales of $5 million). On average, the highest sales were found among enterprises involved in heavy industry, for example, fabricated metal products ($2.4 million per month) and paper products ($1.2 million), and the smallest among services firms, such as business and household services ($150,000) and transportation ($108,000). Sales in two-thirds of firms were constrained by lack of demand or orders for their products, and in one third by an inability to fill more orders than they currently had. Forty percent reported mounting inventories.

Almost a third of managers (31 percent) reported that at least one of their primary products was subject to price controls or profit margins. Some controls were associated with sector, for example, petroleum products, agriculture, and wholesale trade. A few were subject to price controls because the firms were registered as monopolies. Most price controls, however, originated with committees and associations that descended from the former sectoral ministries.

Just under 60 percent of managers said that production had been stable or had increased over the last few months. Sectoral differences were prominent: 60 percent of firms producing textiles and clothing and 50 percent of construction firms reported declining production, whereas 78 percent of furniture manufacturers and 73 percent of transportation firms reported increasing volumes. Over half of mass privatization firms reported declines in production compared with a third of PLC firms.

Just under 60 percent of firms confirmed orders for only the following three months, but a third had orders that would keep them busy for the next six. Large industrial firms producing metal and plastic products more frequently had long-term orders; small firms making consumer goods were likely to have short-term work plans. Again, mass privatization firms were less likely to have confirmed orders for the future than were PLC firms.

Most enterprises had easy access to intermediate inputs. Access was maintained, in most cases, by the continued presence of the former network of suppliers (many now privatized), although some managers complained that markets had become chaotic —with former suppliers changing product lines and charging monopoly prices. One producer described a situation where a monopoly scrap metal supplier cut off all deliveries for a month to increase prices.

Of the 20 percent of managers who had problems obtaining needed inputs, three-quarters relied mainly on suppliers in other CIS countries. These firms typically tied up large amounts of scarce working capital for long periods as they waited for slow and erratic deliveries. They described chronic difficulties in dealing with bureaucratic and unpredictable cross-republic quotas, customs regulations, payment systems, and transport arrangements.

Just under two-thirds of managers cited other private (mainly privatized) firms as their main customers. State enterprises and newly-privatized state companies offered large contracts and the built-in advantages of an existing personal network, but they were much slower to pay for goods and services. Private firms paid their bills faster, but orders were too small to sustain sample producers, and large orders were increasingly hard to come by. Enterprises likely to sell mainly to other private firms tended to be smaller, produce consumer goods (such as clothing and furniture), and to be former leaseholds. Those who relied on state enterprises as their main customers were often large, mass privatization firms that manufactured industrial inputs.

Firms' primary markets were in Russia and there were few problems with distribution. Specifically, half sold most output on national markets, just under 40 percent sold locally and in nearby towns, and about 10 percent sold elsewhere in Central Europe. Only 2 percent of managers reported that they faced any regulations concerning distribution.

A quarter of managers said they had no competitors in their main markets; 40 percent had fewer than ten. The slow development of competitive markets was a bit surprising given that most firms were producing basic consumer and intermediate goods where competition typically is greatest. The highest levels of competition were reported by managers in transport and furniture companies. Among firms that did have competitors, the main source of competition was other large, private firms—again confirming the degree to which the economy had been privatized. The fact that only 11 percent of managers cited state enterprises as their main competitors dispels notions that the existing state sector is crowding out private firms or at least the newly privatized sector. The almost nonexistent level of foreign penetration was evident in that only 2 percent of managers said that their main competitors were imports, and none named joint ventures or foreign firms as competitors.

Just under half of firms were exporting some production (20 percent on average). Two-thirds of those who exported sold directly to buyers; the remaining third sold to intermediaries. Most exports were sold in Ukraine and Belarus, with only a few firms selling in foreign markets outside of CIS countries.

The main barrier to entering export markets was lack of information about potential trading partners, the structure of demand in foreign markets, and required product quality and packaging. Many felt that locating a foreign partner who could inject capital and link the firm with appropriate markets was a prerequisite for successful exporting. Managers also described formidable logistical problems, including payments problems, high export taxes, difficulties with export licenses, and excessive paperwork and fees. Without capital to up-

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grade equipment and thereby improve product quality, most felt unable to compete in foreign markets. Others complained about the share of profits taken by trading companies that could market their products abroad. One manager said that the overvalued ruble meant that he could get better prices on the domestic market; another cited quotas and tariffs in foreign markets.

Almost all managers equated the state of their technology with the state of equipment. Virtually none showed an awareness of technology issues such as information systems and the organization of production. Rather, they focused on the need for better equipment that would produce higher quality output. Some production equipment appeared adequate, but much appeared outdated and run down. Furniture makers needed higher precision machines and better quality finishing equipment. Textile producers needed new knitting and weaving machines. Plastics manufacturers were aware that their production equipment was inadequate to produce higher-tech plastics.

Forty-seven percent of firms had changed their mix of products in the past 12 months, typically starting up production of new products, upgrading product quality, and introducing trade and service activities...

Most managers seemed fully aware of environmental concerns associated with their factories, but actions to ameliorate problems were seldom seen. Many reported that they were subject to environmental inspections by government officials. The most frequently observed problem was toxic fumes that affected workers. Some managers said they had improved ventilation in their factories, but most admitted that measures had been insufficient. A number of managers said that officials routinely measure the level of pollutants in nearby water sources and fine them if levels are too high, but most said they could not afford to build reclamation or water purification plants to solve the problem. The impression was that environmental assessments probably would reveal fairly serious problems with pollution and worker safety in many firms.

Strategies for the future

Firm-level change

Entrepreneurs were asked to identify changes that had taken place in their firms since privatization. Many managers spontaneously revised this question by saying that recent changes in their firms resulted more from the economic crisis in Russia—most notably the recession that is under way—than from the shift in ownership. Even so, the most important changes were:

- On average, 90 percent of enterprise ownership had been transferred to private hands through privatization programs (either MPP or legal buyouts by leaseholds);
- Ninety-five percent of firms owned all their buildings and equipment, and almost 40 percent sold off some redundant equipment;
- Fifty-five of the ninety-two firms surveyed laid off employees (on average, 10 percent of their current labor force), and fourteen hired new employees (on average, 8 percent of their labor force);
- Forty-seven percent of firms had changed their mix of products in the past 12 months, typically starting up production of new products, upgrading product quality, and introducing trade and service activities;
- Seventy-seven percent took (and presumably repaid) short-term loans in the previous 12 months, almost all from commercial banks at going interest rates of 180 to 220 percent a year;
- Fifty-seven percent of managers changed the ways they motivate and reward workers—typically linking performance with payment and differentiating more between skilled and unskilled workers;
- Forty-five percent of firms made investments in other firms; almost 20 percent invested in three or more other firms;
- Fifty-eight percent of firms relied on other private firms (some privatized former customers and some new) as primary customers rather than on the state sector.

Despite the magnitude of aggregate changes undertaken over the previous 12 months, firm-level response was highly heterogeneous. Firms fall into three groups—those who resisted making changes, those who made marginal changes, and those who embraced the new environment and reshaped enterprises as quickly as possible.

The first group (25 to 30 percent of firms) was clinging to the status quo, producing the same products for the same customers, and struggling to hold on to their labor force in the face of falling orders and increasingly inadequate working capital. Except for firms with monopoly power, these firms were among the weakest firms in the sample. The second group (50 to 60 percent of firms) typically made small changes in their product mix in the direction of consumer demand, laid off small numbers of workers, ventured into new markets on a limited basis, and began to think about diversification. The third group (15 to 25 percent) were headed by the most competent managers in the sample, and they typically started up new product lines, downsized, and introduced flexible production.

Corporate governance

Without question, corporate governance of enterprises was in the hands of managers. When queried about how the new ownership structure was affecting the decisionmaking process, most managers exhibited no qualms about stating they were fully in charge. Indeed, an implicit bargain wherein workers' rights to participate in a selected, narrow range of decisions and to receive dividends in exchange for managers' taking responsibility for keeping as many people employed as possible had been acknowledged. Maintenance of the labor force and delivery of social services was felt as an ethical and weighty responsibility by most managers.

Most managers fulfilled the formal requirements regarding governance that came with privatization. Almost 90 percent held shareholders meetings (usually scheduled annually), and over 90 percent had shareholder registers. Many managers reported that shareholders made important decisions at the shareholders' meetings, most focusing on the disposition of social assets. Only about a third issued share certificates and paid dividends; most reported they would soon do both.

Few shares had been traded. In a third of firms—almost all leaseholds that converted to closed joint stock companies—workers were not allowed to sell shares except to other workers and then only with permission of the collective. In another 46 percent of firms, shareholders were free to sell shares but none had done so. Shareholders sold shares in only 20 percent of firms, and most reportedly sold few.

Boards of directors had been established in most firms, but were dominated by managers. Formal membership typically was still the one prescribed in the corporatization legislation—that is, one representative each from managers, workers, the property fund, and the municipal government. New corporate charters, to which enterprises were entitled following privatization, had not been drawn up. Boards met once or twice a year to consider questions concerning issuance of dividends and management of social assets, but they appeared to have little or no involvement in decisions affecting firms' operations.

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Strategies for the future

Managers' priorities. Managers were asked to describe their strategies and priorities for the near term. A common answer was "to survive." When pressed, a third said that investment in new equipment and a quarter said that finding new markets was their first priority. More forward-looking managers in the sample also tended to include improving financial management and marketing skills and entering export markets.

Managers' emphasis on procurement of new equipment was difficult to evaluate. Most managers showed little awareness that they could bring about substantial improvements in production other than through new equipment. Indeed, strategies for increasing production efficiency using current capital stock were seldom raised. Strategies such as improving the lay-out of production, inventory management, product design, and workers' skills took a back seat to acquisition of new equipment. On the other hand, some enterprises were at a competitive disadvantage using outdated machinery, and their ability to compete depended critically on acquiring new equipment.

Managers' emphasis on developing new products and finding new markets reflect-

...managers stressed that most useful assistance avoids conceptual realms and focuses on conveying practical, how-to information in key areas of business management.

ed falling orders from established customers. This was the first priority for large firms as they struggled to maintain working capital and labor forces in the face of falling orders from their old customers. But as seen elsewhere in Eastern and Central European enterprises, managers often were stymied without the necessary market information or marketing skills.

External financing. When asked how they planned to finance future investment, 43 percent of managers said that they would use business profits; 25 percent said they would take long-term loans from banks when available; and 21 percent said that they would rely on equity from foreign investors. The fact that most managers assumed they would be able to finance investment costs from business profits reflected their doubts about accessing external finance and an optimism about the future of the Russian economy and of their enterprises. Most managers felt their businesses would perform better once the economy stabilized. Many spoke readily about the desirability of locating a foreign partner and preference for equity financing, but few had made tangible steps mainly because they did not know how to proceed.

Demand for external finance was difficult to assess. Managers clearly had access to and made use of short-term, ruble credits from commercial banks. When queried about potential demand for long-term loans, most managers indicated they would have numerous uses for investment credits but, with few exceptions, they were unwilling to take on the risks associated with long-term loans in rubles at current domestic interest rates (even if available). The general impression was that most managers were risk averse as regards taking on debt—even though debt to equity ratios were low and ownership of buildings and equipment provided enterprises with collateral.

The single credit package in which managers did express an interest was mid-term (2 to 3 years) hard-currency loans. Many inquired about potential interest rates of hard-currency loans and how the foreign exchange risk might be handled. Interviewers explained the basics of assuming foreign exchange risk, and most managers seemed to understand what was involved. Many managers said that they would have an interest in such loans, but would have to understand the terms thoroughly before making a commitment.

Technical assistance. Some managers said they had no need for technical assistance (TA). Most were unclear about what kinds of options might be available. The first priority among those who acknowledged TA needs was for assistance with marketing, followed by technology and financial management. Many explained that they had never before needed to market products and that the services used in effective marketing (advertising, telecommunications, marketing firms, and so on) were totally lacking in Russia. Assistance in financial management also seemed to be a priority. Survival of many enterprises depended on their ability to diversify, and in the view of researchers, many could have used assistance in strategic planning before investments in new product areas were made.

Managers were divided as to the best format for technical assistance. A third each thought that TA programs should be packaged as short-term consultancies, study tours abroad, and short courses. Almost all who wanted consultants wanted foreign consultants, with few requests for Russian experts. Views were mixed on the subject of study tours. Some managers were clear that they would benefit greatly from actually seeing foreign firms in similar industries at work, and others dismissed this approach by saying that conditions in Russia were sufficiently different to render visits abroad irrelevant.

There was little disagreement about the level at which technical assistance should be delivered or about the kinds of people managers felt were best-suited to deliver. Without exception, managers stressed that most useful assistance avoids conceptual realms and focuses on conveying practical, how-to information in key areas of business management. Along these lines, managers recommended that those who deliver TA programs should be drawn from the ranks of private, international consultants, preferably people with personal backgrounds in firms with like activities. Many thought that international assistance organizations and the Russian government should take responsibility for the organization of such programs—but not the actual delivery.

When asked whether they would be willing to pay part of the costs of technical assistance for their firms, most managers responded affirmatively. Most, however, said that they would only do so if they felt the price was reasonable and the assistance was of the highest quality. This qualification reflected a general wariness among many managers about the true value of consultancies and training programs.

Conclusions

Performance

Prospects for enterprises included in this survey were mixed. About half of the enterprises were "surviving," struggling to find solvent customers and to cover their operating costs. Staying afloat will depend critically on a series of factors, such as firms' ability to maintain adequate working capital; managers' skills in making strategically correct choices about products and markets; the degree of freedom managers can exercise in downsizing in areas such as labor and social assets; the speed with which external competition strikes; and in the longer term, the availability of capital for restructuring. Underpinning all of these factors is the rate at which the economy as a whole stabilizes. Each step deeper into recession diminishes these firms' chances of survival as does each percentage point of inflation.

About a quarter of firms showed promise and were easy to spot. All were covering their costs and many were operating at a profit. Their managers were making strategic shifts in their operations, cutting back on loss-making activities and expanding into profitable private-sector markets where they were less dogged by payments problems. These firms mainly produced goods and services for consumers, and their managers were focusing on improving product quality. These better firms were found more frequently among leasehold companies that had a few years headstart as partially private businesses. Lack of investment capital and chronic difficulties reading an unstable market were their primary constraints.

A quarter of firms are likely to fail, barring substantial restructuring and large infusions of capital. They were operating at a loss—unable to find solvent customers, cut costs, downsize, and reorient their product lines toward profitable markets. Of the medium-size and large firms that came through the mass privatization program, most were associated with heavy industry and almost all were highly dependent on the declining state sector for their sales. Notable exceptions to this characterization were found among some large firms that were able to exploit monopoly positions and inelasticities of demand for their products.

By implication, the most fruitful strategy might be to focus assistance efforts on the large numbers of firms that are "surviving," under the assumption that the strongest enterprises will achieve success without assistance and in spite of external difficulties, and the weakest firms are unlikely to survive even with assistance.

Restructuring

Serious restructuring had yet to begin in most firms, despite the relatively high percentages of enterprises that laid off workers and changed their mix of products. Most of these changes were marginal and probably are insufficient for the mid- to long-term. Obvious needs for restructuring to reduce expenditures included downsizing of operations, adoption of cost-cutting measures, and elimination of nonviable activities in favor of promising ones. Restructuring for competitiveness will call for strategic re-orientation in the direction of consumer demand, development of marketing capabilities, and attention to environmental pollution problems. When foreign competition enters the marketplace, most enterprises will be faced with the additional necessity of modernizing their plants, including upgrading technologies.

Some enterprises can and will restructure on their own as the market settles and capital becomes available. Others will need incentives and financial and technical sup-

Staying afloat will depend critically on a series of factors, such as firms' ability to maintain adequate working capital; managers' skills in making strategically correct choices about products and markets; the degree of freedom managers can exercise in downsizing in areas such as labor and social assets; the speed with which external competition strikes; and in the longer term, the availability of capital for restructuring.

Over time, markets in enterprise shares will develop, corporate takeovers and strategic investments will ensue, board management will change, and managerial behavior will respond to shareholder pressure.

port. A third group should be allowed to fail without attempts to resuscitate them. The challenge for those involved in delivering restructuring services will be to distinguish clearly between the three types of enterprises. As noted in this report, researchers located large numbers of managers who appeared well-qualified for their jobs and receptive to new approaches—a finding that bodes well for implementation of assistance programs.

Labor

A significant new increase in unemployment is coming, not only from business failure and attrition, but also from financially-induced workforce reductions. Forty percent of firms saw themselves as overstaffed, on average by 17 percent. Thirty-five percent of managers reported they were unable to cover their operating costs, a large share of which goes for salaries. Pressures to restructure and establish firm-level viability will engender tremendous conflict for the many managers who have a strong sense of responsibility for their employees. Creating job opportunities for those laid off may be central to successful restructuring efforts, given the strong obligation managers feel to their employees.

A fledgling labor market was observed in the growing discrimination between skilled and unskilled workers, and in reported movement of the most skilled workers to private firms of their own. Linked with these developments, greater social tension can be expected as less-skilled workers lose jobs and skilled workers' salaries increasingly lag. Social safety nets and measure to facilitate labor mobility are crucial, and some firms may need assistance in labor restructuring.

Investment

Managers were anxious to obtain financing for new investment, but few were willing to take the risk under current conditions. Most had taken short-term loans to cover working capital shortfalls, but few had taken or would take long-term loans (which were not available in any case). Despite negative interest rates, managers felt that nominal rates were exorbitant and that commitment to long-term debt payment was untenable given the uncertain future. The exception might be medium-term loans (2 to 3 years) denominated in foreign currency. Managers were interested in loans of this sort because interest rates would be fixed (even though they would assume the foreign exchange risk) and because the term is long enough to finance some capital investments but not so long as to incur unacceptable risk.

Governance

Private corporate behavior is beginning, but true shareholder control is still nascent. Shareholder meetings had been initiated and boards of directors constituted, but it was clear that managers exercised control over almost all aspects of enterprises. The few areas where managers may not have dominated included the disposition of social assets and payment of dividends—both left for workers to decide in many firms. It will take time for shareholders to begin to exercise their power and see the connection between corporate performance and dividend payment. Over time, markets in enterprise shares will develop, corporate takeovers and strategic investments will ensue, board management will change, and managerial behavior will respond to shareholder pressure.

Social assets

Social services, including housing and associated utilities, medical and educational services, and vacation facilities were provided by most firms to significant numbers of workers. Continued provision of social services, mainly housing and utilities, became a large financial burden for many managers, but few alternatives were apparent. In some cases, ownership of some social assets reverted to municipal governments at the time of privatization, but enterprises generally continued to pay large sums for utilities and maintenance costs, particularly for housing.

A small number of enterprises found solutions to some problems associated with social assets, such as privatizing some housing and instituting worker-owned kindergartens. Most need assistance sorting through the knotty social and financial problems associated with divestiture of social assets. Improvements in housing and labor markets could have positive effects in this area.

Technical assistance

Most managers needed and wanted technical assistance. At the same time, almost all expressed doubts as to its usefulness. Areas where assistance was requested included marketing, general management, financial management, and technology. The preference, voiced by virtually all who requested technical assistance, was for experienced Westerners with product-specific knowledge and a practical, "how-to" approach. Most were willing to pay part of the costs so long as the assistance offered was of high quality and useful for their purposes.

Part Four

THE EMERGING PRIVATE SECTOR: CONSTRAINTS AND REGULATIONS

Constraints to Private Enterprise in the FSU: Approach and Application to Russia

Marie Sheppard

The purpose of this paper is to describe the constraints that restrict the formation and growth of private enterprise in Russia and to suggest an approach for alleviating them. When designing a strategy for private-sector development (PSD), a prerequisite is to identify binding constraints. A PSD strategy also requires some method for deciding which constraints to target and what types of remedial programs are likely to be most cost-effective.

This paper is organized into four sections. The first reviews the recent development of private business in Russia. The next section proposes a typology of business constraints. The third section focuses on the most binding constraints to Russian businesses. The final section describes an approach for alleviating constraints to business development and applies this approach to some binding constraints in Russia.

The context

Count Witte, a Russian Imperial Prime Minister at the end of the last century, wrote that his country was different from the rest of the world. Russians had "no sense of property or legality." While the uncertainty regarding property rights is pre-revolutionary, the Soviet period reinforced it by abolishing most forms of private property. Despite the collapse of the Party, ownership and property rights remain ambiguous and there is still no market infrastructure and few incentives (or penalties) which encourage market-oriented behavior.

Simply importing missing elements of a market system will have limited effect if there is no institutional infrastructure to support them. A sound body of contract law, for instance, will not lead to contractual compliance if conditions continue to make it more rational for entrepreneurs to renege on commitments and renegotiate at every step in the process. Such laws are only effective if accompanied by other conditions, (such as penalties, enforcement practices or ethical codes of conduct) that render compliance to a rational business decision.

Property and ownership

Vague ownership and property rights in Russia increase risk, impede investment, and limit economic growth in both the private and public sectors. During the Imperial period, the tsar or tsarina owned everything and his or her approval was required for all contracts. Property rights began to develop before the revolution, but following it, private property was virtually abolished. This did not, however, equate to making enterprises property of the state. State enterprises were legal entities that controlled assets, but the right to dispose of these assets and other concrete resources was never clearly defined. This left enterprise directors in a difficult position; even actions that clearly increased efficiency could be used by a higher political authority as an example of misuse of state property. Hence, enterprise directors had a disincentive to make resource-related decisions that might result in productivity gains.

To answer this dilemma and increase productivity, perestroika introduced the first non-state enterprises. Until 1987, the only legal forms of economic activity were state enterprises, collective farms, and agricultural production on family plots (usually less than 1 hectare). Gorbachev introduced two new management systems—cooperatives (in 1988) and leases. Cooperatives were the first legal non-state enterprise, and all kinds of entrepreneurs flocked to register their businesses as "cooperatives".

The legal foundation for the current enterprise structures was essentially completed by 1990, when it became possible to have a 100 percent privately owned business.[1] During this same period, market liberalization began. Thus Perestroika increased the autonomy of the public sector as well as opportunities for the private sector.

Reforms, however, focused more on ownership than on property rights. So far, while property can be owned, it can seldom be considered secure. Most enterprises (state or private) possess property titles that are less than absolute.

Tellingly, Russians often refer to the private sector as the nonstate sector.

Uncertainty surrounding property rights is exacerbated by the political situation. The collapse of the Soviet and communist systems created a power vacuum that has largely been filled by local governments. The distribution of power varies widely across and within oblasts, and this layering of jurisdictions (often with overlapping mandates) creates confusion, ambiguity, and opportunism amongst both officials and entrepreneurs.

While private enterprises appear more autonomous with regard to property than state enterprises, there is ample opportunity for outsiders to meddle in their operations. Leasing arrangements (primarily of premises) and continuing control over sources of supply (despite some apparent monetarization) guarantee that the directive features of the Soviet system continue to function. Indeed, business people continue to depend on it, and this reinforces the power of the old system. Entrepreneurs will not be willing to break these links until there is an alternative system for resource allocation—one in which property rights are clearly defined and enforced.

Table 14.1 Russian private enterprise in mid-1993

Ownership structure	*Number of companies*
Partnerships	440,000
Individual private enterprise	220,000
Cooperatives	165,000
Joint stock companies	110,000
Associations, consortia	15,000
Total	950,000

Note: These figures include those companies that have been privatized. Partnerships and individual private enterprises (accounting for 385,000 companies) reflect independent start-ups and small-scale privatization. Joint stock companies include firms privatized under the mass privatization program.
Source: Ekonomika i Zhizn, no. 7, February 1993.

Institutions and attitudes

Tellingly, Russians often refer to the private sector as the nonstate sector. From the 1920s to the 1980s, important resources (food, housing, health, education, and work) were allocated through top-down decisionmaking. Economic, political, and social forces intertwined into a stable state system that looked after each member of the society and provided a strong sense of security.

The collapse of this system invokes ambivalent reactions. Market reforms have created countless opportunities for entrepreneurs who are providing services and better quality goods. They are quick to capitalize on opportunities created by the transition process. Exploiting temporary features such as gaps between state and market prices (complemented by the fluid legal and regulatory environment) creates huge arbitrage rents and enables business people to generate vast profits in very short periods of time.[2]

On the other hand, market-driven forces cannot immediately fill gaps left by the retreat of the state system. Individuals fear an immediate worsening of living conditions, and not being able to afford the most important services (housing, health, and education). It is not surprising that most of the population continues to depend on the old system for jobs, along with the package of housing, goods, and services.

Most Russian families have ties to both the state and nonstate sectors, with at least one member moonlighting or engaged in nonstate economic activity. Official jobs are kept to secure housing, goods, and services, but many people earn more money in the non-state sector. Thus an engineer paints apartments on weekends, a research scientist dabbles in a small travel company, and an accountant at a state enterprise keeps the books for small companies. Because these people keep their jobs in the state sector, employment figures are relatively stable. But the bulk of their income may be generated from private activity.

The private sector

As of mid-1993, the official non-state sector accounted for roughly a tenth of the economy in resources and production. Roughly 950,000 new enterprises had been registered (table 14.1). Though imprecise, these figures indicate some growth in private economic activity and this reflects the impact of privatization. But, the pace of change is not enough to avoid the threat of serious social disruption should mass unemployment materialize. Nor is it sufficient to compensate for the drop in productivity in the state sector.

While an increasing number of Russian businesses are wholly private, their daily operations seldom reflect this.[3] Commercial enterprises are dependent on state entities as customers and suppliers, but that dependence varies by ownership type and by line of business. Purely private companies (26 percent) depend less on the state than do other types of companies (47 percent). The greatest dependence is among manufacturers; 60 percent declared themselves "largely dependent" for supplies.

The state sector wields tight control over rubles, resources, and information. Allocation of these resources is highly decentralized, but depends on individuals scattered throughout government and across state-owned enterprises.

As the old system crumbles, opportunities to capture value abound. In fact, a unique feature of the transition period is that these opportunities (usually in trading) far outnumber those for value creation.

There is a tendency amongst Russians to lump this "army of speculators" into a single category that can then be castigated for reaping benefits from Russia's hardship. In reality, many of these entrepreneurs are providing a useful function in commerce, manufacturing or both. These business people share one trait that is common amongst entrepreneurs worldwide: a desire for independence. Strategies for achieving that independence fall into two general categories: entrepreneurs for whom trading is their end business and entrepreneurs that use trade as a means to accumulate capital, market knowledge and other resources needed to build a sustainable production or service-oriented business.

Entrepreneurs in both categories are quick to exploit business opportunities created by the transition; the difference lies in their long term strategies. While both groups use trade to generate cash-flow, for one group, this is enough. Within this first group of traders, there are two subcategories. One is learning commerce and will continue to trade long after the market starts functioning and margins are squeezed. The other is the rent seeking opportunist, cashing in on connections and making a quick ruble while the opportunity lasts; once "rents" are no longer there to be captured, many of these traders will disappear.

The second group is equally quick to pounce on cash-rich opportunities, but these entrepreneurs are using cash-flow from trading to build an asset base. Manufacturing profits are volatile and are driven by value added and by imbalances in prices of input/output markets. The latter is a transitionary feature that creates both obstacles and opportunities for manufacturers. Valuable assets can be obtained from state enterprises and used to build manufacturing capacity for the future.

While an increasing share of Russian businesses is wholly private, their daily operations seldom reflect this.

For instance, a common phenomenon is an imbalance between the cost of raw materials—world market—and the price for which finished goods can be sold—local level—that makes manufacturing seem like a losing proposition. Many entrepreneurs innovate around this constraint by adopting complicated resource reallocation schemes with state enterprises. In essence, the private enterprise purchases inputs from state enterprises at subsidized prices, some portion of which is in cash. The subsidies received by state enterprises are only in credit, and because state-owned enterprises (SOEs) cannot survive without cash, the SOE forgoes the potential profit it could theoretically make (by selling at a market price) in order to receive cash. The private trader then collects the difference between the subsidized price and the market price. If the company uses these inputs to manufacture a product, their margin might be squeezed, but they will be able to produce goods—something the company without access to the subsidized inputs cannot do at all.

Most companies, no matter the size, engage in several activities simultaneously. One characteristic of the transitional environment is the speed with which business opportunities emerge and evaporate. A common coping strategy is diversification. Most companies perform a combination of manufacturing, services and trading. By maintaining a flexible strategy, entrepreneurs try to keep enough of a presence to build on should an opportunity open up and minimize exposure to any single activity. While this flexible strategy helps firms to survive, it also inhibits investment and growth.

There are no black and white distinctions between the state and private sectors. There are degrees of "stateness" and "privateness" in all ventures. The task is to encourage businesses and individuals to behave increasingly in a market-oriented manner. To do this, conditions must be created and supported where market behavior is possible and rational—by removing constraints, creating incentives, and providing means.

Systemic versus operational constraints

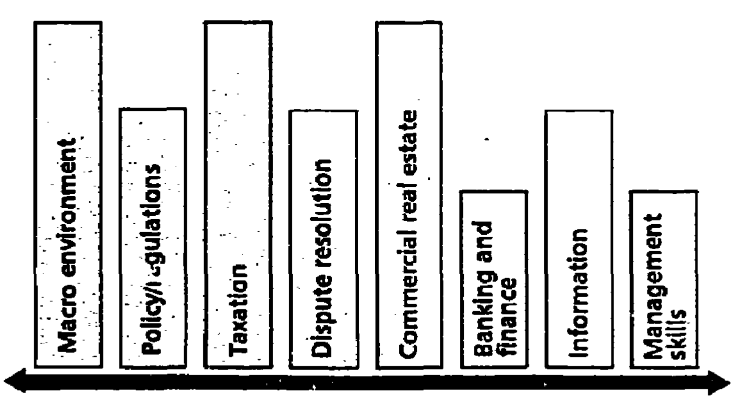
Constraints inhibit economic activity by increasing (perceived) costs of starting or operating a company. They heighten business risk and are a disincentive to entrepreneurship and investment. The greater the constraints, the slower the rate of enterprise formation, investment, and growth.

There are two broad types of constraints—systemic and operational. The entrepreneur has no control over systemic constraints, but has some capacity to control operating constraints. Product quality can be improved through management decisions, such as better inputs or processing techniques. The constraints can be thought of as a continuum, with systemic constraints at one end and operational constraints at the other. While some constraints can be clearly positioned at either end, others can be a little of both. Obtaining capital, whether through savings and friends (as most start up businesses do) or through financial institutions (common for established companies) depends on both the state of the financial markets and on the manager's tenacity and performance.

A business can innovate around systemic constraints, but it cannot change them. For example, entrepreneurs can exploit tax loopholes, and so, reduce taxes payable, but government is the entity responsible for setting rates and rules.

In environments such as Russia's, where systemic risks abound, entrepreneurs tend to increase the range of business activities (and reduce the depth) to manage exposure. In many market economies, governments strive to improve the business environment by targeting systemic constraints; the underlying premise being that less systemic risk will enable entrepreneurs to take on more operational risk, which yields higher returns. Two common strategies are to reduce the real cost (lower inflation, streamlined registration, efficient and equitable arbitration mechanisms and so on), and to maintain a constant legal, regulatory, and macro environment.

Figure 14.1 Constraints to private sector development (a continuum)



Constraints to Russian enterprise

Of all the problems faced by Russian businesses, systemic constraints are the most acute. Foremost is the volatile political and economic environment, particularly inflation (figure 14.1). A businessman from Perm encapsulated the general sentiment, "Inflation, ruble instability, and unpredictable price rises all lead to the absence of any idea of what tomorrow brings and an inability to plan for the future."

Regulatory constraints also rank high and the most costly is taxation. Others are sources of commercial property, access to information, dispute resolution, and business registration. Interestingly, few entrepreneurs consider lack of management skills a constraint.

What follows is a brief description of the priority constraints as perceived by Russian entrepreneurs. These constraints include taxation, sources of finance, commercial property, information, dispute resolution and business registration.

Taxation

Russia's tax system is a major impediment to business growth and to transparency of the private sector. Problems are recognized by both the private and public sectors. For businesses, the cost of the tax system includes rubles paid for taxes and for "services" rendered to appease tax authorities; time taken to understand the complex system; and the uncertainty generated by constantly changing laws and inconsistent administration. Tax authorities themselves are overwhelmed by the complexity of the system. Government receives only a fraction of its dues because of ambiguities in the regulations and increased informal activity.

Tax legislation. Tax regulations are cumbersome and confusing. The average Russian company must comply with fourteen federal, four oblast, and up to twenty-two local taxes. The number of taxes is constantly changing, many new taxes are applied retroactively and reporting procedures are seldom standardized. This can also result in duplication. Witness the profits tax (at 32 percent) and the recently recommended enterprise income tax. Indeed, taxes add up to more than two-thirds of profits.

Tax administration. The driving forces behind the tax administration, which is inefficient and frequently regarded as predatory, seem to be the numerous and varied locations of tax authorities and the control systems that undermine those authorities. Tax authorities lack accountability and credibility. Few have training and most do not possess the information needed to administer taxes according to the law. The widespread complaints of incompetent officials and lack of integrity simply underlines this broader problem.

Tax authorities, moreover, are perceived as having broad discretionary powers, which they frequently use. It is necessary however to distinguish between sheer exploitative behavior of individuals and the blunt instruments the system requires them to use. Take two examples, tax inspectors in Tomsk expected a Federal tax to be introduced on November 1, 1992. Although it was not enacted until February 1, 1993, the authorities required that companies pay the tax from November 1. Those companies that protested were fined until they conformed.

The second example is the mechanism used to collect overdue taxes across the country. At the tax inspector's request, fines for late payment are automatically withdrawn from a company's bank account without even informing the company. This not only allows the government to impinge on property rights, but encourages exploitative behavior of government officials.

The average Russian company must comply with fourteen federal, four oblast, and up to twenty-two local taxes.

Information gaps. Most businesses lack the information they need to comply with the tax regulations. So do some tax authorities. For example, when some business people from Tomsk asked for clarification on how to comply with a recent change in tax codes, local authorities were at a loss to provide answers. While admitting that they did not understand the new tax regulation, the tax authorities insisted that businesses comply and fined those that refused.

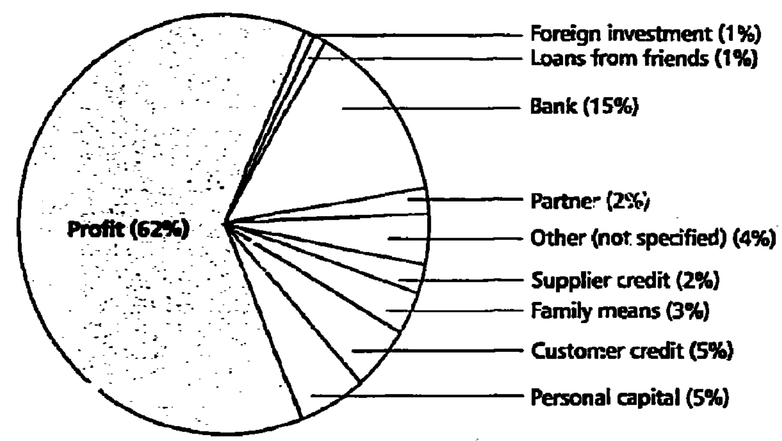
There is no streamlined communication between the federal, oblast, and municipal tax authorities or between the authorities and businesses. Due to the complexity and malleability of the tax code, it is often impossible for businesses to independently ascertain whether they are complying with the law. Many respondents claimed that tax authorities monopolize what information they have, and this enables them to interpret ambiguities to their own advantage. No public body is accountable for providing taxation information to businesses on a timely basis, and while some tax consultants are taking on this role, few businesses are willing or able to purchase their services.

Impact. The dilemma facing the Russian government is how to increase tax revenue and simultaneously encourage investment. To a large extent, it seems that Russia has adopted a short-term strategy of generating revenue by hiking up tax rates. While there have been some attempts to use tax policy to stimulate sectoral development, most of the tax breaks have been clumsy, conflicting, and unattractive. Just when it is critical to take a long-term strategy that encourages business formation, fosters investment, and broadens the tax base, the government appears to be choking business development through high tax rates, a complicated code, and abusive enforcement.

The net effect is that the tax base is eroded and fraud is rampant. Many enterprises evade taxes or remain informal. Some "companies" do not register, have no official bank account, and conduct all transactions in cash. This is not limited to the kiosk traders or government stores which now have "commercial sections" running similar operations. Other "companies" appear and disappear quickly, usually by agreement with the authorities that are supposed to control them. This has given rise to the cliche, "Paying taxes is stupid, but paying bribes is vital."

Most companies use legal and semi-legal means to avoid taxes. Some also inform on competitors to tax authorities. Avoidance extends right through the economy. "Underground" production companies have been operating for years. Most started to become legal, but were driven back underground by the tax regime. Now, they employ various means to evade taxes, including creating unprofitable subsidiaries and false charitable funds. Government experts estimate the undelivered revenues at more than a trillion rubles, hamstringing investment programs and fueling inflation.

Figure 14.2 Sources of finance: average per firm



Based on a 1992 survey of eight oblasts.

Sources of finance

Entrepreneurs across the board were quick to articulate their financing constraints, and the list of finance related problems was extensive—ranging from the cost of credit, to corrupt bankers. However, when ranked against other constraints, finance was not the highest priority.

Whereas most western start-ups are financed from personal savings, in Russia inflation has eroded this option. The dominant source of funds is trading activity, which generated more than 60 percent of total financing (figure 14.2). As the market develops and margins are squeezed, however, this will become less viable.

The banking system. From slow payments to poor administration, the banking system is rife with problems. In fact, carefully selecting a bank seems to be the most efficient way firms can alleviate bank-related constraints and sourcing credit. The primary reason for this is institutional. Government uses banks to control private businesses. The 1992 decree, for instance, obliges all enterprises to deposit money at a bank and use that bank for all transactions (unless previously agreed with the bank). Government can also withdraw tax fines from a company's bank account and restrict the use of deposits when the client is considered behind on accounts payable.

Because bank managers have much discretion over these matters, the most important criteria in choosing a bank is the entrepreneur's relationship with bank management and staff. Given the importance of good banking connections, it is not surprising that entrepreneurs using bank credit were more likely to have been managers of state-owned enterprises (46 percent) and less likely to be women (35 percent).

Bank finance. Compared to past practices (for example, restrictions on multiple bank accounts), it now seems relatively easy for entrepreneurs to open bank accounts. Those companies that wanted bank credit appeared able to get it, roughly 41 percent of enterprises in the survey had used bank credit, of these, 34 percent have outstanding loans. Bank credit does not, however, finance investments in new equipment. Roughly 24 percent of loan recipients reported up-to-date equipment, less than the 26 percent overall.

Bank financing averages 15 percent of total financing. Although complaints of short terms (averaging 2 to 3 months) and exorbitant rates (150 to 200 percent) lose their force because rates are negative in real terms, credit terms are clearly unattractive to most entrepreneurs. Those most interested in credit were existing bank borrowers; 57 percent of bank borrowers plan to finance expansion with bank credit, whereas only 17 percent of non-users do.

So, what type of finance is there demand for? Equity would seem a better fit for the average Russian entrepreneur. Cash-flow would remain untouched, bank red tape avoided, and inflation-related uncertainty reduced.

Equity finance. Because relationships are so crucial to Russian businesses, equity partners and cross shareholdings would seem a natural next step. Russia has no tradition of the independent entrepreneur. Most businesses are jointly owned by three to five partners. Entrepreneurs should, therefore, be more amenable to taking on another partner. Formal equity financing, however, is discouraged in the present environment. There is no established means for investment in (or exit from) the market. Concerns with contractual performance limit the potential for mutually acceptable partnerships. Not surprisingly, capital markets are underdeveloped, and there are no venture capital or investment banks.

Commercial premises

Finding appropriate commercial property and obtaining secure tenure is "the problem of all problems" for many Russian entrepreneurs. This reflects the lack of a functioning commercial real estate market, as well as legislative and administrative support for it. There is a shortage of retail space exacerbated by a rigid system of property administration that often misallocates existing space. (For example, ground floors are used as flats instead of shops and shops are located outside of pedestrian traffic areas). Russia's property markets (such as they are) are dominated by the state as owner and regulator. As "owners," SOEs and local governments are reluctant to sell property and seem to have little incentive to do so. Leasing is more common, particularly informal lease arrangements between acquaintances.

Legislation. Current (and lack of) laws make it difficult for entrepreneurs to find, secure, and use the property they require. As yet, there is no law on private property or land and little economic stimulus for the state to release these rapidly appreciating assets. Even where ownership has been clarified, control is fragmented. As the chairman of Novosibirsk's property fund says, "the property fund owns the property, but districts will not provide information about the vacant premises. If any of them become vacant, nobody will let us know, and if an organization collapses, they will not get out of the premises they used to rent." It is hardly surprising that many premises are underutilized.

Lessors. Landlords range from oblast and municipal GKIs and MKIs to technical institutes and SOEs. The incentives to rent vary among landlords. Some are keen on facilitating "socially valuable" businesses, whereas others are only after a kickback. Landlords across the board saw "no reason for advertising." Demand for premises overwhelms accessible supply, and no body (public or private) disseminated information on available premises. Instead, this information (spotty though it is) is passed on to the ever growing circle of "friends" of the property fund; roughly 90 percent of the entrepreneurs found their premises through personal connections. Of these, half spent more than a year searching.

Rent also varies depending on the goals of the landlord and the extent to which landlords seek to control the use of their property. Official agencies, such as the MKIs and GKIs use similar formulas to determine rent. Their weightings, however, vary across (and within) oblasts. There is also a usage fee, which allows landlords to promote or penalize various activities. For example, in June 1993 the Voronezh MKI charged 2,000 rubles per square meter for "socially valued" uses (such as retail clothes or manufacturing food) but 3,000-5,000 rubles for other purposes (such as retail cigarettes or producing vodka).

Many government and commercial organizations sublet property to private firms, and 50 percent of the renters' revenue is taxed by the mayor's office. Businesses renting from non-government organizations pay a flat fee, plus goods, services, or a percentage of the firms' revenues. Hotel rooms are attractive as offices for two reasons—space and utilities (most importantly, a telephone). The telephones in most hotel rooms have direct outside lines, and given the state of telecommunications, they are a valuable service. The tenants' rent includes a fixed ruble rent plus an in-kind component (linens, mattresses, or other furniture as required by the hotel managers).

Leases. Rent agreements, whether with government, state-owned enterprises, or private firms, are usually for one year, but full-term tenancy is seldom secure. "Although guarantees exist on paper, practically they are meaningless. Everyone who rents can find themselves out of doors at any moment." And while arbitration courts exist, they, too, are "effectively useless." Businesses leasing premises and small "privatized" enterprises are also burdened by profile restrictions on the type or volume of goods to be sold or manufactured, as well as minimum employment. For each municipality, there is usually a department of finance and tax policy which controls the legitimacy of rights on premises. Sanctions are strict, and, if the property is not used for the purposes designated, the lessors must pay the city a share of profits.

According to the Voronezh oblast MKI, many enterprises continue to operate on a leasehold basis, under which lessees have generous buy-out options at the end of the lease. Most intend to exercise this right in the near future.

Impact on lessees. Most private companies hold one year leases for their premises, and those that own property have purchased it through auctions. The only means of locating premises is through informal relationships with officials. One small consulting company has two offices: one at a friend's travel agency and the other at a city government building. Another company is hidden in a state-owned enterprise, using premises (and equipment) in exchange for channeling funds (and resources) to the enterprise's director. While the arrangements vary, the denominators are common—high cost and low security.

Information

The lack of accessible, accurate information is a serious constraint. It increases the cost and uncertainty of starting a business or expanding an existing one. Effective collection and dissemination does not exist. The cause of this information gap is deep rooted. Under communism, the information collected was a function of administrative, not market needs, and there were powerful incentives to distort it. The Party sought to regulate and channel information, making it available only to a select audience.

Information needs. Identifying profitable business opportunities depends on information—knowledge of existing laws and regulations, sources of credit and other inputs, and markets for outputs as well as commercial know-how. Businesses lack the most basic information (telephone books and transportation schedules) and more advanced data (on standards, competitors, potential buyers, and so on). There is no credit rating service and no reliable way to check the history of a potential partner, buyer, or supplier. Ironically, while a few computerized databanks have emerged (on legislation and enterprise directories), these are beyond the means of most private businesses. In most markets, the best source of commercial information is other businesses. In Russia, businesses are so fragmented and information so precious, that such networks are not functioning.

The information gap is also costly to government. Without accurate data on the private sector, government cannot monitor private economic activity, and this impedes their capacity to develop and adjust policies accordingly, as well as collect taxes.

Despite the dearth of information on the private sector, enterprises are required to present mountains of data to various state agencies. Russian companies resent providing statistical data, because little is returned to them in a useful form and it is often costly.

As in the West, information collection is decentralized. Every firm must provide data to the bureau of statistics, tax authorities, pension funds, employment funds, registration bodies, and banks. Not only is this time consuming, but widespread disclosure of proprietary information increases the demands for bribes and the probability of racketeering. All information is regarded as a commercial secret. As corruption and mafia-related activities increase, there is growing secrecy in company operations and a tendency to provide inaccurate data. This fuels the information shortage and prevents the development of an information industry, the most effective way of meeting companies' information needs.

Dispute resolution

Lack of efficient, reliable ways to resolve commercial disputes substantially increases the risk of doing business. Russian business people have two options when trying to resolve a dispute—formal and informal. Most entrepreneurs prefer to resolve differences amongst themselves than bring cases to court for arbitration.

Arbitration courts are overloaded (queues average one and a half years) and plaintiffs pay an advance equivalent to 10 percent of the suit. Even if the case is won, legislation makes no provision for compensation of damages (contractual sanctions for state enterprises cannot exceed 8 percent of the claim's value) and settlements are not indexed for inflation.

Most entrepreneurs adopted a matter-of-fact approach: "try and sort out the problem and, if this fails, never do business with the person again." Although considered less expensive than arbitration, the informal route is costly. It limits contractual options, drives up transaction costs, and the outcome is uncertain—thereby driving up risk.

Business registration

For tenacious entrepreneurs, registration is more of a nuisance than a binding constraint. Tortuous registration, however, sends a strong signal to would-be entrepreneurs and to the population. While registering a business is significantly less difficult than in 1991, roughly 50 percent of the businesses surveyed had trouble registering. The process varies widely amongst regions, but in many, registration is complicated and time-consuming.

...roughly 50 percent of the businesses surveyed had trouble registering.

Process. Most requirements are leftovers from the previous regime (certificates of property ownership, legal addresses, and permission from the police for use of a seal). Requirements such as these slow registration, increase cost, and seem to serve no good purpose.

Many municipal authorities recognize that the registration process is badly organized and too complicated. When the law on entrepreneurship was adopted, it was assumed there would be one state register for all registered and liquidated companies. This did not happen, and municipal authorities developed their own registers. Registration procedures often differ, even amongst districts. In Stavropol, for example, not only does the list of required signatures vary, but it tends to be too many. Entrepreneurs often spend days racing around in search of a sanitary-epidemiological station, environment protection committee, lawyer, tax official, fire-control inspector, and finance inspector to find the necessary signatures. Few of these organizations bear responsibility for the activity of the enterprise, and even if they do, few carry it out. Instead, most documents are signed shortly after bribes have been paid.

Impact. The cost and time required to register a business varies across districts. Total costs include time spent preparing the application, registration fee (and bribes), and cost of the delay. In Novosibirsk, for example, 45 percent of the respondents took 2 weeks to register, 45 percent, 2 to 3 months, and 10 percent, 6 months. Most of these firms paid between 2,000–4,000 rubles, except businesses in retail trade or joint ventures, which paid 15,000 rubles and 40,000 rubles, respectively.

Many organizations have been formed to help business registration. Most companies are associated with the local executive committee (responsible for registration) or other government agencies. For example, one such company in St. Petersburg cooperates closely with the Mayor's department for the promotion of entrepreneurial activity. The firm provides the entrepreneur with a legal address, opens a bank account, prepares seals, and completes required documents. In mid-1992, the cost of a complete package (including approval from the executive committee) was 25,000–70,000 rubles; services that did not require networking were less expensive (2,000 rubles for preparing statutory documents). Entrepreneurs that filed documents independently usually faced delays of up to 6 months.

Targeting constraints

Which constraints to target?

Given the breadth of problems, the difficulty of tackling them, and the importance of making substantive and speedy progress, the approach to reducing constraints must be selective. This section provides a simple framework for selecting the constraints to target.

Figure 14.3 Targeting constraints

Government's potential to influence constraints

Enterprise cost to overcome constraints	Low	High
Low	Labor regulations	Registration complexity
High	Payment system delays	Access to commercial property

The most costly. The first step is to identify those obstacles that are absolutely binding or are the most costly for the average entrepreneur to overcome. Cost refers to the ruble, time, and/or opportunity cost to a firm. For example, to send freight by rail in the Central Black Soil region, entrepreneurs have to pay a standard fee plus a percentage of their revenue (or goods) to the local manager of the state owned rail company. Likewise, a tailor in St. Petersburg is only able to register after he promised free clothes to a local official and his family for an indefinite period. Quantifying cost is subjective. So the key is to determine whether the cost is a nuisance or a serious impediment to profitability. To the extent that the most costly constraints hold constant across firms, interventions that address these constraints should have the most impact on private sector development.

Potential to alleviate. The second step is to determine whether the given constraint alleviated can be eradicated or overcome. Either way, that requires identifying the potential alleviators of a constraint and evaluating their potential to alleviate.

The universe of potential agents is broad and should include those able to have a direct and an indirect effect. These parties might include different layers of government, domestic business associations, educational institutes or private providers of business services, or aid agencies. The evaluative dimension of the analysis should focus on the incentives, capacity, and authority that each agent has to alleviate the constraint. While alleviation need not imply direct intervention, the more indirect the delivery (or distanced a given agency is from responsibility for a constraint), the more dependent that agency becomes on those downstream or upstream in the process. For example, donor conditionality might spur a change in regulation, but the donor cannot control the regulation nor how it is enforced.

Targeting. How should a local government in Russia decide where to intervene? Government will be most effective if it tries to alleviate high cost constraints that government is in a strong position to influence (figure 14.3). Hence, in this example a priority for local government is access to real estate.

Government should exhaust their potential to intervene in the high-cost/high-impact quadrant before considering others. If, having addressed all the constraints in this quadrant, government has some spare capacity, they should then consider the other quadrants. At this stage, government should weigh the trade-offs between the cost of a constraint and government's ability to alleviate it. In most cases, government should target those constraints it can control, even if these are less binding to firms than others might be. Thus, having addressed the priority quadrant, government might turn to business registration or other constraints in the high-potential/low-cost quadrant.

The mapping process also identifies constraints that an organization should not target. If the constraint is not costly and the agency is unlikely to alleviate it, it makes little sense to try. In this example, government should not focus on labor regulations.

Mapping out constraints should be completed on an iterative basis. Not only will the environment change, but as bottlenecks ease, new constraints will emerge. Likewise, the capacity of organizations to intervene will also change.

Alleviating constraints

Having chosen where to intervene and who should intervene, the question then becomes what to do. Quite often these three questions are blurred or one ends up driving the others. It might be assumed that government should only intervene to alleviate systemic constraints—or that systemic constraints can only be alleviated by government. Based on this assumption, government should focus on creating an enabling business environment. Hence, tools to intervene should be limited to passive interventions, including policy, regulatory, and investment decisions that promote entry and competition without targeting specific activities or enterprises.

Conversely, it could be argued that operating constraints are best alleviated by companies either formally (through markets) or informally (through networks). Either way, the private sector is the most effective delivery mechanism for active interventions, such as financial and advisory services. Certainly, evidence of government's use of active intervention seems to confirm this argument. Such interventions are seldom cost effective in developing a sustainable private sector. The reasons are more complicated than those proposed above.

First, government has multiple, conflicting objectives. For example, it's interest in short-term employment creation is often at odds with long-term growth of value-adding enterprises. Second, the structure of the intervention is often poorly designed and delivered, usually due to government's involvement past the initiation stage (extending to design or delivery of the service). Finally, the strategy of the intervention is seldom consistent with the principles of a market economy. Active interventions should encourage, not displace, markets and should work within (or minimize distortion of) market principles.

Unfortunately, many active interventions are often delivered by agents that lack appropriate incentive systems and cost-effective operations. These interventions often provide direct subsidies to enterprises, and this leads to distortions, rationing, and rent-seeking. Such mechanisms tend to send the wrong signals to private providers of services and their clients, thereby stifling the industry. Customers receive variable service, which is often taken for granted as subsidies continue. Poor performers are rewarded and potential competitors are crowded out.

None of this means, however, that government should keep clear of all active interventions. Even if this were desirable, it is not particularly useful for the simple reason that governments worldwide have and will continue to engage in active interventions. To the extent that these initiatives go forward, it makes sense to optimize them and to avoid the costly mistakes made elsewhere.

Government should not be limited to passive interventions, nor the private sector to active ones. Instead, interventions should be viewed in three phases—initiation, design, and implementation. Different players

Government should exhaust their potential to intervene in the high-cost/high-impact quadrant before considering others.

can take responsibility for different stages. Government might be the catalyst for an active intervention, such as a directed credit program (figure 14.4). Government, however, could sub-contract the program's design and implementation to private companies that would operate the program cost effectively. In this example, government is the catalyst for an active intervention, but the private sector is the implementing agent. Another example, is self regulation. In this case, the private sector might initiate and design the intervention, but this will require government approval.

In Russia, the capacity of both the public and private sectors to pursue passive and active measures is limited. Government is highly decentralized and, to a large extent, lacks the resources and incentives to alleviate business constraints of any kind. It might be argued that government should focus on its comparative advantage and not get embroiled in active measures. But the private sector also lacks capacity to initiate active measures on its own. By default, federal and regional governments are initiating measures to alleviate operational constraints, and it makes sense to optimize these efforts.

A practical application of these ideas is the most effective means of explaining them. The following section illustrates what the role of government might be in alleviating three constraints. This section assumes that the mapping process described in figure 14.3 has identified three priority constraints for

Figure 14.4 Average sources of finance per firm

	Passive measures	Active measures
Private sector	Self-regulation	Consulting services
Public sector	Infrastructure	Directed credit

government; these include the tax system, commercial property, and information.

Taxation

Costs incurred by the current tax system stem from the content of the law, the way this information is disseminated, and how taxes are administered. Together they amount to a major constraint to business operations; while efforts to alleviate it are predominantly passive, they are not exclusively so.

Tax law. Content includes the tax base, the number of taxes, and the rates. While businesses worldwide complain of high tax rates, Russian businesses can pay up to 65 percent revenue in taxes. Of almost equal importance is the complexity and changeability of tax regulation. Business people spend many hours a day poring over newspapers to learn the latest changes in tax policy.

While tax rates should be determined by fiscal and other considerations, there are five principles of tax reform, which would greatly alleviate the constraints that taxation systems impose on Russian businesses. First, simplify taxes—reduce the number of taxes, the ambiguity, and the contradictions that currently enable disparate interpretations. Second, provide stability—keep changes to a minimum, prohibit retroactive application of laws, and establish fixed buffer terms for corrections to laws or instructions. Third, give priority to rules that preempt administrative decision making and minimize discretionary options by tax officials. Fourth, reduce the amount of information required by taxation bodies and provide guarantees for the secrecy of commercial information. Finally, develop accounting definitions for taxation that consistently encourage investment instead of relying on tax holidays and other distortionary or discretionary investment promotion schemes.

Dissemination of tax legislation is slow, often spotty, and frequently inaccurate. The lack of information keeps administrators from enforcing the law and businesses from complying. Government should ensure that businesses have access to timely, accurate information. Given its resources, the size of the country, and growing level of decentralization, government might franchise this service with business associations or private firms that would distribute information on a user pays basis. Some private firms have already sprung up, but the accuracy of their material is questionable and the cost of their service prohibitively high.

These problems are often exacerbated by tax administrators, who also lack information but insist on enforcing the "law"—even when the law is unknown, misunderstood, or misconstrued. Tax administration is inefficient and frequently corrupt. There are too many offices to be visited and redundant forms to be filled out. Tax inspectors are often untrained and motivated by their broad discretionary powers as opposed to enforcing the tax law. Inspectors possess the power to set penalties that are automatically enforced.

Improving the quality of the tax inspectorate would be easier if the first two recommendations had been enforced, but this should not be a prerequisite for addressing administration. In fact, because most taxes are enforced by oblast and municipal governments, tax administration (on a pilot basis) is an attractive and urgent target. The tax inspectorate should be reorganized, control systems imposed, and equipment updated. Tax administrators should be trained and incentive (and penalty) systems introduced; non-performers should be dismissed after appropriate warnings. A streamlined appeal mechanism should be established, where complaints are resolved before the collection of fines.

Commercial property

Access to real estate is a critical bottleneck to business formation and growth. Because commercial property is essentially under control of the state, it is a clear case where the public sector must initiate passive and active measures to encourage a commercial property market. Either the assets are under de jure control of bodies of state administration, or they are de facto subject to the control of public property administration policy because of the way ownership distribution has been determined. Other than government agencies, entities with marketable real estate tend to be state-owned enterprises or else the firms only recently privatized. Most of these entities have not faced hard budget constraints and other incentives that could otherwise force them to restructure and divest assets. Hence, the property markets now tend to be dominated by public agencies, and efforts to develop them are largely subject to the explicit policies and operating practices of these bodies.

Thus, development of a commercial real estate market requires both passive and active measures. Passive measures are largely legislative (including enforcement). Laws on land and private property should be enacted, and an appropriate public property administration policy should be established in all relevant jurisdictions. Profile restrictions on leased/sold businesses should be eliminated.

A complicating factor is that there are often several jurisdictions with a role in property management policy—federal, regional, and local government. This makes it difficult to define a framework for property administration regionally. Therefore, it is necessary to understand the existing composition of assets held by state and local government entities and the reasons for this allocation. Different public-sector property-management policy may be followed by each public sector "owner." While the challenges of addressing this complex structure are daunting, substantive work has been done in this area.

City and oblast governments have the legal authority to allocate property within a given region, but it seems that none have pursued it to its full potential. The accent so far has been on privatization of enterprises as going concerns, with distribution of shares to workers and management and voucher auctions being the predominant forms of privatization. This has tended to re-orient the demand for fixed assets around sales of shares of enterprises. The chairman of the Voronezh Oblast Committee for State Property Management articulated an increasingly common belief, that as the initial stage of privatization nears completion, the emphasis will shift towards bankruptcy, and asset sales in liquidation

Access to real estate is a critical bottleneck to business formation and growth.

could facilitate the emergence of property markets. Under law, the management of the asset liquidation would be a prerogative of the arbitration court and the MKI.

Most of these agencies have missed opportunities. Property administrators have a vested interest in maintaining the current system in which property (or information on property) is passed onto colleagues. Transparency has a high price, particularly when the officials involved do not see a viable alternative and will soon lose their justification for existence (as privatization winds down). One approach, in the grey area between active and passive measures, is to help these administrators transform into brokerages for commercial property. Agencies could provide an information clearinghouse for buyers and sellers, lessors and lessees. This activity could increase accessibility of real estate to "unconnected" business people, encourage state-owned enterprises to spin off assets, and shift the profitable part of the MKI and GKI's property management functions to the private sector, thereby reducing their resistance to change. Such brokerages could facilitate the development of a transparent, price-determined market for commercial property.

Active measures that promote a leasing industry might also be effective. Private property management companies could lease a building from a state-owned enterprise or local authority, refit the building as appropriate, and on-lease the office, manufacturing or retail sites to local businesses on a for-profit basis. The concept is similar to executive leasing services used throughout the west, and some additional services, such as utilities or secretarial support, might also be included in the package.

Representatives of the state sector seemed attracted by this proposal because they would maintain ownership over the property and receive rental fees, adjusted for inflation, for a fixed term. In exchange, they would relinquish all control over use of the property. An agreement on the type of construction to be undertaken (which would increase the value of the property) would also be required.

Leasing centers would provide a direct benefit to the numerous private businesses that struggle to secure and maintain rental agreements. The centers would also encourage the development of a commercial real estate market by rewarding the release of under-utilized buildings, demonstrating that real estate transactions can be conducted transparently, and providing an opportunity for private firms to be active in the real estate market.

Information

The goal here is to shift from information rationing to information markets, in which information is accurate, delivery transparent, and organizations generate and access data at minimum cost. Achieving this depends on both the public and private sectors, as each will play an important role in the collection, analysis, and dissemination of different types of data.

The most costly information-related constraints to businesses fall into two categories: description of current legislation and information on private firms (input/output markets and competitors). Similarly, government needs solid information on which to base policies that affect the private sector.

In many countries, government is responsible for collecting and disseminating various types of information—ranging from data on private businesses to updates on regulation and schedules for public services. The Russian government has traditionally collected copious information but was not inclined to disseminate it. Hence, the first step is for government to recognize the value of open information policies. Targeting first that which is most useful to businesses and to government, it should focus its data-gathering efforts and process the ensuing information in an accessible way.

Information on legislation. The information most needed by entrepreneurs is accurate descriptions of regulation. Dissemination is haphazard and largely dependent on the press, whose information is incomplete, and often, inaccurate. Agencies responsible for formulating laws and regulations will not suddenly start disseminating them widely—nor would such a step be cost efficient. A possible solution? To adopt the practice (used in many countries) where legislation is not effective until it has been published in a gazette. Hence, at the origin, there is no gap between information and legislation. The gazette should be widely accessible to individuals, private firms, and public agencies who interpret and use it accordingly.

In a functioning market economy, it might be argued that dissemination of information should be left to private firms who could do it efficiently, profitably, and at a cost reasonable to clients. In Russia, this will take a long time to emerge, meanwhile the cost of waiting is also high. So, why not a compromise that will stimulate an information industry and deliver useful information to companies?

One active measure could be to contract out regional business information clearinghouses, that would collect, codify, archive, and disseminate information on a fee basis. The clearinghouses would prioritize information most valued by customers and then target this for collection and disbursement. Information gaps will close as the information industry evolves. Government subsidies would be weaned over time, until the clearinghouses become self-sufficient. Granted, establishing a network of BICs would be a resource intensive task, and, given that it is unproven, a pilot program might be appropriate. Because of Russia's size and its unreliable postal system, an oblast network might be the place to start. One oblast clearinghouse would serve as the hub for local clearinghouses (which would act as libraries) or clearinghouse vans (which would make a circuit throughout the oblast, disseminating material directly).

As the private sector develops, some clearinghouses would target specialized niches and others would continue to focus on more general material. Such a program could provide a jump start to the emerging information industry.

Information on the private sector. With general data on the private sector, the federal government is in the strongest position to improve the quality and flow. Government should review its current collection practices and consolidate them as appropriate, given the trade-off between the value of information and the cost of collection, compliance, analysis and dissemination.

Government might reduce the number of collection agencies and encourage coordination amongst those that survive (Goskomstat and the Ministry of Finance are in the process of being linked), minimize the number of forms and the frequency of collection (some forms are required on a monthly basis), and simplify forms and cull repetitive questions.

Efforts to improve collection will not be effective until the risk of disclosing information is reduced. Most businesses are penalized for being visible and need encouragement as well as prodding to change their behavior. Confidentiality must be respected, and administrators that violate this ethos should be punished. Publicizing these transgressions and the penalties imposed is one way for authorities to demonstrate that they value confidentiality. If effective, the perceived risk of information disclosure will wane, and there will be less resistance to divulging "commercial secrets." Clearly, this idea will be difficult to implement, particularly given the resources of most local governments.

An alternative is the carrot. After collecting and analyzing the data, administrators could ensure that some of the results are delivered to those firms that complied. For example, given how desperate businesses are for the most basic types of information, a general profile of local companies or open access to registration information would be invaluable. It would also demonstrate that the information disclosed is actually put to good use. Another idea might be to link up information collection with the aforementioned clearinghouses. Companies that disclose requested material might receive a fixed credit at the local clearinghouses.

Notes

This paper is a condensed version of an Internal Discussion Paper, published by the Europe and Central Asia Region of the World Bank. The paper owes much to Mr. E. Rveda-Sabater, Mr. S.

Vasiliev, Mr. V. Shironin, Ms. I. Boeva, Ms. L. McCuaig, and to a number of other colleagues, both within and outside the Bank, but it does not reflect their views. In particular, the paper benefitted from interviews with numerous Russian entrepreneurs and from the collaboration with officials from the Russian government, whose ideas and energy were the key to driving this work forward

1. This system provides for the following legal forms: state, municipal, and individual enterprises, full and mixed partnerships, limited liability (closed stock), and open stock companies, associated, subsidiary, and leasing enterprises

2. Rent-seeking behavior has dangerous attitudinal implications. It seems that may Russians believe that businesses profit from working the system—as opposed to hard work. A poll undertaken by Russia's Public Opinion Center in Autumn of 1992 indicated that roughly two-thirds of the respondents believed that a business' success was a result of swindling, fraud, and crime, 14 percent attributed this to luck, and 13 percent to persistence and hard work. (Source: The Public Opinion Center of the Russian Federation, February 1993.)

3. This information was generated from a survey of 180 companies covering eight oblasts. The survey was conducted in 1992. Throughout this paper, any detailed information (such as percentage of firms responding) or reference to a survey refers to this one.

CHAPTER 15

Private Sector Manufacturing in St. Petersburg

Leila Webster and Joshua Charap

A survey of ninety-nine firms implemented in St. Petersburg in November 1992 documented the characteristics and problems of private-sector manufacturers. In doing so, it produced a historical record of the status of private manufacturing in a major Russian city in the early stages of Russian reform. The research had three specific objectives: to develop a profile of manufacturers and their firms, to identify and analyze constraints to growth, and to reach some conclusions about how private-sector manufacturing is developing, and how it might best be supported.

Firms were drawn randomly from the population of registered, majority privately and domestically owned manufacturers with seven or more employees. Self-employed people, trade and service firms, and joint ventures were excluded.

The entrepreneurs

Russian entrepreneurs were almost all middle-aged men with solid technical educations and previous employment in the state sector. More than 60 percent had university degrees and an additional 21 percent had post-university education. Almost all fit one of four professional profiles: just under half were highly skilled professionals, many with engineering backgrounds; just under a quarter were former research scientists; about 15 percent were former bureaucrats from state enterprises; and 10 percent were novices without relevant backgrounds.

Almost one third of entrepreneurs had an research and development or manufacturing background in the military industrial complex. The most frequent pattern was that two or more colleagues in a research institute or military industrial state enterprise chose to leave, often taking with them skilled workers, equipment, and technical know-how. Although many began their private activities by selling much of their production back to the military industrial complex, the trend was toward sales to nondefense state enterprises and private customers.

Those entrepreneurs who had held positions as managers in state enterprises (about half) started out with substantial advantages in both assets and personal connections. They were able to transfer real estate leases and production equipment to themselves on preferential terms from the state sector. Despite unequal start-up positions, however, many entrepreneurs from nonmanagerial backgrounds also had good prospects: they dominated among exporters, and they accounted for three quarters of the most promising firms in the survey.

Those entrepreneurs who had held positions as managers in state enterprises... started out with substantial advantages in both assets and personal connections.

Many entrepreneurs expressed confidence in their knowledge of production, less so about how best to organize their businesses. Specifically, entrepreneurs wanted to know more about management (financial planning, accounting, inventory control, quality control and technology applications); marketing (market research, advertising); and export markets (requirements for entry, criteria for success). Most felt that would-be trainers should come with first-hand knowledge of industrial production in market economies. Regardless of the sponsor of training programs, entrepreneurs repeatedly stressed the importance of recruiting experienced practitioners rather than theoreticians. Many expressed frustration with the lack of adequate basic information such as economic forecasts, business directories, details on available assistance programs, and foreign business in general.

The firms

Twenty-nine percent of sample firms were limited liability companies, 25 percent joint stock, 19 percent cooperatives, and 16 percent private small enterprises. Half of surveyed firms had operated previously in other legal forms, some private and some state-owned. As privately-owned enterprises, the median firm age was 22 months, with the oldest private firm dating from May 1985. The average firm was larger than might be expected in terms of workers (sixty-three full-time workers) but smaller in monthly sales ($14,810). Entrepreneurs manufactured a wide range of products that can be loosely classified into three groups—low-tech consumer goods, such as books and cigarettes (33 percent of firms); low-tech industrial inputs such as construction materials and spare parts (40 percent); and high-tech goods such as precision testing equipment and optical devices (26 percent).

Almost all firms traced their genesis to one of three sources. Either they were fully private since start-up, they began as quasi-private enterprises—cooperatives and leaseholds—mostly in the late 1980s, or they were privatized units of state enterprises

Production arrangements were uniquely Russian and transitional. They varied equally among firms that were entirely free-standing, entrepreneurs who functioned primarily as brokers (obtaining orders from one state enterprise and contracting with workers in another state enterprise for production), and enterprises that were embedded within the state sector.

Almost all firms traced their genesis to one of three sources. Either they were fully private since start-up (38 percent of firms), they began as quasi-private enterprises—cooperatives and leaseholds—mostly in the late 1980s (37 percent), or they were privatized units of state enterprises (25 percent). The types of business established and their timing almost perfectly mirrored the opportunities that came with each liberalization of private enterprise regulations. Cooperatives and leaseholds started up in 1988 and 1989 when these forms of enterprise were first permitted; most small enterprises were established from 1990 onward when they were first permitted; and limited liability and joint stock companies, allowed in 1990, were registered in large numbers from 1991. The jump in registration of privatized state firms as joint stock and limited liability companies in 1991 and 1992 corresponded to the onset of spontaneous privatization and the enactment of privatization laws allowing managers and workers to convert state enterprises to joint stock companies and to buy majority shares.

In general, prospects appeared strongest for privatized firms and new start-ups and weakest for cooperatives. Privatized firms were substantially larger, with a larger assets base than most new private entrants. The strength of many new entrants stemmed from their flexibility. Similar to the earliest Polish entrepreneurs, lack of fixed investment, small size, and sharp noses for profitable niches may be the Russian entrepreneur's keys to survival. Prospects for cooperatives that operated independently of state enterprises appeared equal to other types of firms, but those that maintained physical location within state enterprises generally were poorly positioned for success.

Two-thirds of entrepreneurs used their own savings for start-up capital. Almost 40 percent of new firms also relied initially on advance payments from customers. Commercial bank credit played a less important, albeit significant, role during the first six months of operations with 22 percent of entrepreneurs receiving loans. The majority of transactions were in rubles, and most went through the banking system. Entrepreneurs said that there were no barriers to legally obtaining foreign exchange, but only about a quarter reported that they used foreign exchange in their businesses and most used small amounts.

Entrepreneurs used few financial services, usually restricted to obligatory current-account transactions and short-term credit. Many complained about the poor quality of services from banks. Forty-seven percent of sample entrepreneurs had received loans, of which 42 percent were short-term and 5 percent were long-term. Thirty-five percent of loans came from banks, 22 percent from nonfinancial institutions, and 8 percent from both. The consensus was that short-term credit was available at nominal annual interest rates of between 100 and 200 percent, but most entrepreneurs were unwilling to borrow at such rates. Long-term credit was said to be virtually impossible to obtain.

Entrepreneurs generally had ready access to capital equipment through purchase or lease, virtually all from the state sector. The 20 percent of entrepreneurs who reported access problems typically needed equipment that was produced exclusively in one of the other republics of the former Soviet Union. Inside deals with the state sector were obvious. Almost a third of those who purchased equipment cited the state enterprise where they worked previously as the source. Similarly, almost half of entrepreneurs who leased their equipment cited their former state employer as the lessor. Entrepreneurs indicated that there were no regulations blocking equipment sales from state enterprises, but that the opportunity to purchase depended heavily on personal connections and substantial bribes.

Most production equipment appeared to be old, energy-inefficient, polluting, and often dangerous. The average age of equipment was 10 to 20 years, and many firms rebuilt and jerry-rigged decrepit equipment. By comparison with firms surveyed in Central Europe, production equipment in St. Petersburg firms appeared much older and far more dangerous.

It was difficult to measure precisely the size of an enterprises' labor force, due mainly to the widespread practice of subcontracting workers in state firms. The average number of full-time workers in sample firms was sixty-three; the number of part-time employees averaged twenty-three. The fact that twenty-eight firms had more contract workers than full-time employees underscores the extent to which entrepreneurs relied on temporary, subcontracted labor. In November 1992, average monthly salaries were 12,000 rubles ($30) for skilled workers and 5,300 rubles ($13) for unskilled workers.

Labor markets were best characterized as provisional. Because future developments were so uncertain, the principal players—workers, state managers, and private entrepreneurs—were hedging their bets. Although large-scale transformation of state enterprises into joint stock companies appeared well underway, there was no evidence that state workers were sufficiently concerned about potential lay-offs to seek jobs in private companies, particularly as they could bid up their wages when private entrepreneurs appeared with contracts in hand. State managers were holding on to as many workers as possible in hopes of future subsidies, social payments, or policy reversals in the direction of maintaining output—that is, anticipating a link between allocations of state funds and the size of the labor force. Many private entrepreneurs avoided carrying the overhead and commitment associated with in-house labor and instead, maintained their flexibility by subcontracting to workers in state firms.

Only twelve entrepreneurs had been able to purchase factory buildings. The majority leased their business space—roughly two-thirds with multi-year leases and one-third with annual leases. Virtually all real estate was owned by state enterprises, the city government, and a handful of other government institutions. The consensus was that production space was available but leases typically were insecure and increasingly expensive.

State enterprises were the primary source of raw materials and intermediate inputs. Entrepreneurs reported that one could find any input or raw material needed (if willing to pay the price) and yet, access problems were sufficiently serious that almost half said that they had problems getting the domestic inputs they needed. Survey data suggest that three issues underlie problems in input markets: the loss of suppliers from other republics of the former Soviet Union, the informality of input markets, and the high transaction costs associated with sourcing raw materials.

Over half of the entrepreneurs said state enterprises were their major customers. Some said that orders from state enterprises had fallen sharply, but others said that such enterprises had become their best customers since government injections of cash resumed the previous summer. Competition was minimal but growing: almost a third of entrepreneurs said that they had no competitors in their main markets, and another third said they had fewer than ten competitors. Over 90 percent of entrepreneurs reported no problems with distribution.

Exports accounted for less than 3 percent of total sales within the sample. Only

...three issues underlie problems in input markets: the loss of suppliers from other republics of the former Soviet Union, the informality of input markets, and the high transaction costs associated with sourcing raw materials.

eleven firms exported for hard currency, with the remaining exports selling to other republics of the former Soviet Union. Barriers to export were significant. Exporters were required to obtain export licenses that reportedly involved bribes, long delays and detailed restrictions. Transaction costs were high. Entrepreneurs had to pay substantial fees to change currencies, take an additional exchange loss when surrendering the required 50 percent of hard currency earnings, and pay a higher rate of profit tax on export earnings.

Problems cited most frequently were excessive and frequently changing taxes, inflation, and an ineffective banking system.

Strong firms versus weak firms

Groups of strong and weak firms were identified and compared to help clarify factors associated with success. Firms were classified according to three criteria:

- How production had changed in the previous months;
- Trends in profitability;
- Rankings given each firm by interview teams.

Survey teams ranked firms' prospects based on having listened to their owners and managers, viewed their facilities, examined the trends in their businesses, and compared firms in the same sectors. If firms received positive rankings, profits were increasing and production was rising, firms were classified as strong. Similarly, if rankings were negative, profits were falling and production was falling, firms were classified as weak. Using this criteria, twelve firms were classified as strong and seven were classified as weak, with the remainder in between.

The numbers of strong and weak firms were too small to yield definitive results, but an in-depth look at each group of firms provides some insight into factors associated with success. The most pronounced difference between the two groups of firms was the competence of their managers. Regardless of their origins, size, or sector, strong firms were led by strong managers—individuals who were savvy about how to navigate in the difficult business environment they faced. They knew how to spot profitable niches, forge needed connections, assemble the factors of production, create workable contracts, and obtain payments. In contrast, managers in the weakest firms had chosen products unwisely and faced marketing problems for which they were ill-equipped.

Strong and weak firms also differed in their basic characteristics. Strong firms generally enjoyed revenues more than twenty times as great, while providing employment for more than four times as many individuals, at wages nearly twice as high. Furthermore, the replacement cost of enterprise capital stock was more than five times larger than in weak firms, and more than one quarter of capital stock was new, compared to less than one percent of new capital in weak firms.

In all weak firms, entrepreneurs had used their own savings as start-up capital, and only one had received a bank loan at the outset. In contrast, almost half of strong firms had received an initial bank loan. In the whole sample, only 25 percent of entrepreneurs said they used hard currency in their business. Almost half of strong firms used hard currency (many only for bribes), but no weak firms used hard currency. The most frequently cited problem among strong firms was "taxes" which they felt were draining their profits. In contrast, entrepreneurs in weak firms complained first of poor demand which perhaps reflected their inability to choose their products wisely and market well.

Relations with the state sector were another important factor. All weak firms sold mainly to state enterprises, whereas some strong firms sold directly to private retailers. Since payment delays were frequent, particularly in the state sector, the inability to collect accounts receivable adversely affected weak firms. Again, effectiveness of management in locating new, solvent customers was a decisive factor in success.

Major constraints

Entrepreneurs were asked to identify their three largest problems in order of importance. Problems cited most frequently were excessive and frequently changing taxes, inflation, and an ineffective banking system. Other problems included unclear and unstable regulations and policies, poor internal management skills, weak demand, and high nominal interest rates.

Taxes

High rates of tax and frequently changing tax regulations were cited by 36 percent of entrepreneurs as being among their top three problems. The prevailing view was that the government was robbing private entrepreneurs through excessively high taxation. In addition, many had trouble getting accurate information about the numerous tax regulations. Entrepreneurs complained that modifications in taxes commonly were enacted retroactively, making planning and compliance difficult. The number of new taxes reportedly was increasing monthly.

Primary taxes are:

- *Value added tax* (28 percent) is collected on sales. Several entrepreneurs described difficulties obtaining credit for VAT paid on inputs. Although widely resented, most businesses appeared to comply with VAT. On January 1, 1993, the standard rate for VAT in Russia was lowered to 20 percent.
- *Corporate profit tax* was said to vary according to activity. Most entrepreneurs in the sample were liable for 32 percent. Wages in excess of four times the minimum wage were taxed as profits at 32 percent. Entrepreneurs complained that some expenditures, such as investment in new equipment, could not be expended against profits tax liability. Interest on bank loans was deductible only when the proceeds of the loans were used for operating expenses, and then only to the extent that the rate of interest did not exceed by more than three points the rates set by the Central Bank. Thus, interest on bank loans used to acquire fixed or intangible assets was not deductible. Nor was interest on nonbank loans.
- *Payroll tax* (39 percent) includes pension (28.0 percent), social insurance (5.4 percent), unemployment (2.0 percent), and medical insurance (3.6 percent). An additional one percent of wages was withheld by employers for contribution to the national pension fund. Entrepreneurs had to provide their banks with evidence of tax compliance before banks would permit wage payments.
- *Import and export taxes* were paid by those involved with foreign trade. Import tariff rates were increased for all categories of goods, and the general rate rose from 5 percent to 15 percent from September 1, 1992. In addition, a 0.15 percent customs processing fee was applied. Export taxes differed according to product. Raw material export taxes were designed to capture 30 to 40 percent of the sales price of taxed exports outside the CIS, but evasion appears widespread. Some manufactured exports were not taxed; others were taxed at 10 percent.

In addition, entrepreneurs were subject to a multiplicity of other small taxes, each with a different timetable and basis. The most common included: a hard currency tax (10 percent of gross hard currency revenues); a road use tax (0.4 percent of gross sales, payable monthly); an advertising tax (0.5 percent of expenditure); a property tax on all assets including inventories and bank accounts—excluding liabilities but after depreciation (one percent of gross based on repriced value); a police tax; and a car tax (based on horsepower). Payment schedules and procedures varied by type of tax, and entrepreneurs relied heavily on bookkeepers and attorneys to maintain their compliance.

Compliance with tax regulations was difficult to evaluate. Many entrepreneurs seemed to be making extensive efforts to meet their obligations. Without question, regulations mandating companies to make payments via the banking system limited the scope for evasion. High penalties on delinquent payments, reportedly one percent per day, also were an incentive. Tax officials apparently were active in monitoring enterprises' books, auditing them once every three years, and making frequent, random spot checks. Several entrepreneurs complained that tax offices imposed penalties without juridical process, and that they were powerless to contest these decisions. Local tax offices were said to have an unofficial collection target of 25 percent of enterprise gross revenues, irrespective of enterprise costs.

At the same time, there were numerous instances of tax evasion. Discounts for cash payments were common, as were efforts to avoid reporting activities. The shortage of cash rubles and the poor quality of banking services facilitated tax evasion by increasing the incentives for cash transactions. Entrepreneurs actively engaged in paper transactions to limit tax liabilities. For example, one profitable company underpriced its products, sold to a loss-making company, and repurchased them at a higher price, thereby decreasing reported profits and value-added. The inflationary environment also facilitated these transactions, since prices were changing rapidly and paper transactions could occur at different dates than the real exchanges. Other methods of tax avoidance included provision of in-kind goods to employees and understatement of the numbers of workers and hours worked. In January 1993, the tax code was changed and in-kind payments are now taxed as regular income along with the value of training provided to workers.

Taxes created disincentives to building a business. For example, one entrepreneur observed that 80 percent of his gross revenue was taken away by taxes, whereas continued employment in the state sector would have guaranteed a modest income. Moreover, high taxes do not necessarily correspond to high levels of government revenue because of exemptions, frequently to the benefit of state enterprise. For example, in 1992 export taxes were expected to raise revenue of 17 percent of GDP. Actual collections were 2.7 percent of GDP, primarily because of exemptions and evasion. Furthermore, the ability of an enterprise to extract tax concessions or subsidies is linked to its size, importance, and connections, all of which tend to be less significant for private businesses.

Inflation had a mixed impact on entrepreneurs' tax liability: it eroded the real burden of some taxes, but the absence of indexation in the tax law made businesses liable for increases in nominal values. Accordingly, delays in the payment of profit tax could decrease the real burden, but VAT had to be paid on inflation in the value of inventories which increased the tax burden. For example, one entrepreneur noted that prior to introduction of VAT, it was advantageous to maintain high inventories as a hedge against inflation. But under present circumstances, the real level of inventories had to be understated for tax purposes. Many sample entrepreneurs were paying for training of company accountants, reflecting both the importance they attached to compliance and their desire to lower taxes legally.

Inflation

Severe macroeconomic instability complicates business decision-making because relative prices are constantly changing and future interest rates and exchange rates are unpredictable. Average prices were increasing by about 25 percent a month (almost 1,400 percent annually). Virtually all entrepreneurs were acutely aware of the impact inflation was having on the cost of inputs and salaries of workers, and of the necessity to reflect increased input costs in the price of products. But most felt unable to raise prices to cover fully increased costs because, in their view, consumers could not afford to pay more. In fact, weak demand was cited by 14 percent entrepreneurs as one of their top three problems. In most cases, however, demand seemed to constrain expansion rather than endanger survival. In some cases, complaints of falling demand may have been camouflage for poor marketing.

Entrepreneurs blamed inflation for increasing the cost of short-term loans. Annual interest rates offered by banks (100 to 180 percent) were seen as unfairly high. Few understood concepts such as value of money, and compound and real interest. Many entrepreneurs suggested that they were prepared to accept loans at annual interest rates of no more than 40 to 50 percent. Only one person said that he thought a loan at the prevailing interest rate constituted "a good deal given inflation." Strategies to cope with inflation included stockpiling raw materials; repricing products based on raw materials costs; diversifying products; using the index of inflation to revalue inventories; and indexing contracts. Rising input costs also increased incentives to seek out "under the table" contracts at reduced prices.

Movements in the exchange rate are linked to current and expected inflation, and one entrepreneur producing knitwear gave an example of how exchange rate depreciation affected his business. His production process required large needles for weaving polyester and fine needles for cotton. Large needles were available from Russian manufacturers, but fine needles had to be imported from Germany or Japan at 0.80 German marks. Given the current exchange rate and low quality of Russian cotton (which consumed the needles rapidly), it was unprofitable for the entrepreneur to purchase imported fine needles for cotton production. Instead, he focused on polyester weaving, and a valuable piece of German equipment sat idle.

Ineffective banks

Entrepreneurs reserved particularly harsh criticism for the Russian banking sector, ranking problems with banks third on their list of most serious problems. Despite introduction of reforms in state banking and the appearance of numerous private banks, Russia's banking sector appeared inefficient and ill-equipped to handle the requirements of a rapidly expanding private sector. In general, entrepreneurs described their relations with banks as adversarial or, if positive, based on personal connections and quid pro quo. Many complained that banks were not interested in their clients and treated even large and profitable private companies poorly.

The most serious problem, long delays in processing current-account transactions, was due to nationwide gridlock in payments clearance. Entrepreneurs reported delays as long as four or five months between different cities in the Russian Federation. In several cases, payments initiated in the first quarter of 1992 had not cleared by November 1992. One firm's electricity was cut off because its bank held up payment to the state utility. Delays frequently meant that entrepreneurs were unable to pay salaries or purchase raw materials, forcing them to cut back production or lose orders. Apparently, it was not uncommon for banks to misplace documents needed to process payments.

Problems with inter-republic transfers were particularly severe, although it was sometimes difficult to distinguish between slow processing by commercial banks, and delays due to problems between the respective central banks. Some entrepreneurs reported that they routinely traveled to collect payments directly from customers in other republics.

Given the lack of information and transparency in the system, it was often difficult for an entrepreneur to know where the problem with payments lay. The lack of electronic banking and clearance systems meant that transactions were largely dependent on the slow Russian postal system. In some cases, delays could be attributed to delinquent payments by customers. Many entrepreneurs also maintained that banks intentionally delayed payments to earn interest on captive deposits. Two firms reported that banks had been instructed by the Central Bank to delay payments by up to two weeks. The end result for virtually all enterprises was massive forward and backward payments arrears.

Short-term credits were widely available if one were willing to pay the costs associated with obtaining a loan—that is, current interest rates, bribes, and costly guarantee fees. Most entrepreneurs were unwilling to do so. Claiming that banks discriminated against private manufacturers, they alleged that state enterprises received preferential treatment, including ready access to cheap credits that they were not expected to repay.

There was much variation in interest rates charged by banks. Some rates were "fixed," particularly cheap long-term credits, but it was doubtful that fixed or flexible had true meaning. Banks appeared to act sporadically, doubling or tripling rates whenever they saw fit. Even the expensive rates of 200 percent were highly negative in real terms. One puzzled entrepreneur pondered why banks charge extortionate rates but continually claim that "we are all going broke."

Russia's banking sector appeared inefficient and ill-equipped to handle the requirements of a rapidly expanding private sector.

...the role taken by the banks sometimes appeared to have more to do with controlling enterprises than delivering financial services.

The lack of transparency in what constituted creditworthiness was a particular problem. One producer had a large order from the Soviet Chief of Police in his hands, but his bank refused to lend him the money needed to purchase machinery. The lack of collateral was acute, since most entrepreneurs leased building space and owned no land. Fixed assets such as equipment, when not leased, tended to be antiquated and of little value as security. The usual collateral requirements were not in excess of what is seen in other countries—that is, assets with a book value of 100 to 150 percent of the loan. But even companies with viable collateral had book values eroded by inflation. The common response to inadequate collateral was to obtain often costly guarantees from SOEs, state trust companies, and insurance companies.

Informal credit markets, a familiar phenomena in countries with inefficient formal banking sectors, were present in many forms. The common practice among state enterprises of extending credit to one another at low or zero interest also was observed among private manufacturers. Some state enterprises gave loans to private entrepreneurs who leased plants and equipment from them. In several cases involving former cooperatives and units of SOEs, new spin-off firms were able to secure large, low-interest loans from the parent company.

Denial of financial services and high fees for such services were additional problems. Bank officials reportedly discouraged entrepreneurs from opening accounts, claiming that they did not want more clients and they did not like doing business with private manufacturers, preferring "more creditworthy" traders or state enterprises. Entrepreneurs reported that banks routinely charged fees of 40,000 rubles ($100) or more to open accounts, creating a "devil you know" situation where competition in the banking sector was stifled by the high cost of switching banks. Many entrepreneurs preferred to remain with state-owned banks rather than risk their money with a private bank.

According to entrepreneurs, banks required high fee, multiple transactions for foreign exchange transactions, a practice which increased the overall anti-export bias. For example, one firm ended up paying a total of 12 percent in paperwork fees for a foreign exchange transaction that was shuttled between Moscow and St. Petersburg four times, a 3 percent fee charged per transaction. Frequently bank practices encouraged the cash economy that Moscow was trying to discourage. One entrepreneur returned to paying workers with cash after his bank instituted a 2 percent commission on direct transfers to their accounts.

Banks appeared to exercise inordinate power over enterprise activities. Indeed, the role taken by the banks sometimes appeared to have more to do with controlling enterprises than delivering financial services. Examples include:

- Entrepreneurs must show evidence of having opened a current account with a bank before their registration can be completed. And banks reportedly extracted high payments in return for opening accounts.
- According to Central Bank regulations, all inter-company payments must be effected via the current account. Thus, banks effectively function as bookkeepers and overseers of enterprise accounts. In principle, entrepreneurs are required to notify banks as to their forthcoming current-account transactions at the beginning of each quarter, and are limited to what has been requested.
- To an important extent, banks control the amount of cash that enterprises can hold. By regulation, the maximum cash withdrawal, aside from that needed to pay workers' wages, was 1,000 rubles per month until October 1992 (increasing to 5,000 rubles by the time of this survey). Firms complained that banks frequently charged high fees for withdrawals or claimed they had run out of cash.
- Some banks reportedly froze accounts without warning or explanation, made payments to other firms without permission, and denied firms access to their money.

Researchers also observed other critical issues in the business environment that undermined entrepreneurs' abilities to operate their businesses effectively. The most important appeared to be lawlessness, corruption, and isolation.

Lawlessness

In addition to frequent, retroactive changes in tax structure, almost one in five entrepreneurs cited ambiguous or unstable government regulations among their top three problems. There appeared to be no definitive source for information on government regulations. Nor was there effective legal recourse for entrepreneurs who considered themselves unfairly treated. Entrepreneurs with a commitment to compliance were forced to constantly check official and informal sources for details of new regulations. To a significant extent, business decisions relied on speculation and rumor about future government policies. Presidential decrees were issued frequently. Some published, some ignored, some implemented, and some contradictory. Enforcement reportedly was at the discretion of local officials who may selectively enforce regulations in pursuit of self-enrichment.

Fewer than one in ten entrepreneurs considered start-up regulations, licensing, and permits to be one of their three main problems: most had acquired their start-up licenses and permits in three months or less. Fewer than 25 percent said they had any problems obtaining other licenses and permits they needed, although many admitted to smoothing the process via the distribution of side payments. The number of firms offering "expediting services" was said to be increasing, and competition led to lower prices and faster services. Overall, the researchers formed the impression that most regulations were not major obstacles for entrepreneurs even though compliance was far from straightforward. The problems with regulations were linked to the rate at which they changed and the ambiguity of their content.

The lack of clear and enforceable contracts and property rights appeared to be a critical factor slowing and distorting private-sector growth. The lack of such rights greatly increased uncertainty in the business environment, fostering a provisional quality in leases, purchasing and sales contracts and real estate markets, and reinforcing the power of personal contacts in securing resources. In instances of violation, mechanisms for contract enforcement were unclear, and entrepreneurs seemed to have limited legal recourse. Some entrepreneurs recounted stories of successful lawsuits for breach of contract, but settlement amounts were significantly below the level of economic damage. Generally, the judicial system appeared undeveloped, and compliance with contracts appeared closely linked to the ability to enforce.

Ambiguous property rights, particularly with respect to the assets of state-owned enterprises, also created strong incentives for all levels of society to expropriate state property with few mechanisms to prevent them from doing so. State enterprise managers seldom sold assets outright, but they appeared fully able to use them for personal gain by leasing them informally to the private sector.

Sample entrepreneurs described the deficiencies of a business climate lacking the basics of a modern economy—business ethics, codes of conduct, and reputation. Given the degree of uncertainty in the economy, it is rational for most entrepreneurs to focus on quick profits which obviates the need to develop a reputation. A pervasive lack of trust impedes the development of sophisticated business relationships and narrows the scope of private activity. At present, entrepreneurs must either have close control over business activities, or find direct means of enforcement or redress for breach of contract which do not rely on the effectiveness of state authorities. Inevitably, development of these basics will proceed slowly, "from above" with effective law enforcement by the state, and "from below" with respect for and adherence to law.

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Corruption

Corruption and illegal practices were rampant and costly. Even so, entrepreneurs rarely identified corruption as a major obstacle in business. Rather, practices that would raise legal and ethical questions in the West were frequently framed as "good connections" and widely cited as keys to success. The exchange of favors of significant commercial value, including interest-free loans and steep discounts on products, was normal practice even between private businessmen.

Access to almost all resources required payoffs. Bribes reportedly were required to obtain leases, lower raw material prices, and lock in contracts. Apparently, bribery was requisite to obtain bank loans: the going rate was said to be a 5 percent cash payment. Payments could expedite bank transactions that might otherwise take months. Due to price liberalization, factors of production generally were available for purchase on the open market. But side payments could lower the prices of most resources. Formerly, bribery was said to account for about 25 percent of raw materials prices, but had declined to less than 5 percent for most entrepreneurs. Purchase of some types of equipment still required bribery, but most was reportedly available on the "legal market for stolen parts."

Organized crime, the "mafia," was said to be interested primarily in trading companies, not manufacturing, since profits from trade are higher. The reportedly high payments required to obtain valuable, centrally-located retail space were avoided by manufacturers who could locate their production space far more cheaply on the outskirts of the city. Those who did lease retail space in the city claimed that one could chose freely between purchasing requisite protection services from the police or from organized crime. One highly successful entrepreneur said that he realized it was necessary to approach the mafia once his company became sufficiently large.

The "government racket" was a term used to refer to corruption within local administrations and bribe-seeking behavior of officials at all levels. Mid-level local officials were said to offer paid "consulting services" to businesses for expediting paperwork that might otherwise take months. One entrepreneur stated that administration officials were afraid to accept bribes from capable professionals but were quick to spot the inexperienced. Apparently, licenses for certain activities, such as cutting timber or exporting raw materials, involved substantial side payments. One entrepreneur said: "Exporting is too expensive; you have to pay too many people." Similarly, some public utilities were rationed and bribery was said to expedite service. For example, the going rate for telephone installation was reported at $200.

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Although entrepreneurs were quick to admit that pervasive corruption was costly to them, the researchers noted a high level of acceptance of practices judged illegal and unethical in the West. For the most part, corruption appeared as the inevitable legacy of an economic system based on administrative allocation, that was further exacerbated by unclear property rights. The extent to which corruption would constrain the growth of the private sector was ambiguous because the economic burden it imposed was unclear. Some incidents described by sample entrepreneurs could be considered as a market mechanism repricing goods and services. In this light, one might regard aspects of official corruption as nothing more than efficient allocation of scarce government services to the highest bidder. A potentially serious concern, however, is the degree to which patterns of behavior from the old system become the norm for the new economy, and the economic burden this may impose. The extent to which corrupt elements become organized will influence their longevity, and the numerous references to organized crime by sample entrepreneurs may mean that this behavior has already become entrenched.

Isolation

Researchers formed the impression that most entrepreneurs were isolated from each other, from the state sector, and from the outside world. Entrepreneurs tended to conceal their physical location and limit their contacts with each other out of concern for physical security and suspicion of contacts originating from outside their networks. Isolation from the state sector was more common in new ventures than among privatized units of state enterprises, but even the latter tended to have links only to their state parent rather than to a larger business community.

There are, for instance, two relatively large, private businesses (each employing about 200 people) located across the street from each other, but unaware of the other. When an interviewer offered to put them in contact, the response was not only favorable, but led the entrepreneur to explain his view that such contacts were essential for the survival of the private sector. Nevertheless, horizontal links between entrepreneurs were virtually nonexistent, and there seemed to be no lobby groups for their interests. As a result, the influence of private enterprise in government circles is likely to remain marginal compared to larger state enterprises with greater political leverage.

Close connections with the state sector were critical for many firms. Those entrepreneurs with close and favorable links reaped significant benefits, whereas others were out of touch with the complicated yet crucial system of connections. Connections were based on prior employment in the state sector, family links, or straightforward bribery, but the net result seemed to be the same—improved access to input and output markets.

The population of the former Soviet Union was generally cut off from the rest of the world for decades, and many entrepreneurs had not yet overcome this legacy of isolation. Most had little knowledge about business in the West including tastes, standards, preferences, and codes of conduct. Many said they would like a Western business partner, but none had any idea how to locate one. Some portrayed a more insular attitude, pronouncing: "We are here, why doesn't a Westerner come and find us?" Others had the view that since they were doing "well enough," there was no need to actively seek new markets or new partners. The degree of isolation from the West, observed among entrepreneurs in St. Petersburg, was far greater than observed among their Central European counterparts who were quick to break down barriers with the West, in part by simply crossing over the borders.

Conclusions

Prospects

The vitality of Russian entrepreneurship was evident in St. Petersburg, both among sample entrepreneurs drawn from the approximately 30,000 private enterprises registered in mid-1992 and in the burgeoning informal sector visible in the streets. This first wave of private manufacturers tended to be highly educated, technically skilled, and adept at survival and growth in the turbulent Russian business environment. If the rate of market entry remains high and the privatization program continues at a fast pace, the private manufacturing sector should grow rapidly.

Close connections with the state sector were critical for many firms.

The playing field in private manufacturing, however, was far from level. Opportunities were unequal because individuals with closer links to the state sector were better situated to gain preferential access to resources. Half of the entrepreneurs sampled were former managers from state enterprises. Demonstrating a strong spirit of entrepreneurship within what was once the state sector, many former managers had used their positions to obtain factory space and production equipment at below-market rates, giving them significant advantages over others from nonmanagerial backgrounds. Until markets normalize and a substantial portion of state assets are privatized, such inequality of opportunity is likely to continue. Despite their headstart, however, prospects for former managers did not appear better and, in some cases, were worse than other entrepreneurs. A primary difficulty faced by some former managers who took over units of state enterprises was the need to restructure, usually without access to investment financing and sometimes with restrictions on deployment of capital assets and labor.

The Russian business environment was particularly uncertain and risky. High inflation, continually changing relative prices, and unpredictable interest rates and exchange rates, all obscured the economic signals necessary for properly functioning markets. Capital and labor markets functioned poorly

The most successful entrepreneurs secured orders, obtained supplies of raw materials, arranged for use of equipment through long-term or temporary leases, employed or contracted workers to produce the order, and netted profits of 30 percent or more.

and were frequently influenced through personal connections. Liberalization had improved access to most resources, but critical distortions remained, including price-fixing in energy and raw materials and subsidies for the state sector. The legal and regulatory framework (particularly taxes) was chaotic, constantly shifting and poorly administered; and corruption, lawlessness, and isolation were pervasive. The inadequacy of the banking sector made many routine transactions time-consuming and costly. There were numerous systemic biases against exports. At the same time, chaos created significant opportunities that capable entrepreneurs had turned to their advantage.

Most entrepreneurs responded to their environment rationally by attempting to minimize risk and maximize flexibility to protect against possible unfavorable developments. The focus clearly was on short-term profits, and the extent to which entrepreneurs made long-term commitments varied widely depending on expectations. Entrepreneurs sought to hedge bets. Some had set up free-standing businesses. Others worked primarily as brokers with few, if any, fixed investments. Yet others remained embedded inside state enterprises. Those entrepreneurs with the possibility of purchasing factory space and production equipment frequently chose to do so (predominantly at below-market rates), but some preferred the greater flexibility of leasing. Other entrepreneurs leased because they had no choice. Some businesses had taken on full-time labor forces, whereas others used a mix of their own workers and subcontracted labor from state enterprises as needed. Although almost half of the entrepreneurs had short-term credits, the demand for credit was notably low at going interest rates. This can partially be explained by a reluctance to make financial commitments, even as short as six months into the future.

What are the implications of economic transition for private sector development? First, Russian entrepreneurs showed themselves capable of responding rapidly and effectively to opportunities. There appeared to be no shortage of entrepreneurs in St. Petersburg. Indeed, many had built substantial businesses, despite the difficulties presented by the environment. At the same time, uncertainty and lack of transparency distracted them from core activities, and limited their willingness to invest. Despite such difficulties, most entrepreneurs seemed prepared to make significant investments once the business environment improves.

Second, the ways in which privatization is taking place in Russia contain both positive and negative aspects. Allowing managers to move some of the best state assets into companies they own or control through spontaneous privatization is inherently unfair. Returns accrue to the individual rather than the state. Formal privatization facilitates a process that is crucial to the development of the Russian economy, but the Russian model gives workers and managers an unfair advantage in acquiring property—perhaps further exacerbating appearances of unfairness and leading to a social backlash against reform. At the same time, it is reasonable to assume that the new private owners will extract higher returns from these assets than was the case when the state owned them, and will do so far faster than if these assets are held back for a more equitable approach to privatization. Moreover, the government is unlikely to be able to impede this process without adversely affecting the momentum of economic reform. Inequities in opportunities to acquire resources may be an inevitable price of rapid privatization, providing that society can absorb the injustice. Ultimately, the appropriate (economic) yardstick by which to judge privatization is the effectiveness with which new owners deploy the resources they control.

Winners and losers

There were four major players in the microeconomy of private manufacturing in St. Petersburg—private entrepreneurs, managers in state enterprises, workers in state enterprises, and the state (that is, the national government). Analysis of the relative positions held by each group of players provides insight into the dynamics of their relationships, and helps identify winners and losers.

Many private entrepreneurs were earning high profits, based on keen perceptions of market niches and strong skills as brokers. Most had engineered subcontracting arrangements with state enterprises. The most successful entrepreneurs secured orders, obtained supplies of raw materials, arranged for use of equipment through long-term or temporary leases, employed or contracted workers to produce the order, and netted profits of 30 percent or more.

But in exchange for profits, most entrepreneurs tolerated significant constraints and undertook large risks. In all cases, entrepreneurs were trying to make plans in a highly unstable economy while facing a maze of regulations that absorbed their time, cut into revenues, and threatened high penalties for lack of compliance. All operated businesses with little or no access to basic financial services considered indispensable in the West. All were forced to coexist with the dominant state sector whose managers effectively controlled most industrial assets in St. Petersburg. Most leased factory space from the city and from state enterprises where officials and managers offered escalating rents and changeable terms to those without ironclad connections. Most had no opportunity to purchase real estate due to obstacles to clearing titles and the unavailability of term financing. Many characterized popular and official attitudes toward them as hostile.

Managers in state enterprises enjoyed the considerable advantage of controlling almost all assets needed by private manufacturers, including real estate, production equipment, stocks of raw materials—and most workers. Their ability to maintain control over these assets was enhanced by government subsidies in the second half of 1992, which allowed them to continue paying workers and provided them with a financial cushion. A wide spectrum of interaction was observed between state managers and private entrepreneurs—from those who were taking full advantage of their positions to extract considerable rents from private entrepreneurs in exchange for real estate leases and sales of raw materials, to those who lost money (in real terms) in deals with private firms. In some instances, the "state enterprise manager" and "private entrepreneur" were the same person—with the manager running both businesses from the same office without official sanctions against his clear conflict of interest.

At the same time, state managers faced urgent problems stemming generally from the transformation and specifically from conditions in the enterprises they managed. Regardless of the outcome of the political struggle over the scope and speed of the Russian economic transformation, the heyday of the large state enterprises seems to have passed and managers face monumental changes. Although state managers control assets, the profitability of those assets is often questionable due to outdated and inefficient production equipment and to sharply contracting markets. Many state managers are saddled with large, often unproductive workforces to whom they are at least partially accountable. The researchers encountered some dynamic state managers, particularly in smaller enterprises, who already were transforming units into joint stock companies and seeking means of enhancing competitiveness. But the general impression was that there are many more managers who bear the burden of maintaining or dismembering dinosaurs—with little assistance from anyone.

Workers in state enterprises—particularly skilled workers—were key to many private entrepreneurs' abilities to generate high profits. The competitive edge in manufacturing rested almost entirely on entrepreneurs' abilities to deliver high-quality products quickly. This ability depended, in many cases, on contracting with skilled workers on an "as-needed" basis to produce orders. Some entrepreneurs had large orders for mass-produced goods that made use of short-term contracts with crews of unskilled workers. In both cases, workers were able to use their leverage with private entrepreneurs to bid up their wages by 10-20 percent and to secure valuable overtime work. Most workers were reportedly unwilling to give up the security of state employment, but many were able to supplement their declining incomes by extracting relatively higher wages from private entrepreneurs—a practice which may have enabled some to hang on to their secure, albeit low-paying, state jobs.

Despite their capacity to extract high wages from private entrepreneurs in the short run, most workers in state enterprises face structural changes that are unlikely to favor them. When the inevitable layoffs begin, some workers will find niches in the private sector, but most risk finding themselves unemployed and without marketable skills. Older workers, particularly those with less flexible skills, will be more vulnerable. Real wages have declined, despite injections from private entrepreneurs, and many reportedly have faced periods when wage payments were delayed or suspended.

The entrepreneurial skills that mattered most... were the abilities to choose products,... assemble factories,... motivate workers,... and sell the output...

In this provisional status quo, the state, as owner of the assets in state enterprises, would appear to be the loser on all counts. To an unknown extent, the assets of state enterprises have been moved into private firms by managers who purchased them, presumably at below-market prices without facing a competitive process. Despite formal ownership of most assets, the state appeared to receive almost no returns on them. Entrepreneurs leased production equipment belonging to state enterprises, but rents reportedly went directly into managers' pockets. Entrepreneurs purchased raw materials mainly from state enterprises that bought in bulk, but mark-ups were often pocketed by managers. Enterprises assumed the overhead for workers, and private entrepreneurs merely paid wages. Workers were able to use their positions in state firms to postpone making their way into the private sector. At the same time, many of these same state enterprises were making losses, which tend to be financed by the state—a root cause of inflation.

At present, the state is unable to effectively own or manage most of its assets, but is politically too weak to avoid stemming the losses on those assets. In such an environment, the productive capacity of state assets is siphoned off by managers and workers, in conjunction with or as part of the private sector, while liabilities and costs are transferred back to state budgets. Privatization must effectively transfer both the rights and responsibilities for the use of assets to the private sector, ridding the state of its liabilities and enhancing economic efficiency.

Cross-country comparisons

Russian entrepreneurs and firms can be compared with their counterparts in Poland, Hungary and the former CSFR in three key areas—entrepreneurship, constraints, and relations with the state sector.[1] Entrepreneurs in St. Petersburg presented unique accounts of their businesses and the environment in which they operate, but similar themes have surfaced across countries.

Entrepreneurs were remarkably similar across all three countries: well-educated men in their forties with solid technical skills and indefatigable ambition to succeed in their new businesses. The majority of the Central Europeans were engineers, whereas the Russian sample included many research scientists. Almost all came from high-level positions in the state sector. In all cases, those who came from the highest positions in the state sector started out with considerably more advantages than did newcomers. The entrepreneurial skills that mattered most in all countries were the abilities to choose products for which demand was strong and competition weak; assemble factories by buying or leasing space and equipment piecemeal; motivate workers to upgrade quality and learn new skills; and sell the output in markets that typically were contracting. Exceptionally competent individuals could be identified as the key factor in almost all successful firms in each country.

Constraints varied across each survey location according to the particulars of the respective business environments. The importance of a stable macroeconomic environment can not be overstated. Entrepreneurs' businesses were negatively affected by inflation in St. Petersburg and by recession in Poland and Hungary. Only in the former CSFR were entrepreneurs not critically affected by macroeconomic problems. Issues of finance arose in all cases, but problems with access were not universal as is often assumed. Entrepreneurs had relatively good access to short-term credit in St. Petersburg and Poland, but somewhat less so in Hungary and the former CSFR. Long-term finance was available only in the former CSFR. The need for capital infusions was universal, but in all locations except the former CSFR, demand for credit was constrained by entrepreneurs' refusal to borrow at prevailing nominal interest rates which were considered too high. Financial services were dismal in all countries. Unstable and unclear regulations—particularly surrounding taxes—negatively affected each group of entrepreneurs.

One approach to analyzing the relationship between the dominant state sector and the fledgling private sector in these economies is to look at the firmness of boundaries between them and assess the extent to which people and assets flow from one to the other. Two patterns were observed across the four countries. In the first, observed in Poland and the former CSFR, boundaries between private and state firms were well-defined with relatively little interaction beyond state enterprise sales of inputs and some purchasing of outputs. Leasing of assets, sharing of work forces, and mixing of enterprise ownership were relatively rare. In essence, the state sector in these countries remained intact awaiting the formal privatization processes, and the private sector pried loose what it could in the way of cast-off equipment and workers willing to make the leap to private sector employment.

In St. Petersburg and Hungary, boundaries between state and private sectors were blurred and integration was relatively high. This pattern may have developed as a result of early reform programs that introduced quasi-private enterprise forms into the state sector—leaseholds and cooperatives in Russia and economic work groups in Hungary. Many enterprises became fully private as new laws were passed, but they continued to maintain strong ties with the state sector. Production equipment was shared, primarily through leasing, and pervasive subcontracting effectively bridged labor forces. Ownership was mixed, most often seen as state enterprises taking equity in private companies. Capital was shared in the form of suppliers' credits and other inter-enterprise payments networks.

Which set of relationships most effectively furthered private-sector growth? The data are inconclusive, but several points can be made. First, private entrepreneurs must have access to productive equipment and labor held in state enterprises. Private-sector growth can not wait for a lengthy process of formal privatization. Interim arrangements, such as leasing, piecemeal sales, and subcontracting from state to private sectors, are crucial in order to grant fast access to needed resources in the state sector. At the same time, soft boundaries that facilitate these arrangements have opened the door to widespread corruption and raised serious equity questions.

Second, it can be hypothesized that a high level of integration of the state and private sectors may ultimately retard private sector growth. Entrepreneurs desperately need the assets held in state enterprises, but when assets are shared in a way that causes the sectors to become interdependent, private firms become vulnerable to inevitable downturns in the state sector. Examples included spin-offs from state companies created only to supply the parent company, and equity arrangements that combine private and state interests and pit them against changes in the status quo. In such cases, widely observed in St. Petersburg and Hungary, a downturn in the state sector brings a downturn in the private sector. In contrast, when entrepreneurs are given access to assets without restrictions, they are more able to deploy them flexibly to exploit available opportunities—the pattern seen more often in Poland and the former CSFR.

Third, personal connections—strong determinants of access to resources in all post-socialist economies—were particularly important where state and private sectors were highly integrated, in effect the glue that held together cross-sector networks. Access to resources in St. Petersburg and Hungary depended to a large degree on having the right personal connections which, in effect, ensured the flow of goods and services as formal allocation systems broke down and markets had not yet replaced them. But allocating resources based on personal connections instead of the formal marketplace has the highly negative effect of freezing out newcomers. The researchers observed many instances, in both locations, of newcomers whose chances for success were significantly diminished because they were effectively outsiders.

Implications for assisting

Despite an urgent search for a magical formula to promote the Russian private sector, there is no quick and easy route. Evidence from this survey, however, suggests efforts on two fronts—improvement in the business environment and direct assistance to entrepreneurs.

A number of measures could significantly improve the business environment. An important step would be to ensure that private sector development is given a key role in the formulation of the national agenda in both words and deeds. Decisionmakers at all levels must recognize the importance of private sector development—its potential contribution to GDP, employment, and the growth of competition and markets. Experience in Poland, the former Czechoslovakia, and Hungary indicates that decisionmakers often do not understand the role of small business in developed economies, and hence do not focus on its development. Thorough analysis of the impact of legislation, policies, and regulation on the small businesses is necessary. Formation of private-sector advisory groups that include representatives of government and private business might be a useful forum for reaching consensus on the changes that are needed.

In terms of general policies, the importance of macroeconomic stability as a precondition for private investment can not be overstated. Removing remaining price controls, especially those on raw materials and energy, would enable markets to operate with fewer distortions and entrepreneurs to better plan for their businesses. Elimination of systemic biases against exports would increase foreign trade, introduce stable markets, and generate benefits associated with exposure to competitive marketplaces. As noted above, rapid progress in privatization is critical for a variety of reasons.

Because of the high degree of monopolization in Russian industry, the privatization process should strive to break up larger enterprises and facilitate demonopolization and deconcentration of the economy. It may be desirable to maintain most newly-privatized enterprises as going concerns as restructuring takes place. But, from the perspective of small business development, entrepreneurs need the opportunity to purchase only those assets appropriate for their businesses, without restrictions and obligations to maintain production and labor forces. Since smaller businesses are likely to acquire assets from larger companies, piecemeal sales of assets should be encouraged where feasible.

Almost 30 percent of sample entrepreneurs came from the military/industrial complex. This sector possesses an abundance of technical knowledge and skills. Some departments and units within military enterprises are actively involved in commercializing technology, and this spontaneous development should be nurtured and enhanced by facilitating technology transfer and spin-off companies from the military/industrial complex. Particular attention should be given to the effectiveness of "bottom up" initiatives in bringing new products to market.

High priorities for regulatory reform are:

- *Property and contract laws and regulations.* The focus should be on the formulation of an appropriate legal and regulatory framework for private sector development and on strengthening the enforcement of laws and regulations. Private ownership of land should be clarified to provide property to the private sector.
- *Reassessment of the tax system* in terms of its effects on private business. In particular, a review should concentrate on easing administrative burdens by creating a clear, logical basis for taxes, which may include realigning the tax basis to facilitate transparency and compliance.
- *Export procedures* including licensing, hard-currency transactions and customs, environmental regulations, and intellectual property rights.

Similarly, reform of the banking sector is critical to improve the efficiency of private-sector operations. Banks must be redefined as facilitators of transactions rather than instruments of state control. At present, Russian banks are generally ineffective in taking deposits, giving account balances, collecting on payments, and transferring money. Improvements of payments systems should be a high priority, perhaps furthered by installation of efficient financial information systems and training of bank personnel. Training programs that increase human capital in the banking sector could be a significant step towards providing effective banking services.

Effective implementation of policy and regulatory reforms depends on institutional capacity. Improvements are needed in local government offices, tax offices, and banks. Foreign assistance could be of help in this area. Strategies for assistance depend on whether the aim is to improve an entire organization or to carve out an "island of efficiency" within an institution. Useful approaches might include technical assistance in governance (the rights and responsibilities of different levels of government); civil service reform; and an assessment of the incentive structures in government offices.

In direct assistance, entrepreneurs spoke clearly about their desire for help in management, marketing, and exporting, and for an increased understanding of Western business practices. They emphasized that training programs should avoid the theoretical and focus on the practical. Lack of access to specific information on domestic markets (suppliers, customers) and export markets (opportunities, requirements) was a big handicap. While both areas represent potential market niches for Russian entrepreneurs, foreign support could facilitate entrepreneurs' contacts with the West, a service requested by almost all entrepreneurs.

A discussion about the design of assistance programs is beyond the scope of this study, but some implications arise from this survey. A critical question is how to educate entrepreneurs while taking the Russian context into account. The answer is probably a partnership between Russian and Western professionals. Reverse technical assistance programs could send Russian entrepreneurs abroad on study tours. Such a program could be organized according to sector or function, and participants could include entrepreneurs as well as individuals from private and government agencies. Programs would need to be tailored to specific needs. Particular attention would need to be paid to participant selection, choosing people based on aptitude and ability to use and disseminate education, rather than on an individual's informal links to those responsible for local management of the program.

In some Central European countries, regional centers for small business support have been established where active and potential entrepreneurs can go to for information, referral, and support in developing business plans. Although the provision of general information and counselling on how to start, run, and grow a business may not constitute a viable opportunity for private business, these services can be provided by public-private partnerships that are financed by fees and by subsidies. And private provision of services, perhaps as subcontractors, should be sought wherever possible.

Access to credit was not cited by entrepreneurs as one of their major problems. Short-term loans were said to be widely available, but demand was low primarily due to entrepreneurs' perceptions that nominal interest rates were unacceptably high. If the economy stabilizes and inflation falls, demand for credit may increase although the high real interest rates that typically accompany stabilization are likely to limit credit demand. In the long term, however, entrepreneurs will probably seek to make significant capital investments to restructure and upgrade equipment.

Note

1. These comparisons are based on comparable surveys carried out in Poland, Hungary, and the former Czechoslovakia in 1991–92. Reports on these surveys are available from Leila Webster, Private Sector Development Department, World Bank.

Competition Law and Policy

R. Shyam Khemani

One of the few areas of at least approximate confluence between the Neoclassical and Marxist schools of economic thought relates to the problem of monopoly. For neoclassicists, monopoly is a problem because it gives rise to prices and profits that are above those that would prevail under competitive conditions, and an inefficient level of output is produced. The principal concerns are that consumer welfare is not maximized and a misallocation of resources takes place. In mild contrast, the focus of attention of Marxist economists is on the high prices and profits earned by monopolies. Concerns are expressed regarding the income distribution and economic and political power consequences of monopoly.

These perspectives have also been historically reflected in the policies proposed to resolve the monopoly problem. The neoclassical approach is to foster market conditions by reducing barriers to entry, to enact government antitrust policy, or both in order to erode the position of monopolies. Where this strategy is not feasible, such as in the case of natural monopolies, regulations may be imposed. The Marxist approach has been to institute government ownership and direct control over prices, profits and output.

In the transition from a centrally planned economy to a mixed-enterprise free-market system, the monopoly problem has re-emerged as a central issue in Russia. In connection with instituting market-oriented reforms, the Russian government has recognized the need for privatization of previously state-owned enterprises, in order to provide the necessary economic incentives for increased efficiency and output. However, in part because of the high levels of industrial concentration[1] inherited from the command-control economic planning system, and in part due to the need to guard against monopolistic practices, the Russian government has also enacted an anti-monopoly law.

The purpose clause of the law states that it "... shall determine the organizational and legal foundations for the prevention, limitation, and suppression of monopolistic activities and unfair competition and is directed towards ensuring the conditions for the creation and effective functioning of goods markets" (article 1).

The purpose clause suggests that the law will apply to existing or emerging anti-competitive situations, and that it will also pro-actively foster an economic environment in which competitive markets can properly function. Russia's anti-monopoly law has not been effectively applied. Moreover, the Russian State and Regional Anti-monopoly Committees (the administrative bodies that enforce the law) have been overly preoccupied with the possibility that the privatization process will simply transfer state-owned monopolies into private hands, resulting in monopolistic exploitation. Until recently, the committees have not played an active role in the privatization process, nor have they attempted to reduce various centrally determined barriers to entry, in order to address these concerns. Instead, they have adopted a regulatory approach by maintaining a list of enterprises which are deemed to be dominant in their sphere of economic activity and have subjected them to profit margin and output controls. These controls distort the price-profit signals and the flow of resources from lower to higher valued uses. Such controls also tend to adversely effect markets and the structural adjustment process.

...particularly [for] Russia, fostering competitive markets represents a low cost method of efficiently allocating resources...

Russia has framed a reasonable competition law. However, the implementation of this law and the role and capabilities of the State and Regional Anti-monopoly Committees need to be enhanced to promote efficient enterprise and industrial restructuring and to foster market-oriented processes.

Dimensions of competition law and competition policy

Broadly defined, the term competition policy encompasses the area commonly known as antitrust (in Russia anti-monopoly) law, as well as various micro-industrial policies affecting the market system and the allocation of resources by firms and other economic agents. Examples of such policies would be foreign investment, international trade, intellectual property, industrial policy, and regulation of natural monopolies and specific economic sectors. Competition policy, when properly designed and implemented, corrects market failures and distortions that arise from monopolistic business practices and extensive government ownership and regulation of economic activity. It enhances the mobility of resources and facilitates adaptation, flexibility, dynamic change, and efficiency in the economy. In the face of fiscal deficits and severe budget constraints confronted by governments in many countries, particularly Russia, fostering competitive markets represents a low-cost method of efficiently allocating resources that avoids the administrative and bureaucratic costs associated with direct government oversight.

Additional reasons for having an effective competition policy arise from the numerous benefits of a well functioning competitive market system—namely the entry of new and innovative firms, greater variety and choice of products, lower prices and price stability, increased consumer and total economic welfare, diffusion of technology and information, and reduced scope for rent seeking behavior by special interest groups (a factor of particular saliency in present-day Russia).

Competition law is a framework policy which seeks to strengthen the market mechanism as the primary vehicle to promote economic efficiency and consumer welfare. The principles of competition law should be integrated into the formulation and implementation of government policies; otherwise they may adversely impact the prevailing state of competition in the economy. This implies a larger role for competition authorities. Not only should these authorities attack existing or emerging anti-competitive situations, but they should also play a role in economic policymaking as advocates for competition. In particular, competition authorities should be pro-active in reducing government-induced barriers to entry.

This paper's primary focus is on Russian competition law and not on the range of other government policies that also affect competition.

Competition law in an emerging market economy

The proper implementation of competition law hinges on clearly distinguishing between those business practices and arrangements that substantially lessen or prevent competition and those that are legitimately pursued to respond to changing market conditions. A zealous application of the law may dampen legitimate competitive strategies of firms, whereas an overly lax approach may give rise to a new, or entrench an existing, monopolistic market structure. Either approach will impede the development of the market mechanism. In the context of emerging market economies such as Russia's, the risks of this occurring are particularly high, for two important reasons:

- The distinction between the types of business practices that are legitimate and those that are anti-competitive is particularly difficult to define in highly-concentrated economies.
- Identifying actual or potential anti-competitive situations is not a trivial exercise. It requires legal and economic expertise that is generally lacking in former centrally-planned economies, and that takes considerable time to develop.

This suggests that the law must be selectively applied, perhaps only in blatant anti-competitive situations (such as collusive agreements to divide markets or fix prices or abuse of a dominant market position that blocks the entry or expansion of firms). Highest priority should be attached to easing conditions for entry of new firms, foreign investment, and import competition. Not only do these measures positively influence the economic environment, but they also avoid the risks of inducing other economic distortions through the misapplication of competition law. In emerging economies such as Russia's, most firms, particularly those dominant in specific industrial sectors, have come about because of central planning and administrative fiat. In these cases, should an active deconcentration policy of breaking up large firms be pursued in order to create the structural basis for increased competition? If so, will this encounter the risks of incurring losses in economic efficiency? The likely answer is that such risks are low. In other words, the State and Regional Anti-monopoly Committees in Russia may have the luxury of adopting more structurally-oriented solutions toward competition problems (stemming from existing large, dominant firms), than their counterparts in Western industrialized countries.

To promote competition and economic efficiency, competition authorities need to be given a larger role in government policy formulation and economic decisionmaking. This is not the prime issue of concern in the context of Russia. The Russian State Committee for Anti-monopoly Policy and the Promotion of New Economic Structures has a wide formal mandate—perhaps too wide—relating to competition, consumer protection, export promotion, privatization, and small and medium-sized enterprise development. If the agency is to realize its potential of having a major influence on the economic climate, organizational structure and market performance of Russian industry for years to come, the committee must adopt a more pro-active role.

The application of competition law in Russia

Russia's Supreme Soviet adopted the "Law on Competition and Limitation of Monopolistic Activity in Goods Market" on March 22, 1991 (amended July 15, 1992). Subsequently, the State Committee on Anti-monopoly Policy and the Promotion of New Economic Structures (SCAP) was established to administer and enforce the law. In addition to the State Committee, eighty-two regional and local committees were created, with a staff of approximately 2,400 officials, to implement the law across the whole country. This makes Russia's competition agencies the largest in the world. The law contains a conventional set of provisions to address the following types of competition related matters:

- *Abuse of dominant market position (AOD or monopolization)—article 5.* The provision prevents practices such as monopolistic pricing, impeding entry, discriminatory or extortionary contractual terms and violations of pricing procedures in other Acts.
- *Price-fixing and other types of collusive behavior—article 6.* The article is aimed at agreements and concerted actions by competitors to fix prices, rebates, and mark-ups, divide markets and customers, refuse to sell, and impede market access. However, there is no ban against price-fixing or other collusive agreements per se. In exceptional cases these agreements can be reviewed and registered, especially when markets are saturated or involve exports.
- *Restrictive business practice (RBP)—articles 7 and 8.* These articles extend to discriminatory sales and conditions, price and nonprice predation, exclusive dealing, and geographic market restrictions.
- *Mergers, acquisitions, corporate reorganizations, and liquidations (M&A)—articles 17 and 18.* These provisions are particularly directed to keep business entities from establishing dominant market position through mergers, acquisitions, affiliations, associations, and various other means. Extensive registration requirements and approval procedures are put into place to prevent such business consolidation and order divestitures.
- *Divestitures—articles 19 and 21.*
- *Right of access to information (for investigatory purposes)—articles 13 and 14.*

...the law must be selectively applied, perhaps only in blatant anti-competitive situations...

In addition, the State and Regional Anti-monopoly Committees can impose penalties and issue various types of orders to address different competition concerns. Failure to comply with the committees' measures are backed by legal sanctions, including prison sentences.

There is a lack of accurate statistics on the activities of the State and Regional Committees, and at times conflicting information is provided by different senior officials. One source states that as of summer 1993—since the passage of the law—over 4,000 queries and individual cases have been examined by the State and Regional Committees. A rough estimate of the breakdown of these queries is as follows:

Articles	*Percent*	*Subject*
5	30	AOD
17	26	M&As
19 and 21	11	Divestitures, corporate reorganizations
6, 7, and 8	10	Collusion-RBPs
13 and 14	6	Information requirements
Others	17	

Another source states that in the first quarter of 1993 alone, nearly 3,000 complaints were received by these committees, and of the nearly 800 cases initiated, 64 percent pertain to article 5 and 22 percent to article 7 of the law. If this is the case, the level of enforcement activity in Russia far exceeds that of many OECD countries.

Given the high level of industrial concentration prevailing in Russia, and the large amount of privatization, a higher incidence of cases and queries relating to abuse of dominant market position and restrictive business practices is to be expected. Moreover, the lower incidence of price fixing and other collusive arrangements may be due to the high levels of inflation and the changing market environment. In such an environment, stable inter-firm anti-competitive arrangements are difficult to monitor and maintain. Also, with increased privatization one may expect a fair number of cases in the areas of mergers and acquisitions and corporate reorganizations.

The number of queries and cases handled by the State and Regional Anti-monopoly Committees seems to be large, but to date there have been only a few cases litigated before the Arbitrage Court—the body that adjudicates differences between the views of the Anti-monopoly Committee and business entities. The majority of these matters have been resolved through negotiations or rulings of the State and Regional Anti-monopoly Committees.

Russian observers suggest that the time and resources expended by the committees does not correspond to the distribution of queries and complaints indicated above, and that as much as 55 percent of the committees resources is devoted to reviewing formation of new businesses, joint stock companies, and enterprise reorganizations. Apparently, new and restructured business entities can only be formally registered after the Anti-monopoly Committee has examined and reviewed their formation and organizational structure from a competition viewpoint. This procedure imposes an unnecessary regulatory burden on companies and delays the entry of new firms and the restructuring of enterprises.

The State Anti-monopoly Committee has been preoccupied with formulating new rules, regulations, and procedures on the interpretation and implementation of the law. This may be justified to foster consistency in the application of the law across the Russian Federation, given that there are eighty-two separate Regional Committees.

At the initiative of the Anti-Monopoly Committee, a memorandum of understanding has been agreed between Russia, the CIS countries, and some Baltic republics on exchange of information and mutual cooperation and assistance to prevent anti-competitive practices by enterprises located in different jurisdictions. These measures are also aimed at maintaining the production and supply linkages that existed between enterprises in the former Soviet Union, thus facilitating transborder transactions (which may otherwise have been restricted by artificial and unfair restraints to trade).

These measures, as well as amendments to the law currently under review, suggest that the legal infrastructure is in place for a much more vigorous application of the law. However, they also imply that the State and Regional Anti-monopoly Committees may be even more prone than the State Committee toward a regulatory approach to implementing the law. Nowhere is this more evident than in the maintenance of a "Register of Dominant Firms."

According to the Russian Anti-monopoly Law, a dominant firm is one which has 35 percent of the relevant market. However, because statistics are not available to delineate the relevant market, the State and Regional Anti-monopoly Committees have relied primarily on census production data compiled by the State Committee for Statistics (Goskomstat). Once an enterprise has been deemed to be in a dominant position, it is listed on a register and subjected to profit-margin, price, and output controls. The register is also material to the privatization process, as the State Committee for Management of State Property (GKI) uses it to select the order of enterprises to be privatized. Because being listed on the register introduces constraints on operational freedom as well as on restructuring and privatization, managers have initiated legal challenges and applications to the Anti-monopoly Committees to have their enterprises delisted. The register is updated monthly and the exact number of listed enterprises varies by region and over time. The register was instituted in February 1992, and at that time contained approximately 2,000 enterprises at the state and regional levels. While precise data is not available, it is apparent that the designated list of dominant enterprises on the register has been shrinking during the past year.

The Dominant Enterprise Register is maintained in an effort to prevent monopolistic exploitation by state-owned and newly-privatized enterprises in the wake of price liberalization. Initially, various decrees and resolutions were introduced during the 1991–92 winter, to control the pricing behavior and business practices of enterprises which had abused their market power. To deter and counteract these abuses the committee was empowered to take measures to restore contractual terms, maintain supplies, withdraw subsidies, force enterprise restructuring, and require contributions to the state reserve funds from the sale of output at regulated prices.

The decrees and resolutions relating to the register reflect difficulties encountered in directly controlling prices and the behavior of enterprises, and represent an example of incremental regulation. Initially, the decrees concerned the pricing policies and other business practices of dominant firms that had abused their market power. Then they related to control of prices of specific industrial and consumer products considered to be important or vital. Subsequently, measures were instituted to control the prices of dominant firms engaged in the production of these products. When it was found difficult to directly monitor and control prices of these enterprises—in part because of high rates of inflation, decline in output, and deterioration in general economic conditions—profit margin ceilings were established for dominant firms producing specific products. All these policy changes took place over a span of five months. (The profit-margin ceilings and other controls do not apply to nondominant enterprises producing the same products.)

Constantly changing government policies introduce additional business risk and uncertainty. It has been well established in the economic literature that price, profit, and output controls give rise to distortions in the allocation of resources. These measures also act as impediments to efficient enterprise restructuring. In several situations, existing product lines could not be altered in response to changing market demands. In addition, enterprises have engaged in regulatory avoidance by inflating costs to obtain price increases while keeping within the established profit-margin ceilings.

Establishment and maintenance of the register has changed the role of the Anti-monopoly Committee from that of an agency that encourage competition and corrects market failures arising from monopolistic practices, to that of a regulatory agency that further distorts price-profit signals and the efficient resource allocation process. Firms on the register must not only

Fostering effective competition is as much a vigorous application of competition law as it is promoting a liberalized economic environment.

respect the established profit-margin ceilings, but also declare and receive approval for any price increases. Failure to do so carries fines that are equal to twice the additional income earned between the difference of the previous and subsequent price levels. According to one informed source, violations of this policy have led to fines of 2.7 billion rubles. In one oblast (Kurgan) over fifty dominant enterprises failed to register price increases and had to return (were fined) 220 million rubles.

In addition to maintaining the "Dominant Enterprise Register," the committees have the right to veto a privatization proposal. This powerful instrument can, in theory, be applied to accelerate the break-up or divestiture of integrated monopolistic firms. However, this policy lever has not been effectively utilized, especially at the state level. As a consequence, large integrated firms in highly-concentrated industries have been privatized as single entities, missing the opportunity of demonopolization and increased competition.

In several cases where privatization has taken place and a number of independent business entities have emerged, there has been a tendency to re-establish previous horizontal and vertical linkages through the establishment of holding companies and associations. In some situations these linkages represent legitimate attempts to maintain vital technological linkages, realize certain efficiencies, and reduce the risks associated with various inter-firm contractual relationships. However, it is more likely that they will act to limit competition through price-fixing and other anti-competitive practices. Given the highly concentrated nature of Russian industry, the committee must be particularly vigilant of these developments. It should develop strict rules for mergers and acquisitions and the formation of holding companies. The burden of proof that efficiencies are likely to be generated and that competition will not be significantly impaired should rest with the firms. Wherever possible, inter-firm rivalry should be encouraged to prevent managers from gravitating to the comfortable relationships central planning had previously established.

An area of particular importance is wholesale and retail trade distribution (including warehousing). Regulatory impediments, high concentration, restrictions on private ownership of land and real estate, and increased market segmentation due to the breakdown in transportation systems have all contributed to heightening the barriers to entry in this area. As a consequence, the flow of goods and the market adjustment process have been adversely affected. Local and regional monopolies are widespread.

All in all, in order to foster competition in the Russian economy, the Anti-monopoly Committee should be a much more active advocate of competition rather than simply a regulator of suspected abuse. It must:

- Promote the break up of large integrated enterprises (demonopolization) during the process of privatization;
- Attack various licensing regulations, administrative obstacles, and procedures that impede the entry and restructuring of enterprises; and
- Pro-actively encourage pro-competition government policies, such as in the areas of private ownership of land and real estate, financial markets, foreign investment, and trade.

Fostering effective competition is as much a vigorous application of competition law as it is a promotion of a liberalized economic environment. A complementary and reinforcing set of actions need to be taken on multiple fronts.

Information on the operations and priorities of the Anti-monopoly Committee must be made available and public awareness of the importance of the law and competition policy needs to be increased. These actions would contribute toward creating a broad base of support for competition in the Russian economy. At present the committee has a low profile both inside and outside the government. This has led to the view that it is not a significant player in the economic transition process.

Conclusion

Much needs to be done to effectively implement Russia's competition (anti-monopoly) law and to foster a competitive environment to facilitate enterprise reform and structural adjustment. The law has not been vigorously applied by the Anti-monopoly Committee, in part because of the lack of institutional capability, trained personnel, and financial and other resources. In addition, the committee has tended to be regulatory in its approach by maintaining the dominant enterprise register and imposing profit-margins, output, and other controls which overly constrain the operations of these enterprises. The register and related regulations need to be abolished. Concerns regarding monopoly pricing by the dominant enterprises are best addressed by reducing barriers to entry—most of which have been created by government policy itself. The existing law contains sufficient instruments to remedy other anti-competitive practices which these enterprises may engage in.

A number of other recommendations have been made in the this chapter. To recapitulate, the Anti-Monopoly Committee must:

- Formulate strict rules for mergers, acquisitions, and holding companies with the burden being on the enterprises to prove that efficiencies will be generated and that competition will not be significantly reduced.
- Increase the scrutiny and break-up of large integrated enterprises and industrial associations, particularly those seeking to re-establish traditional concentrated-monopolistic linkages fostered by central planning.
- Initiate competition in the wholesale and retail trade distribution and transportation sectors.

To effect these changes, the institutional capabilities and resources of the Anti-monopoly Committee must be enhanced. Technical assistance is needed to:

- Provide visiting and resident expert advisors in the field of industrial organization and competition policy.
- Train and develop staff in Russia and provide internships in established competition agencies in industrialized countries.
- Undertake legal and economic studies to further improve the application and development of competition law and policy in Russia.

Notes

Without implication, this paper has benefitted from exchange of views and information with Charles Blitzer and Irina Starodubrovskaya, The World Bank Resident mission, Moscow; Vladimir Capelik, Working Centre for Economic Reforms, Moscow; and various officials in the State and Regional Anti-monopoly Committees.

1. There are differing views on the degree to which industrial concentration can be characterized as high in Russia. Brown et al (1993) found that very large firms are more prevalent in the United States, and there is little aggregate or industry concentration at the national level in Russia. However, they find that barriers to competition highly segment product markets in Russia, suggesting that industry concentration at regional and local levels is much higher. One problem with the data set used in their analysis is that it does not include the production of civilian goods by enterprises in the defense sector, which, depending on their relative size and number, can significantly bias the measures of concentration. For other views on industrial concentration in Russia, see citations in Brown et al and in Starodubrovskaya (1994).

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Synopsis of Conference Proceedings

Privatization and the Emerging Private Sector in Russia, June 20–21, 1994

Grace Lao and John Nellis

On June 20–21, 1994, the World Bank held a conference in Washington, D.C., on the subject of "Privatization and the Emerging Private Sector in Russia." Those making presentations included:

- Anatoly Chubais, Russian Deputy Prime Minister
- Maxim Boycko, President of the Russian Privatization Center
- Peter Filippov, Head of the Department of Information in the Administration of the President of the Russian Federation
- Andrei Volgin, Director of the Derzhava Investment Fund, Moscow
- Andrei Shleifer of Harvard University, Advisor to the GKI
- Jonathan Hay, Advisor to the GKI
- Charbel Ackerman, Advisor to the GKI
- Joseph Blasi of Rutgers University, Advisor to the GKI and Russian Privatization Center
- Leroy Jones of Boston University, Advisor to the GKI
- Sven Hegstad of the European Bank for Reconstruction and Development
- Mark St. Giles of Cadogan International, London
- Walter Coles of USAID
- John Moran of USAID
- Alexandra Vacroux of Harvard University, Advisor to the GKI
- Thirteen staff members of the World Bank and IFC, all of whom have worked on the privatization process in Russia.

Attendance at the two-day meeting varied from 50 to 200 persons, depending on the session. What follows is a synopsis of the verbal presentations made in the course of the conference, both by presenters and discussants.

June 20 – Day One

An Overview of Russian Mass Privatization

Maxim Boycko, Russian Privatization Center

The principal goals of the Russian Mass Privatization Program (MPP) were to transfer state-owned enterprises (SOEs) to the private sector. The intention was to remove firms from the control of politicians, and create a constituency for a market economy. The Russian MPP has been very successful in achieving these goals. The speed of transfer of so large a volume of assets is without precedent.

The implementation phase of the MPP started in December 1992, with the sale of eighteen enterprises. Since then, between 12,000 and 13,000 large and medium-size enterprises have been privatized, across all sectors, increasingly even including some in the defense industry. Russia has gone much farther than many countries in choosing to quickly privatize infrastructure firms, including electricity, telecommunications, and gas. The view sometimes expressed that large enterprises have not been privatized is incorrect—one-third of all divested assets are in companies with over 10,000 employees. Two-thirds of total industrial employment will be already privatized by July 1, 1994, with the average privatized company employing 1,100 people.

Privatization has catalyzed a number of important reforms elsewhere in the economy. One example pertains to the development of capital markets. In 1992, only a few companies were publicly traded. Since the inception of the MPP, 16,000 companies have issued shares and more than 600 investment funds have been created. Vouchers have been actively traded, at a volume which sometimes reached 400,000 to 600,000 per day. There are now more shareholders in Russia than in the United States and United Kingdom combined.

The ownership structure in most companies is dominated by insiders, holding an average of 60 percent of the shares of each privatized firm. But the negative effects of insider domination are less than anticipated, and secondary trades are beginning to take place. Very often, for example, companies in need of cash solicit outside investors, including foreign investors. Workers and managers own shares on an individual basis, not in a collective manner, and in many cases they are selling shares to outsiders. Information from a survey conducted by Leila Webster of the World Bank showed that 60 percent of newly-privatized enterprises have introduced new products, and 40 percent have laid off workers. Data from three regions show that large outside investors have successfully appointed new managers to privatized companies; and another study indicated that managers have been replaced in 10 percent of all firms examined. Thus, insiders have not been able to totally block restructuring, and outsider ownership continues to increase, mitigating the potential problems of concentrated insider ownership.

...the negative effects of insider domination are less than anticipated, and secondary trades are beginning to take place.

The next phase of reform must focus on attracting foreign investment into the Russian private sector. The critical measures required to achieve this goal are:

- *Implement a "classical" privatization program.* The 10,000 or more companies not included in the MPP, and the remaining (minority) state-owned shares in MPP companies, should all be sold using classical privatization methods—auctions, trade sales, tenders, and so on—thus finalizing the separation between the state and enterprise. This program would also generate cash, of which about 50 percent would be returned to the enterprise for use in restructuring. Both investors and the existing insider-owners should find this prospect attractive.
- *Further develop capital markets.* Effective regulation and efficient support systems in capital markets will have an important impact on enterprises' ability to raise capital. Transparent transactions and liquid markets must be assured if the capital markets are to be a vehicle for enterprise reform.
- *Implement land and real estate reform.* In Western economies, nearly one-half of total tangible wealth is in land and real estate assets. In Russia, these assets are today controlled by the local governments. A clean and transparent system for real estate registration must be established. Further privatization of land and clear property rights will also allow enterprises to attract capital for restructuring, by permitting them to mortgage their real estate holdings. Measures such as development of a mortgage finance institution should also be considered.
- *Facilitate spin-off of social assets.* Only limited progress has been made in separating social assets (such as housing, childcare, and healthcare) from enterprises. The maintenance of these assets poses a high financial burden on firms, diverts scarce management resources from restructuring, and makes an enterprise unattractive to investors. Even more importantly, enterprises use these assets as hostages and pressure the government for funding, predicting social catastrophe if the flow of subsidies is cut off thereby ruining any hopes of depoliticizing the new enterprises. Russia has proposed that the World Bank fund a pilot program for divesting social assets, and awaits its decision. In this area, a great deal of foreign aid and technical assistance is needed.

The MPP has led Russia through incredible reforms in record time. The array of accomplishments would have been unimaginable without the MPP. Most importantly, the MPP has made market reforms irreversible.

The discussant for the Boycko presentation was Walter Coles of USAID, who presented five elements that contributed to the success of the MPP. First, consolidation of donor resources led to quick and concerted action. Second, flexibility and speed were emphasized over rigid strategies. Third, independent advisors were used, instead of a prime contractor with implementation responsibility. Generally, a sole contractor tended to become closely aligned with one government institution, and its own interests might have conflicted with the best interests of the program. Fourth, Russian managers were trained and appointed early in the process, and therefore enterprises did not have to continually rely on long-term foreign consultants. Lastly, clear and transparent systems were developed to avoid reliance on case by case approaches. Through application of these principles, both the Russian privatization team and the donor community avoided problems common to aid-supported operations.

A Regional View of Privatization—Primorsky Krai
Alexandra Vacroux, GKI

Primorsky krai lies seven time zones from Moscow. Until the last few years its center was a closed military city with a population of 2.3 million. Over 1.0 million people are part of the military industry, which comprises 25 percent of the regional economy. The region has many natural resources, such as ore and mineral deposits, timber, and marine products. It has the advantages of geographic location with three ice-free ports, natural resources, and a highly-trained labor force.

The region had 1,800 small-scale enterprises, of which 51 percent have been privatized since the spring of 1993. Most were privatized through competitive tenders, with restrictions forbidding the new owner to change the line of business for a period of five years. Both the enterprises and the local government responded quickly to the cash incentives presented by small-scale privatization. Problems which surfaced included disputes between regional and municipal governments regarding who actually owned what, and complaints that private enterprises were "reprofiling" or closing, thus failing to provide necessary services. In reality, the nonprivatized enterprises were the ones reprofiling and driving up prices. Privatized enterprises sometimes closed temporarily to enable labor collectives to develop business strategies.

The regional large-scale privatization program was a multi-step process. First, the enterprises were transformed into joint stock companies. Employees in most enterprises chose the second of available options, in which 51 percent of the shares get transferred to insiders. The voucher auction process then distributed all but 20 percent of the shares of each enterprise, with this remainder held by the regional property fund. Enterprises were sold in waves of forty to fifty every two months. By the third quarter of 1993, Primorsky was one of the top fifteen Russian regions in the number of enterprises sold. Thus, it was a shock when the local administration effectively banned further auctions in August 1993.

An analysis of the interaction between the four groups of active participants in the privatization process illustrates why such a decision was taken. The participants were local government, federal government, enterprises, and entrepreneurs.

The local GKI and local property funds were most influential in deciding the order in which enterprises were to be privatized. The Central GKI and Central Property Fund struggled with each other as well as with the local agencies. The state remained dependent on enterprises for tax revenues and the provision of social services. The entrepreneurs found privatization profitable, and wanted it to continue. (A potential fifth group, labor leaders and local politicians, were found to be generally inactive in this region.)

Enterprises formed a basically defensive structure called the PAKT to protect themselves from outside investors. This organization sought to transform the economic power of industrial enterprises into political power. In May 1993, the governor of the krai appointed members of the PAKT to his administration. The enterprise managers wanted to maintain control of their firms, and they used the power of the PAKT and the local administration to challenge and halt privatization. Ultimately, pressure from Anatoly Chubais, the Deputy Prime Minister, and the entrepreneurs

Enterprises formed a basically defensive structure called the PAKT to protect themselves from outside investors.

forced the local administration to reverse its decision.

The struggle in the relationship between the central and regional agencies continues to evolve. The central government wants to maintain a supervisory role over the local government. The central government had a particular interest in Primorsky krai because of the wealth of the region. On the other hand, the natural resources and wealth in Primorsky krai reinforced a local perception that it did not need the assistance and interference of the central government.

The discussant, Igor Artemiev, of the World Bank, noted that this type of political maneuvering, which caused Primorsky krai to fall from its position as one of the leaders in privatization, has been quite common in Russia. He presented some likely future problems concerning the role and authority of local governments. The conflict over distribution of proceeds from privatization will become more intense as more cash auctions take place. The battle for the proceeds of privatization among the central government, the regions, and the enterprises will escalate. He predicted that regional authorities will become more resistant to the privatization of land and real estate because that is their last area of control. The regional authorities also want a role in corporate governance, and they seek control over a percentage of the state shares. Lastly, regional authorities will seek a role in holding companies and industrial groups that are being created.

In the ensuing general discussion, Maxim Boycko pointed out that Primorsky krai was an exception in the degree of prominence and power of the PAKT. Mr. Boycko also made a comparison with China regarding the relationship between central and local government and the role of competition in incentivizing managers. The Chinese government has a straightforward relationship with all local governments, but this is not the case in Russia, where the fight for authority takes place in individual negotiations with regions. In China, managers' compensation needed to be aligned with the shareholders' interests in order to provide incentives. In Russia, managers hold blocks of shares, so they already, presumably, have the same objectives as shareholders.

Land Privatization in Nizhny Novgorod
Gretchen Wilson, IFC

The International Finance Corporation started working with the GKI in December 1991, to complete privatization transactions which would put the new laws and approaches into concrete action. Nizhny Novgorod was chosen as the experimental site because it was Russia's third largest city, was a leading industrial area, and had a mayor and a governor committed to reform in general and privatization in particular. The IFC's approach was decidedly grass roots, meaning it sent staff to live in the field, and gain the knowledge and trust necessary to develop open, rapid, and fair sales processes—with the further hope that they be transferred to other regions. In collaboration with the regional authorities and with central GKI, IFC concentrated on four areas of privatization: small scale, trucking, large scale, and land reform. The first three have been described in other seminars; Ms. Wilson concentrated on the last, less known program.

The IFC initiated the land reform program in January 1993, at the request of the local authorities. There are 700 state collective farms in Nizhny Novgorod, with an average size of 3,000–4,000 hectares. An average of 600 people live on each farm, one-half of whom are pensioners.

The objective of the program was to transfer land and property to private ownership. The design of the program adhered to five basic principles: participation was voluntary; participants chose the structure of ownership for the new units which were created; assets were transformed into family farms, partnerships, or companies; discussion of all contracts and agreements was an open public process; and information was widely disseminated. Six farms volunteered to participate in the pilot program.

Actual reforms were implemented in five stages. The preparation stage involved assessing the land and preparing an inventory of property. The description and characteristics of the farm were verified, its balance sheet revalued, and the qualifying individuals were confirmed. In the first stage, entitlement certificates were distributed to all qualifying individuals, specifying the number of hectares of their entitlement. The public information program was also initiated at this time to educate people about the program.

In the second stage, contracts creating new enterprises were finalized. Individuals were presented sample contracts for different types of entities—private family farms, partnerships, and companies—and the rights and obligations of each type of entity was explained. Individuals then chose the type of entities they wanted to form. Pensioners who did not wish to farm could lease or gift their hectarage.

Stage three was the auction process. Land was divided into the smallest units, so that private farms could apply for individual fields. Each entity applied for the land and property it wanted, indicating the amount of land entitlement certificates they were willing to bid. In practice, the land and property have already been divided between the participants through their own negotiations. Only in a small number of cases did conflicts arise over the same property, in which case it went to the highest bidder. In the final stage, land and property were transferred, and titling was completed. Both the World Bank and USAID have been working to develop the titling system in Nizhny Novgorod.

Between November 1993 and May 1994, all six test farms were privatized. This process created sixty new private entities, ranging from an individual who now owns a truck and provides trucking services, to small families with their own farms, to companies operating a large farm with hundreds of owners. Prime Minister Chernomyrdin endorsed this program as a model for other regions in a conference with governors from eighty-eight regions held in March 1994. Work has just begun with two other regions in implementing a similar program and fifty more farms have volunteered to be privatized. The process generates new issues which need to be addressed, such as marketing, infrastructure, and access to credit and supplies. Nizhny Novgorod was successful because of the high level of commitment, voluntary participation, and foreign assistance in initiation stages.

John Nellis of the World Bank praised the IFC's commitment and the active, residential, hands-on implementation role it has taken in this and all its activities in Russia. He asked whether land allocations were adjusted for differences in land quality, and asked about the time and estimated cost of implementing this type of program on a widespread basis, noting that a major effort was required to privatize just six farms. Ms. Wilson responded to the first issue by citing the widely accepted Russian method for rating land quality. Hectarage is simply adjusted by this rating. This pilot program privatized six farms over eighteen months at a cost of $2.5 million, but once the systems and procedures are developed, the cost and time requirements should decline dramatically. The next six months of the program will concentrate on training officials from other regions, so they can implement the program themselves.

Voucher Investment Funds in Russia
Andrei Volgin, Derzhava Investment Fund

In 1992, there were less than 100 small investment funds in Russia; now, there are over 640 funds. There are four types of funds: funds created by banks; funds created by financial institutions, such as brokerages or investment consultants; "amateur funds" created by regional authorities, or solely to purchase a single company; and fraudulent funds. The recent exposure of a fund with a million shareholders, which lost one-third of its assets due to fraudulent behavior, has focused attention on preventing phony funds.[1]

The size of a fund is generally dependent on the geographic scope of its investments. Some of the most popular funds are small regional funds with 1,000 to 10,000 shareholders and less than $1.0 million in assets under management. However, approximately 30 percent of these funds cannot cover their operating costs, and are seeking mergers with other funds. The interregional funds generally invest in five to thirty regions and manage $1.0 million to

$10.0 million in assets. The largest funds, the national funds managing asset bases of $25 million to $50 million, are held by 1.0 million to 3.0 million shareholders.

The government sponsored advertising campaigns to encourage people to invest their vouchers, rather than sell them. Most people had no experience in investments or investment funds, and responded to advertising and promises of high returns. The funds had no time to build their reputation, and had to rely on advertising and promises to attract investors. The largest funds spent 3 percent to 10 percent of their assets in advertising. This created unachievable expectations, and funds faced great difficulty in the first quarter of 1994 explaining their low performance. The popular perception of investment funds is currently at a very low level.

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Most funds had difficulties developing their back office systems for collecting vouchers and recording shareholders. Funds contracted with Sberbank (the Russian national savings bank, with offices throughout the country) and the post office for collection of vouchers. Most funds issued certificates indicating shares in the investment fund in exchange for vouchers; only a few funds had a book entry system for recording this information. The largest funds have not yet completed the work of recording all shareholders.

Russian equity markets are not very liquid and suffer from poor trading systems. Fund managers prefer to trade directly with each other rather than through an exchange. Systems for trading, information depository services, and clearing are being developed. The problem of enforcing full disclosure regulations must still be addressed in order to create efficient markets.

There are only a few funds with a pronounced investment strategy that is strictly followed. One such strategy is the speculative approach, whereby funds purchase shares of companies in special situations with the intention of selling them quickly. Often, these are companies in which the managers and outsiders are quickly purchasing shares in order to gain control. Another strategy combines the speculative approach with a focus on new venture investments. Other funds combine the focus on new ventures with an emphasis on long-term portfolio investments. Generally, in companies which are held for long-term investments, two to three funds each control up to 25 percent of the shares, and work together to push restructuring quickly. Lastly, there are diversified funds, which hold shares in 70 to 240 enterprises, and funds that specialize in particular sectors.

Emerging Capital Markets in Russia

Claudia Morgenstern, IFC

The development of efficient capital markets is a critical part of the Russian transformation for two reasons: capital markets serve to allocate funds needed to restructure enterprises and they provide a source of discipline and incentives for enterprises. Capital markets regulate a company's access to, and cost of, capital. Shareholders can discipline poorly performing managers through their voting rights or through exit in the secondary market. Neither of these functions can be provided solely by banks.

The Russian market is currently very fragmented. There are more than eighty licensed exchanges, but most of the trading occurs outside the market. The exchanges account for no more than 10 percent of total trading volume. Foreign portfolio managers are extremely active in the market.

Two recent presidential decrees seek to establish minimum standards for reliable information in the capital markets, including the investment funds. The first decree specifies truth in advertising standards, the other establishes standards for distribution of new securities issues and financial reporting.

The perceptions and objectives of the participants are the main impediments to the emergence of efficient markets in Russia. First, brokers and their customer are not concerned with transparency or efficiency; they want to manipulate prices. Second, many brokers were permitted into the market without any regulation, and without much concern toward the broker's stability. This will need to be better regulated as the secondary market develops and brokers have to provide counter-party transactions. Third, investors are concerned not with the pricing mechanism which an efficient exchange provides, but with promises of return. Investors tend to think of stocks more as fixed income instruments. Fourth, brokers see control over their economic environment as a higher priority than efficiency, and are suspicious of any collective institutions for centralized clearing and settlement. Lastly, brokers see only the issuers as their clients, and aim to monopolize trading in a particular issue, rather than to serve the investors.

The first two areas of regulation for the Securities and Exchange Commission in the United States were the registration and deposit of securities. Nearly all new securities in Russia have been issued in the form of bearer certificates. Many investors, including investment funds, want certificated shares so they can be traded immediately. The development of a reliable registration system is the only solution to persuade investors to switch from share certificates.

Russia's capital markets have a strong regional bias due to the size and geographical diversity of the country. The regional emphasis is somewhat beneficial, because officials in a region will have the best and most current information on companies in that region. But the current situation—a large number of exchanges with high fixed investments and low trade volume—cannot be maintained.

A substantial number of existing institutions are not motivated financially to work through collective institutions. A shift in economic incentives, so that brokers view the investors as their primary clients, will be an important turning point toward rationalizing markets.

Mark St. Giles, of Cadogan International, commented on the presentations by Volgin and Morgenstern, noting that the reason investment funds devote so much energy to control is because there are no reliable support systems. Once the market and the infrastructure develop, and brokers develop more trust in these systems, the obsession with control will decline.

John Moran of USAID described some equity funds in Russia, which USAID has taken a role in establishing, in conjunction with OPIC and EBRD. For example, USAID is involved with one fund which focuses on small and medium-sized enterprises with fewer than 2,500 employees, and another fund which focuses on larger companies, in two regions. These funds take equity positions and provide technical assistance to companies in which they invest.

Private Sector Development in Russia
Leila Webster and Marie Sheppard, World Bank

Leila Webster presented the results of a survey she conducted to identify the types of people in the emerging Russian private sector, their operating strategies, and the implications for future assistance programs. The survey, undertaken in November 1993, shows a private sector that is very heterogeneous, composed of new firms, newly-privatized state-owned enterprises, and firms which have been operating in a quasi-private mode since the Perestroika reforms of the late 1980s.

Who are the managers? The managers of private firms are overwhelmingly male, with university degrees, between the ages of forty-five and fifty. They are either former managers of SOEs or have technical backgrounds. These are educated, skilled people who have gaps of knowledge in a number of specific areas related to operating a private business.

How do they maximize profits? The new firms generally have a short-term outlook, seeking to capitalize on a few niche opportunities, while the privatized firms have a longer-term outlook. Many new firms generate profits by supplying import substitution goods, which they can monopolize for a short period. They are flexible and can react quickly to serve the market, taking advantage of the inefficiencies of the former SOEs. The privatized companies provide greater assurance of delivery for large orders, and continue to work with other former SOEs. They are making small changes to enhance productivity and responsiveness, as well as to minimize the burden of social assets.

There is little import competition now, so we (the World Bank and external aid agencies) need to encourage trade liberalization.

How do they minimize risk? Managers of new firms hesitate to make large investments and generally rely on leased equipment and space. They avoid hiring full-time employees and taking on long-term financing. They rely on short-term loans and customer advances for working capital. The managers of privatized firms are not laying off workers, either because they do not want to be caught with insufficient labor when a large order appears or so they can use the workers as "hostages" to negotiate subsidies. They too tend to avoid long-term debt.

How can we help? There is little import competition now, so we (the World Bank and external aid agencies) need to encourage trade liberalization. We need to respect the people we are assisting; they are competent. We need to listen to what they need, and provide practical training, not theories. We need to encourage more activities along the lines of a recent project which establishes a 2 to 3 year financing mechanism for enterprises. And we must prove our worth by providing top quality assistance.

Marie Sheppard dealt with alleviating constraints to businesses. She discussed how to identify the most important constraints and to examine the potential to alleviate the constraint, using the shortage of commercial property in Russia as an example. The first step in alleviating constraints is to determine whether a perceived constraint is a serious impediment, or merely a nuisance. Constraints which have the greatest commonality should be addressed first. The resources and participants must be examined in light of their potential to alleviate the constraint. Thus, one should target constraints that are most costly to the greatest number of firms, and that one has the ability to alleviate.

The mode of intervention can be passive or active. Passive intervention includes addressing policy or regulatory issues, while active intervention involves actually providing services to firms that would alleviate the constraint. It is rare to find active government interventions which are cost-effective and target the appropriate people. Governments tend to have multiple, conflicting goals (employment and efficiency), strategies that are inconsistent with a market economy (provide subsidies to alleviate the constraint), and poorly-designed and -delivered programs. For these reasons, many people believe that the government should only provide passive intervention, and should leave the active measures to the private sector. Government can play a role by identifying the appropriate organizations to work on various components of an assistance program.

In Russia, finding and securing commercial property is a severe constraint. There is a shortage of retail space, but there is an excess of manufacturing space. Property use is misallocated, creating areas where street level space is reserved for housing, so that retailers must be located far from residential areas.

One passive solution to this problem is the lifting of profile restrictions for privatized companies, so they could provide whatever services the area market needed. Secondly, effective mechanisms for dispute resolution would allow contracts for space to be enforced. A gray area is provision of information on available properties, formerly available only through the GKI. This information could be provided by the private sector to allow businesses easier access. An active measure that addresses this problem is the creation of semi-permanent street markets. The government could regulate these markets and contract out the maintenance to a private firm. This solution would provide a stable location for the sellers, access to the buyers, and revenues for the government, and might even provide business people with some relief from the "mafia" that interferes in real estate and other business operations. Another solution might be the development of leasing centers which would renovate underutilized space for retail and manufacturing use. This option, however, requires financing to renovate space and development of contracts which provide the legal assurances necessary for making large investments.

Commenting on these presentations, Michael Gould, of the World Bank, presented a broader view of Russia's passive and active measures for developing the private sector. Over the last few months, Russia has shown some signs of increasing macroeconomic stability, which should alleviate some of the most pressing constraints on the private sector. In addition, however, Russia needs to develop laws defining and regulating commercial operations, institutions to enforce these laws, and a supportive public opinion toward not only these laws, but also toward the concepts on which they are based. On the micro level, extensive training of entrepreneurs, providing knowledge of modern technology, markets, and operations is extremely important.

View of the Private Sector and Entrepreneurship in Russia Today
Peter Filippov, Administration of the President's Office, Moscow

The extent of misleading information and fraud in the private sector has surfaced as a real problem. Private companies and investment funds are making promises they cannot keep to investors, and there are fraudulent companies and funds which rob investors of money and enterprises of assets. Recent decrees have been enacted to protect investors' interests and ensure truth in advertising, but these decrees will take time to implement, and they cannot at once create a mentality for ethical behavior.

Cash payments account for 50 percent to 70 percent of trade turnover, creating easy opportunities for those in control to defraud shareholders and avoid tax collectors. Individuals who know of such robberies usually cannot report it because there is insufficient documentation. Shareholders have little alternative but to turn to the mafia to punish these crimes and redress their grievances. In the newspapers there are daily reports of explosions which kill or wound managers and directors of companies and banks. There have also been cases where mafia figures have investigated cases of tax evasion in order to use such information to blackmail an enterprise—and the enterprise pays the mafia because it is cheaper than paying taxes.

Often, enterprises show signs of reform on the surface, but in fact have little commitment to the new system. For example, a manufacturer of voltage converters, which had worked on the Strategic Defense Initiative (Star Wars) some years ago, had been financed directly from a supposedly infinite state budget. Today, it competes against Siemens and must be much more cost-conscious. While this company seems to have made a smooth transition, one of the directors, who controls 40 percent of the enterprise, continues to financially support the Communist Party and openly wishes for a return to the times of SDI.

This shows that significant resources must be dedicated to media and public relations campaigns. One of the main obstacles to reform is the mentality of the people, which can only be changed through effective advertising and education programs. The average Russian is still quite ignorant of the reasons for reform. Eight out of ten Russians today cannot explain why a market economy is more efficient than a communist system. Shareholders realize that they are owners of the country's assets, but they still feel subordinated to the national and local bureaucracies. Many people still believe the president determines prices and everything else in the economy. Life in Russia has turned out to be more difficult than expected, driving people to turn to extremists who promise quick solutions to all the problems.

Eight out of ten Russians today cannot explain why a market economy is more efficient than a communist system.

The future of Russian privatization and reform might collide with traditional Russian psychology. It is our task to steer, and shift this psychology so that a fatal collision does not occur.

June 21 – Day Two

Privatization in Russia—After the Voucher Program
Anatoly Chubais, Deputy Prime Minister of Russia

The Russian economy is currently in a deep recession, experiencing an average decline in output of 25 percent (over last year's already depressed figures). Official unemployment remains very low at 2.3 percent, but it is increasing at a rate of 8 percent per month. The three main reasons for this decline are the process of financial stabilization, workers' strikes, and cutbacks in the military industry. On the other hand, macroeconomic conditions are improving—inflation has stabilized at less than 10 percent per month and is declining, savings have increased, and the Central Bank interest rate has declined moderately since the end of 1993. Time lost to strikes has declined substantially in the last two years. However, the consolidation of the military industry, which accounts for one-half the decline in output, has yet to be addressed.

The mass privatization program has produced many important results and has achieved its primary objectives. Approximately 80,000 retail shops and restaurants, or 72 percent of small scale enterprises, have been privatized. By the end of this year, approximately 85 percent will be privatized. The program distributed vouchers to 99 percent of the population, and over 50 percent of the GDP has been privatized. The program also created 40 million shareholders and 640 investment funds. It has created an environment in which the private sector can survive and grow.

Many companies have seen their stock values multiply as a result of restructuring efforts, so there are high potential returns in the market.

The primary objective—making market reform irreversible—has clearly been achieved. A new administration will not be able to demand the return of equity assets from 40 million shareholders. The most convincing sign of stability is that even after the first group of reformers left the government, the reforms continued.

In the next stage of reform, the critical issues are attracting capital for the restructuring process and resolving the problems that the privatization process highlighted. Capital is needed to support enterprises in their restructuring efforts, and conversely, restructuring must occur in order to attract foreign and domestic capital. Many strategic investors have invested in Russia, including PepsiCo, Phillip Morris, Siemens, and United Technologies. Institutional investors are only beginning to enter the market, having invested $1.0 billion between March and May 1994. Many companies have seen their stock values multiply as a result of restructuring efforts, so there are high potential returns in the market. In addition to attracting capital, other issues to be addressed include the regulation of the securities market, privatization of land and real estate, and the restructuring of social assets.

Mr. Chubais addressed a variety of issues during the question period:

- He defended the role of insider preference in the MPP as absolutely necessary for political reasons. Shares held by workers and mangers are now being redistributed in the secondary market. In the next phase of cash privatization, privileges for employees will be cut sharply, reducing both the percentage of shares and the price discount they can receive.
- He elaborated on the need to privatize and develop the urban land and real estate market, and to establish firm property rights. Privatization of urban land will lead to more efficient use and allow enterprises to sell or lease extra land in order to support restructuring.
- He did not have many details on the forthcoming sectors targeted for privatization, nor on the speed of the cash privatization program. Approximately 70 percent of Russian industry has been privatized; another 10 percent will likely be held by the state indefinitely, including sectors such as steel and nuclear materials; the remaining 20 percent, including much in the military-industrial complex, will be privatized in this next stage of reform.
- Regarding laws for joint stock companies and securities regulation, there are currently drafts under consideration by the Duma. It will create a significant problem if they are not enacted by September; if this is the case, these laws may need to be enacted through presidential decree.

The Next Stages of Reform in Russia
Andrei Shleifer, Harvard University

The principle achievement of the mass privatization program has been putting into motion the wheels of reform. A tremendous amount of restructuring is already under way. Enterprises are changing product lines, shutting down bad operations, and searching for new markets. The military industry has lost 20 percent of its employment, yet most of these workers have been absorbed into the private sector.

Many lobbying groups have been created to accelerate and deepen the reform process. The private sector would like more focus on developing property rights laws and curtailing the power of organized crime and the local governments. This is a time to speed up reforms and to capitalize on the accomplishments of the MPP.

The success of the reforms to-date was partly dependent on agreement, in 1993, by all in the donor community that rapid, genuine reforms were achievable if implemented quickly. It was not the amount of aid that was vital, but the quality of aid and the consensus on promoting reform. Recent confusion in the West over the next priorities for reform has led to a reduction in aid, and even more importantly, a decline in the quality of aid. Foreign funding and technical assistance must continue to be focused on programs that promote a market economy, reduce political interference in everyday life, and expand the private sector.

There are six priority areas for future reforms.

- Move to cash privatization to attract capital and create core investors;
- Implementation of legal reforms, particularly in commercial law, to allow law and government to replace the mafia;
- Privatization and registration of land and urban real estate;
- Further development of corporate governance functions;
- Development of securities markets, so shareholders can exercise their most basic governance power—exit rights; and,
- Development of a social safety net, to prevent enterprises from using social assets as an excuse to extract government subsidies.

During the discussion, Mr. Shleifer elaborated on the social safety net issue. The main areas of concern are unemployment, housing, and childcare. An unemployment system must be developed to accommodate layoffs which occur during restructuring. Housing and childcare must be addressed because they account for 85 percent of the total costs of social services provided by enterprises, according to a World Bank estimate. Social assets provide an excuse for subsidies from the government. Ira Lieberman added that administration of these assets also diverts valuable management time which needs to be devoted to restructuring.

Mr. Shleifer also addressed the topic of governance pressures from commercial banks and capital markets. He predicted that an active stock market will be established in the next 3to 4 months, based on self-regulation, but it will need to be transformed into a liquid, organized market. Commercial banks, on the other hand, are lobbying to delay this, proposing ways to monopolize the process of financial intermediation. Nonbank institutions, given further development of stock market's infrastructure, may become more active in corporate governance than commercial banks.

In response to a question about the lack of standardized accounting principles, Mr. Shleifer reiterated a basic concept governing future reforms in Russia: Russian companies will not initiate changes because of recommendations from Western advisors; they will make changes because it is in their best financial interests. Thus, as securities markets develop and firms find it useful to attract private domestic and foreign investors, they will develop standardized accounting principles because of investors' demands.

Legal and Regulatory Reform in Russia—The Next Steps
Jonathan Hay, GKI

The written law in Russia today does not have much significance. There is widespread use of private law-enforcement mechanisms. The private sector would prefer the state enforce laws, because private law enforcement is costly and risky. But, until the state issues laws that the people want enforced, the Russians will continue to avoid and evade the law.

Even laws that people support in principle are often unenforceable because people do not turn to the state for enforcement.

Even laws that people support in principle are often unenforceable because people do not turn to the state for enforcement. To illustrate, private entities do not bring contract or property rights disputes before the state, preferring to use private enforcement mechanisms. The main reason is that once an entity comes before the state for law enforcement in some area, it exposes itself to liabilities in other areas of the law which it wants to avoid. For example, the tax law is so burdensome, few people abide by it; but people then hesitate to bring contract disputes before the state because it may lead to exposure of their tax liability. In another case, a shareholder asked the state to settle an issue over registration of a trade; the state investigated and concluded that the shareholder might not legally be entitled to hold any shares. Thus, there are high risks in involving the state.

A second problem is that the state does not create laws or rules that people want to follow because the process of lawmaking is controlled by special interest groups. These groups capture the limited resources available to devise and enforce laws that are in their own interests. As a result, most private activities are outside of the law, and most of the private sector is uninterested in laws. The creation of laws that people have an interest in following is essential if we want them to be law-abiding and involved in the lawmaking process.

In contrast, the privatization law—and by implication the program—was successful because it gave incentives to all interested parties. The rules for privatization were extremely simple and made violations easily visible. The rules resolved differences between stakeholders and united them in favor of privatization. Also, the GKI was a new bureaucracy, and old bureaucrats played a limited role. Before privatization, managers and bureaucrats diverted assets from SOEs. Organized crime has become established in the past few years as a result of people turning to private enforcement of ownership rights. But, while privatization clarified ownership, the laws on actual rights associated with ownership are so poor that people [illegible] are forced to turn to private enfor[illegible]

Russian [illegible] markets are now in need of efficient, en[illegible]eable rules. The creation of an effici[illegible] capital market would lower the cost of capital to private enterprises by promoting competition between financial intermediaries and distinguishing the reputable players from others. Russia has made progress in this area, but the market is still unstable. The huge potential profits in financial intermediation and recently uncovered scandals should produce quick action in this area. But a potential problem in the development of the capital market is that the lawmaking process is captured by small interest groups. For example, a proposal that all trading be done on the Moscow exchange could later be turned into a device for rent-seeking. It is important to maintain competition between various markets to prevent such a situation. Other examples of rules that do not serve all interest groups include proposals that all financial intermediaries have a banking license, or that all share registries are controlled by the local government. There is a high risk of the creation of laws which only serve the interests of a small group.

There is no organization that is responsible for regulating capital markets in Russia. A newly created Securities and Exchange Commission should try to win legitimacy by issuing rules that people want enforced. This organization should maintain independence from the day-to-day politics of the government. The organization would create rules and delegate enforcement, such as licensing of participants or review of prospectuses, to private market institutions.

Both funding and moral support from the West are very important to further legal and regulatory reforms in Russia. New reforms should create rules that the market requires to function, not bureaucratize procedures that are currently functioning.

Andrew Vorkink of the World Bank presented his observations on the legal system and the Constitution in Russia. There are many gaps in the legal system yet to be resolved including civil code, joint stock company act, securities law, property rights, and bankruptcy law. There are two areas of the Constitution which require further clarification: the lawmaking role between the executive and legislative branches, and the relationship between the central and local governments. The next steps toward addressing these issues include creating a legal information system to keep people informed, training people to enforce the new laws, and furthering coordination among different authorities.

Competition Policy in Russia
R. Shyam Khemani, World Bank

There is a fundamental difference between the neoclassical and Marxian approaches toward competition. The neoclassical view is that monopoly gives rise to high prices and profits, lowers output, and misallocates resources. The Marxian view sees the monopolist as an exploiter of the masses.

Since 1990, Russian competition policy has been modeled after the European approach, rather than the North American. The competition law is more anti-monopoly than pro-competition in orientation. The Anti-Monopoly Committee has not played a large role in formulating deconcentration policies for newly privatized monopolies. There is a pervasive view that competition law is not necessary, as long as trade policies allow import competition. But it is unlikely that Russian markets can become competitive quickly without a law to promote competitiveness.

The Russian anti-monopoly law is based on a model derived from OECD advice. It includes a clause which addresses abuse of dominant power, but without firm guidelines for defining the appropriate market. Price fixing behavior is also deemed illegal if it has a substantial effect on the market. Other clauses cover vertical constraints and mergers and acquisitions.

There is little public education on the subject, and private actions in protest of monopolistic behavior are seldom taken. What few private inquiries do occur cite abuse of dominant market position, existence of vertical constraints, inquiries into divestitures, and price fixing.

Russia has the largest competition bureaucracy in the world, with over 80 regional offices and 2,400 staff. The Russian law determines the legal foundation for suppression of monopoly and can be applied to existing and emerging monopoly situations. The anti-monopoly authorities do not apply the law, however, but instead spend most of their resources creating distortions worse than those under monopoly, through the dominant firm register. This register was created to highlight dominant firms that raise prices, with a focus on products that are important to the state. Firms in the register are subject to profit margin ceilings and other controls, that are not applied to nondominant firms producing the same products. Steps are being taken to abolish the register, but it has already had many damaging effects in preventing restructuring.

During the discussion period, many participants reiterated the conclusion that competition policy in Russia should focus on enabling free entry rather than preventing monopoly. Russian firms tend to be very concentrated at the oblast level due to regulatory and institutional barriers preventing contestability from firms in other regions. Competition advocacy is needed to encourage enterprise restructuring.

Russia has the largest competition bureaucracy in the world, with over 80 regional offices and 2,400 staff.

Restructuring Newly Privatized Enterprises
Charbel Ackerman, GKI

The great majority of privatized enterprises are large and medium-size enterprises, with 80 percent of the enterprises employing over 1,000 people. Management and workers own 59 to 60 percent of the shares on average. When blockholders exist, they hold an average of 18 percent of the shares. Based on a survey conducted by Leila Webster, privatized enterprises have taken measures to increase efficiency:

- 60 percent of the firms laid off an average of 10 percent of their workforce;
- 57 percent changed their incentive system;
- 15 percent hired new labor;
- 40 percent sold redundant equipment or leased-out excess space;
- 47 percent made changes to their product line; and
- 60 percent now have privatized companies as clients.

Privatized enterprises have also improved their use of working capital, as illustrated by this example of a shoe manufacturer. Prior to privatization, the enterprise produced shoes for all seasons year-round, maintaining a set level of stock in all styles. After privatization, it immediately changed its operations so that it produces its shoes just in time for the appropriate season. It has tightened its working capital and maintains only a one-month supply of production.

...while insiders hold the majority of shares, top management's share is relatively low at 8.6 percent on average.

The basic issues involved in enterprise restructuring are change in organization and management, choice of product markets, development of marketing and distribution capabilities, reduction of staff, and management of social assets. The presentation focused on the first and last issues.

Organizational changes are required in large Russian corporations mainly because the existing structure is overly centralized and does not permit analysis of the performance of any single product line. Functions such as accounting, finance, research and development, and marketing are generally centralized for up to 200 to 300 product lines. There are almost no incentives in this type of structure because performance cannot be determined. The structure must be changed so that it is more decentralized and a manager can be held accountable for the business unit. This change will also allow the enterprise to determine which business lines are worth additional investment and which must be divested or shut down. The main themes to consider in programs to train new managers are restructuring business units, managing cash flow, finding domestic and foreign partners, reducing costs, analyzing product profitability, organizing foreign marketing, performing marketing research, and establishing distribution channels.

As noted by previous speakers, social assets are a severe financial drain on enterprises. On average social assets' costs are 5 percent of sales, but there are examples of enterprises where they total over 20 percent. Most enterprises want to divest social assets to stop the drain on funds as well as to conserve valuable management resources.

Sven Hegstad, of the EBRD, stressed how important it was for the government to focus on macro issues that will create an attractive environment for foreign investors in Russia. Foreign investors are the best-qualified restructurers of Russian firms. The government's role is to provide incentives and support for foreign investors, support the economy with equity capital, and deliver training and technical assistance.

The EBRD has been actively supporting restructuring both on a wholesale and retail level. On the wholesale level, it has established financial intermediaries in the form of venture capital funds, which provide funds to upgrade enterprises to a credit-worthy status. On the retail level, it has made direct investments in individual enterprises and has assisted in the identification of foreign partners.

Governance Issues in Newly Privatized Enterprises
Joseph Blasi, Rutgers University

A study of ownership structure based on a sample of 200 enterprises in 33 regions revealed that while insiders hold the majority of shares, top management's share is relatively low at 8.6 percent on average. Where blockholders exist, their holdings rarely exceed 20 percent of the shares. Overall, blockholders hold only 11 percent of all shares sold to date. In the next reform phase the remaining state ownership should be sold to other investors—including blockholders—who would, it is hoped, take an active role in corporate governance.

In the firms surveyed, top management was very frustrated with the MPP, feeling that they got an unfairly small share of the enterprises. General directors of enterprises were asked to state the ideal ownership structure of an enterprise. The common response was that insiders should own 72 percent, with top management owning 40 percent. Of the share held by top management, they responded that 31 percent should be held personally by the general director. They also responded that the state should not maintain any residual ownership. The general directors' responses are not encouraging because there is no vision of the firm as an open, public company with a variety of blockholders. General directors want a closely-held firm that they can dominate and control. But, this may be a transitional issue because general directors will come to realize that the companies need to raise capital, which is only available from outsiders.

The general directors exert control under the current ownership structure in many ways. In most cases, they informally control the employee block. Generally, 80 percent to 90 percent of the employees give their proxies to a small group of managers. More formally, general directors can control the employees through a trust that holds the shares owned by employees. Use of trusts has not been widespread because it is unnecessary; informal control has worked well—though there have been cases of general directors making illegal changes to the corporate charter in order to limit outsiders. Lastly, general directors have also purchased shares either from employees or investment funds.

In January 1994, President Yeltsin issued a mandate requiring that enterprises implement cumulative voting for board seats and limit insiders to one-third of the seats on the board of directors. Only three out of forty firms questioned on this matter had implemented the decree or planned to implement it at the next board meeting. Outsider stakes in these three firms were 37 percent to 48 percent. Of the firms that did not implement cumulative voting, 33 percent had outsiders on the board. Of these firms, average outsider ownership was 32 percent, with 26.5 percent held by blockholders. Other firms that did not implement the decree either had no blockholders, friendly outsiders, or widely dispersed outsider shareholders. Overall, the decree did influence the behavior of firms.

Managers want to increase their ownership, but they lack cash to buy shares. Sixty percent of the managers surveyed oppose having a dominant outsider who would provide capital needs. This opposition is declining over time—as resources from the state decline and financial needs grow more acute, but there is still a conflict between the need for control and the need for capital. As a hypothetical exercise, the expected insider ownership was calculated based on the current insider ownership and the general directors' estimates of market value and capital requirements. In all cases, top management's share would drop dramatically if there were a capital infusion by outside investors. In one-third of the firms, the insider stake becomes minuscule; 10 percent of the firms would still maintain majority insider ownership; and 20 percent of the firms would maintain significant, but minority ownership.

One should consider the low percentage of shares owned by management as a victory. The majority insider ownership has not hindered restructuring, as the workforce and unions have been fairly passive. Although general directors want more control, they do not have sufficient cash to make this a reality. There is a crying need to better educate general directors, showing them the practices of chief executives in Western firms, who hold very little equity, yet control the company and are well-paid.

Cheryl Gray, of the World Bank, presented a more pessimistic view of the governance issue in Russia. She highlighted examples which showed that managers and workers are still lacking the mentality and values to create a real market economy. Workers are exerting little control because they do not know their rights as shareholders. Managers want control, not as a way to further restructuring, but as a means to maintain control of their former empire. Unfortunately, there is growing managerial control through control of insider shares, prevention of employee sales to outsiders, purchases of shares from investment funds, and solicitation of friendly investors.

Managers do not know which business lines are profitable and worth continuing. Their ideas of the amount of capital needed for restructuring are wildly exaggerated. There is no focus on profitably, only on growth of the empire. Managers are looking to expand wildly at a time when they should focus on divesting assets.

There are two big risks in the current situation in Russia: slow death of enterprises and pressure for bailout once there is macrostability. If outsiders are successfully kept out, entrenched insiders will manage the firms into decline. The other risk is that once firms are faced with real financial constraints, they will pressure the government for bailout funds. Should this become the case, functional bankruptcy procedures and not a government bailout would be necessary.

Leroy Jones, of Boston University, raised two questions to be used as the criteria for judging whether the MPP has indeed been a success. Are people actually better off after the firms are privatized than before? And, how quickly are enterprises changing their behavior? We know that eventually enterprises will have to change their behavior, but we must assess whether the MPP has been an effective catalyst for change.

The most basic change that is required is new management. New managers will have a much greater impact than any additional capital. Further, capital will not be found until there are good managers in place. There is some evidence of this change—10 percent of boards changed their managers in the first board meeting. There are also examples of old managers retiring and ceding the way to younger, market-oriented managers. Another basic change is a reduction in the workforce. Almost all employee reductions so far have been voluntary. Thus, it is not yet clear to what extent the MPP drove changes.

Mr. Blasi responded that while some managers may still be vying for control, there is evidence of declining management ownership and attempts to shed labor. The issue of entrenchment and whether current managers should be allowed to accumulate larger shares is an honest policy debate. It has not been established that managers cannot drive reform as well as outsiders.

Note

This synopsis was written by Grace Lao and John Nellis of the World Bank's Private Sector Development Department.

1. Mr. Volgin was not referring to the MMM Fund, which ran a classic pyramid scheme and collapsed at the end of July 1994.

Glossary

Enna Karlova

ADMINISTRATION (authorities, government):
Federal administration—responsible for privatization of federal properties;
Krai administration—responsible for privatization of krai's properties;
Municipal administration—responsible for small-scale privatization program;
Oblast (Regional, Local) administration—oblast property committees and funds; they carry out the practical tasks of privatization at the oblast level along with the approval of the GKI or the Federal Property Fund before proceeding with privatization.

ALL-RUSSIA AUCTION CENTER—see *National Auction Center.*

ANTI-MONOPOLY COMMITTEE—responsible for antitrust or pro-competition policy in Russia, in principle, all enterprises with 35 percent or more market share.

ASD (U.S.)—Association of Securities' Dealers.

ASSOCIATION OF INVESTMENT FUNDS—a voluntary trade association representing the interests of the managers of voucher funds.

AUCTION—in small-scale privatization, the enterprise is sold to the highest bidder, with no special conditions attached. All potential bidders have to pre-register, deposit 10 percent of the price as a sign of good faith, and bid in person. In mass privatization, regional voucher auctions were the primary means of privatization. All-Russian or national auctions were established for the largest companies.

CIDA (Canada)—Canadian International Development Agency.

COOPERATIVE—form of an entity permitted from 1988, often a subcontractor or spin-off from a state enterprise; often set up to exploit privileged access to scarce goods.

CORPORATIZATION—first step in the mass privatization program; a process by which an enterprise becomes an open joint-stock company with a legal identity. The enterprise is no longer an adjunct to a branch ministry. It has its own charter (rights and obligations of shareholders) and a board of directors that has the right (in theory) to appoint and dismiss management, and operates under the same commercial law as the private sector. All large-scale enterprises, except those for which privatization is forbidden, must be corporatized prior to privatization.

COUNCIL OF PEOPLES DEPUTIES—see *Soviet.*

DEPOSITARY (of an investment fund)—holds all the assets and cash of the fund; receives all the interest, dividends and other income; executes transactions in securities and for cash on instructions from the manager; applies money to the payment of dividends according to the decision of directors; maintains accounts of the capital and income of the fund and of expenses for statutory, regulatory, and shareholder information purposes.

EESF—Enterprise Employees' Shareholding Fund (see *Personal privatization accounts*).

FEDERAL—meaning at the state, central government level.

FUNDS MONITORING UNIT—a Moscow-based agency that collects information on developments in the industry from oblast KIs, analyzes financial statements of funds, and initiates action against unlicensed funds and other illegal behavior.

GKI (Goskomimushchestvo)—The State Committee for the Management of State Property, formally responsible for managing the property of the state. GKI serves as the driving force behind the privatization program.

GKI (KI):

Federal (Central) GKI—is responsible for formulating and implementing privatization policy, for drafting annual privatization programs, drafting privatization laws and decrees, distributing vouchers, licensing investment funds, and enforcing privatization legislation. It is supported by local and municipal subsidiaries (KIs).

Municipal KI (MKI)—a municipal property committee, subsidiary of the Federal GKI, attached to administration of the municipality. The head of each municipal KI is appointed by the local city mayor. The municipal KI ensures that each state enterprise sets up a privatization commission, produces a privatization plan, and is later corporatized.

Oblast (Regional, Local) KI—an oblast property committee, subsidiary of the Federal GKI, attached to administration of the locality. The head of each oblast KI is nominated by the governor of the oblast subject to approval by the central GKI. The oblast KI ensures that each state enterprise sets up a privatization commission, produces a privatization plan, and is later corporatized.

GOSPLAN—State Planning Agency.

GOSSNAB—Committee of Deliveries and Supplies, which distributed product groups in the economy of the former Soviet Union.

INVESTMENT FUND:

Nonvoucher investment fund—licensed and regulated by the Ministry of Finance. Can subscribe for cash.

Voucher investment fund (VIF)—a part of the mass privatization program. Russian individuals and firms (but not state enterprises) are free to start up voucher funds that can accumulate vouchers and bid for enterprises, subject to minimal criteria. Voucher funds are licensed and regulated by the GKI, and can subscribe for cash. Voucher funds are closed-ended—they have a fixed number of shares per issue. An investor subscribes capital during specific offer periods, and once the fund is set up, the investor recoups investment by selling voucher fund shares on the secondary market. Unlike in open-ended funds, investors in a closed-ended fund cannot subscribe more capital or ask the fund to redeem shares.

IPO—initial public offering, the flotation of a company's shares on the capital market; used as a privatization technique in Czech and Slovak Republics and Poland.

KRAI—an administrative area which is not an ethnic unit but may contain ethnic units (autonomous oblasts) within itself. Often translated to English as region, thus having the same meaning as oblast.

LEAGUE OF INVESTMENT MANAGERS—a voluntary trade association representing the interests of the managers of voucher funds. It has a self-regulatory status with the GKI and the Ministry of Finance; it was modeled after the ASD in the United States and the CIDA in Canada.

LEASEHOLD (leaseholding) COMPANY—form of an entity permitted from 1988, usually a sub-unit of big state enterprise. Groups of workers would often lease space and equipment from their state enterprise; the leasehold is free to accumulate new assets through retained earnings or bank loans, with these assets becoming the property of the leaseholders.

MASS PRIVATIZATION PROGRAM (MPP)—the term used to describe Russia's large-scale privatization program which is the centerpiece of its formal privatization process. It entails the privatization of some 5,000 large state enterprises and gives 16,000 to 20,000 medium-sized enterprises the option of joining the program.

MITI (Japan)—Ministry of International Trade and Industry, Japan's industrial policy agency.

NATIONAL AUCTION CENTER—established in March 1993, based in Moscow. Allows the equity of an enterprise to be sold concurrently through a large number of oblasts. The center is almost exclusively reserved for the very largest enterprises, almost all of which are federally owned properties.

NAV—net asset valuation, value.

NMP—net material product.

NATIONAL NETWORK CENTER—see *National Auction Center.*

OBLAST—region. Oblasts are merely administrative divisions with no titular ethnic group. They are named most often for the largest city within them, which also serves as the oblast center.

OPEN JOINT STOCK COMPANY—a company whose shares can be bought and sold by third parties.

OPIC (U.S.)—Overseas Private Investment Corporation.

PAKT—the Primorsky Manufacturers Shareholders Corporation

PERSONAL PRIVATIZATION ACCOUNTS—are part of an enterprise's social fund. A social fund is composed of such items as a housing fund, wage fund, bonus payments, and, more recently, privatization accounts. Each year part of the enterprise's net income is allocated to the social fund. Employees can use these privatization accounts to finance their share purchases in the closed subscription.

PRIVATIZATION COMMISSION—established at the enterprise level, its composition is determined by the chief executive of an enterprise; by law the commission has to include three to five members, one of whom has to be from the workers' collective. The privatization commission has to lay out a proposal for the sale of the equity remaining after the closed subscription.

PRIVATIZATION—sale of the assets of state-owned enterprises

Small-scale privatization—is under control of municipal authorities. Small enterprises are not to be corporatized and are to be sold for cash through one of the two methods—an auction or commercial tender. Small enterprises are usually retail establishments, restaurants and other service organizations.

'Spontaneous' privatization—the term refers to setting up of cooperatives and leaseholds and outright confiscation by well-placed managers in order to divert profits and assets in the late 1980s and early 1990s.

PRIVATIZATION VOUCHERS—were put on sale on October 1, 1992, valid from December 1, 1992, to July 1, 1994. Each Russian citizen regardless of age, residence, workplace, or income, was eligible to receive one voucher denominated at 10,000 rubles for 25 rubles. Vouchers were accepted by privatization agencies anywhere in the Russian Federation for the sale of state assets. Once received by the agency, vouchers expire. Vouchers are bearer documents and can be used to buy shares of the enterprise in which the voucherholder works, in the auction of any other enterprise in the Russian Federation, or in a commercial or investment tender, exchanged for shares of a voucher investment fund, sold for cash, or used to pay for housing and small-scale property.

PRODUCTION UNIT (PTK)—production technical complex.

PROPERTY—a series of laws passed by Parliament in 1991–92 categorized state property as federal, local (oblast), or municipal and allocated responsibility for privatization to property committees and property funds at the appropriate levels.

PROPERTY FUND—assumes the state's stake in an enterprise from the GKI or KI (as relevant) after corporatization of the enterprise.

Federal (National) Property Fund—a rival agency to the GKI, created by the Russian Parliament. The Fund reports directly to the Parliament. Responsible for sale of the enterprises' shares.

Oblast (Regional, Local) property fund—its head was appointed by and reported to oblast soviet until the latter was abolished in October 1993, following the failed coup. The fund exercises ownership rights on behalf of the state and is responsible for the management and dispersal of the state's remaining stake, such as publishing the legal notice announcing an auction and distributing property titles.

ROSKOMZEM—State Committee on Land Management.

RSFSR—Russian Soviet Federative Socialist Republic, the name used in the former Soviet Union, presently Russian Federation. The Russian Federation consists of eighty-nine subjects, including twenty-one republics, six krais, forty-nine oblasts, ten autonomous okrugs, and the cities of Moscow and St. Petersburg.

RUSSIAN-AMERICAN ENTERPRISE FUND—established by the U.S. government as a venture capital fund to invest in Russian enterprises post-privatization.

RFCSE—Russian Federation Commission on Securities and Exchanges.

RPC—Russian Privatization Center, established as a not-for-profit institution to assist GKI in implementing the privatization program. It has become a recipient of G-7 (donor) funds to assist in post-privatization efforts as well.

SBERBANK—the state savings bank with 42,000 local branches.

SHARE FUND FOR EMPLOYEES OF THE ENTERPRISE (FARP)—allows certain groups of employees to subscribe for up to 5 percent of the enterprise's capital after the closed subscription and the voucher auction. FARP applies to those who could not participate in the closed subscription, such as former or retired employees.

STATE-OWNED ENTERPRISE (SOE)—until 1985 there were some 47,000 state enterprises in the USSR industrial sector. Including energy and large service firms, the total rises to 55,000.

Large-scale SOEs—a category established for privatization purposes, includes a state enterprise with more than 1,000 employees or assets over 50 million rubles as of January 1, 1992.

Medium-size SOEs—neither large nor small, defined by exclusion.

Small-scale SOEs—a category established for privatization purposes, includes a state enterprise with less than 200 employees or assets less than 1 million rubles as of January 1, 1992. They follow a different privatization procedure than large enterprises. All small-scale enterprises (such as retail shops, catering facilities, and consumer services) are under municipal authorities.

SUBSCRIPTION:

Closed equity subscription—the first step in corporatization. Closed subscription allows employees of an enterprise to purchase its assets. It gives Russian managers and workers a right to secure big (often majority) shareholdings before equity is put up for general sale. Employees have three different options available to them.

Open subscription—part of the mass privatization program, sale of the equity remaining after the closed subscription. Three options were available: a voucher auction, a voucher auction combined with commercial tender, and a voucher auction combined with investment tender. Each of these options could also be followed by a sale of shares for cash.

SOVIET—at the federal level, Supreme Soviet, Soviet Union's Parliament; at the local level, local Soviet (Council of Peoples' Deputies).

TENDER:

Commercial tender—in small-scale privatization can include post-privatization conditions for potential bidders, and the highest bidder satisfying these conditions will acquire the enterprise. Restrictions can cover employment, investment, change of business profile, the financing of social programs, and the preservation of historical buildings. Bidding can be open or closed. Commercial tenders have been used for most sales. In large-scale privatization the enterprise is sold (in an auction room or by a sealed bid) to the highest bidder accepting specific conditions.

Investment tender—suitable for large enterprises. The evaluation criteria are not restricted solely to price, but may also include investment, employment guarantees, and other provisions. Investment tender is very rare.

TORG—a huge retail, wholesale, or distribution monopoly, sometimes comprising up to 100 different stores.

TRADE SALES—sale to an investor group, usually through some form of competitive process; privatization technique used in Czech and Slovak Republics and Poland.

VOUCHER AUCTION—part of the mass privatization program, an effective way to disperse outside share ownership and, as a consequence, limit and dilute the influence of outsiders. A minimum of 29 percent of the total equity of an enterprise has to be sold in a voucher auction. Types of auctions include local (regional), national, and inter-oblast. In a typical regional auction, the shares of between five and twenty enterprises are sold at the same time. Bidders must report physically to the voucher auction center or to a satellite bid center within a specified period—normally two to six weeks. Voucherholders have two choices. They can submit any number of vouchers, not specify the number of shares they expect, and accept the strike price that clears the auction. Or they can submit any number of vouchers with a specific maximum price (that is, the maximum number of shares per voucher). Those who bid at or above the strike price are then allocated shares. Those who bid below the strike price do not receive any shares and have their vouchers returned for use in a future auction.

VOUCHER DEPOSITARY NETWORK—established in 1993, it consists of thirty centers around the country; it allows voucherholders to deposit vouchers at one of the centers in exchange for a receipt. The receipt is used to bid at a voucher auction held in other oblasts. At that voucher auction, the authorities verify the receipt by checking through the depositary network to see that vouchers had indeed been deposited at the point of issue of the receipt, and that they had not been used in another auction. On verification, the voucherholder's account is debited.

Note

This glossary was prepared by Enna Karlova of the World Bank's Private Sector Development Department.

Contributors

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