Privatization in Russia: Some Lessons from Eastern Europe

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Throughout Eastern Europe and the former Soviet Union, the collapse of communism has left behind a state enterprise sector without clear incentives or satisfactory governance of state assets. The communist system was a despicable and inefficient system, but it was a system nonetheless. Managers acted according to the commands of supervisory bureaucracies, whether in the government or the Communist Party apparatus. These commands were backed up by terror or at least its threat.

With the demise of the Communist Party, the commands are mercifully gone and so too, inevitably, is the system of enterprise management. In conjunction with macroeconomic stabilization, currency convertibility, and rapid legal reforms introduced by the postcommunist governments, a new and vibrant private enterprise sector is growing with remarkable speed in several countries of Eastern Europe. However, for the large industrial enterprises that remain in the state sector, the collapse of the old system has been followed by a mix of aimlessness, political rent-seeking, asset-stripping, and corruption and not by the clear motivation of wealth-maximization that comes with private ownership.

Not only do state enterprises face a lack of clear incentives for restructuring, but they also face organizational challenges of significant dimension. There is, of course, the need for internal restructuring to adapt to market forces, including changes in accounting practices, the establishment of independent profit centers in large enterprises, the introduction of incentive pay systems, the creation or expansion of marketing and design departments, and so on. At the same time, external shocks, especially the collapse of trade with the former Soviet Union, have abruptly left large numbers of enterprises without their traditional customers and, therefore, in growing financial crisis. These enterprises must find new customers, new products, and often new capital to support restructuring.

Most of these problems can be ameliorated by rapid privatization, but the postcommunist governments in Eastern Europe have generally failed to devise privatization strategies that adequately address the systemic crisis of the state enterprise sector. With the exception of some promising, but not-yet-implemented programs (including the voucher program in Czechoslovakia and the investment fund program in Poland), the Eastern European countries have tended to view privatization as an exercise to be carried forward one enterprise at a time and on a "voluntary" basis, in which various stakeholders in the enterprise are given a veto over the process.

As a result, the vast majority of large enterprises that were in the state sector at the start of the reforms remain in the state sector today and typically are still without any clear path for their future privatization. Enterprises are sometimes stripped of assets by self-dealing managers, in a process that has come to be called "spontaneous" or "nomenklatura" privatization.[1] This kind of uncontrolled behavior of course has cast a shadow over the whole process of privatization in the minds of many citizens.

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[1]For one discussion of spontaneous privatization, in the case of Ukraine, see Simon Johnson and Heidi Kroll (1991) and Sachs (1991).

Even aside from self-dealing managers, a less visible but more pervasive form of decapitalization exists. Workers and state managers, freed from communist suppression, collude to raise wages and salaries sufficiently to absorb the cash flow of the enterprise, absorbing profits, depreciation funds, and so on. Since there are no real representatives of capital income at the firm level, the process runs virtually unabated, and government incomes policies can only partially mitigate the problem. As the enterprise insiders quickly observe, there is no reason to deliver profits to the state budget when compensation can be raised instead. The problem is especially acute in cases where state enterprises are formally under the guidance of worker's councils, as in Poland. The state budget as well as the enterprise's capital investment spending suffers as a result of the excessive wage pressures.

Russia is now embarking on economic reforms with the benefit of Eastern Europe's unsatisfactory experience in the realm of privatization and with spontaneous privatization already raising public distrust. The key task for Russian privatization is to break out of the one-by-one, "voluntary" approach that has frustrated the reforms in Eastern Europe and to adopt transparent and fair privatization methods that address the ownership system on a comprehensive and rapid basis.

I. Lessons from Privatization in Poland

Poland's experience in privatization exemplifies the strengths and weaknesses of Eastern Europe's reforms to date. The Polish economic reforms recognized that the creation of a private-ownership market economy would result from two forces: "bottom–up" privatization, in which new private firms are established and grow; and "top–down" privatization, in which state assets are transferred to private owners. The wide-ranging measures of liberalization and stabilization initiated at the start of 1990 were designed to foster the bottom–up privatization, while the Privatization Law of July 1990 was to provide the basic framework for the top–down program (see David Lipton and Sachs [1990a] for an overview of the Polish economic reforms, and see Lipton and Sachs [1990b] for an early discussion of Poland's privatization strategy).

The development of new private enterprises has proceeded rapidly, with the creation of more than 500,000 individual proprietorships between December 31, 1989, and September 30, 1991, mostly in domestic trade and services.[2] In addition, there has been an increase of around 34,000 private commercial companies (including partnerships, limited-liability companies, and joint-stock companies) between the end of 1989 and the end of 1991, with an increase of around 6,000 in industry.[3]

Top–down privatization, on the other hand, offers a mixed record. There has been an overwhelming success in privatizing small shops previously in the state-trading sector. An estimated 50,000 or so shops have been leased or sold, mostly under the responsibility of local governments. Small industrial enterprises, with employment of around 500 workers, have also been privatized in reasonably significant numbers, through a process known as "liquidation." The state-owned company is legally wound up, and the assets of the company are sold or leased to a group of managers and workers, typically with provisions for full purchase of the assets on an installment basis. Through this procedure, more than 500 enterprises have been privatized.

It is in the area of large industrial enterprises where the failures of the privatization process have been manifest. The Privatization Law was crafted with so-called "British-style" privatization in mind, in which enterprises are "prepared" and sold on a one-by-one basis.

[2]The total number of "individual business establishments" (self-proprietorships) rose from 813,500 at the end of 1989 to 1,365,600 at the end of September 1991 (see *Biuletyn Statystyczny*, 1991 table 36).

[3]Commercial law partnerships increased from 11,693 at the end of 1989 to 45,077 at the end of 1991, while the number in industry rose from 2,769 to 8,676 (see table 35 in *Biuletyn Statystyczny* Nos. 5 and 12 (1991).

In the dominant track foreseen in the law, each enterprise is to be privatized on an ad hoc basis, after receiving the go-ahead from the workers' council, the management, and the bureaucratic "founding organ" (typically the Ministry of Industry). Thus, each of the stakeholders is given a veto in the process, as well as the incentive to hold out for the privatization option most favorable to their particular interests. Once a privatization plan is approved, the enterprise is converted to a Treasury-owned joint-stock company, a process termed "commercialization." The privatization is then to be carried forward, as was done in Britain in the 1980's, by a public offering of shares, or through trade sales or some other means. The workers have the preferential right to purchase shares at half price for up to 20 percent of the shares, or up to a savings of one-year's wage, whichever is less.

Predictably, the law has been a failure on several counts. First, the procedures have been extremely burdensome, since the need for multiple approvals to begin privatization has simply invited open-ended wrangling, as well as lobbying in the Parliament, delays by the Ministry of Industry (which does not want to lose its current stake in the enterprises), and of course self-serving maneuvers of managers and workers' councils. The law has probably undermined property rights, rather than clarified them, since it has invited a proliferation of claims over the enterprises.[4]

Second, the standard methods of sales have (not surprisingly) proved to be time-consuming and expensive, as in the cases of Western Europe. Contrary to wildly optimistic predictions of several international investment bankers and the International Finance Corporation of the World Bank, that hundreds of privatizations through public offerings could be achieved by the end of 1991, only about a dozen enterprises have actually been privatized in this manner. Trade sales, also championed by the investment bankers, have similarly been limited to a few dozen enterprises at most.

In the meantime, hundreds of large state enterprises (with more than 1,000 workers each) and thousands of state enterprises overall, have remained without any ownership restructuring whatsoever. These enterprises continue to be governed by workers' councils, managers, and the bureaucracy. Managerial authority is sufficiently watered down by workers' councils, and the long-range ownership and economic prospects of the enterprises are so clouded that the behavior of workers and managers tends to be exceedingly short-sighted and geared to wage increases, asset-stripping, and job protection, rather than to long-run restructuring.

Social support for privatization has naturally waned under these delays. The continuing industrial crisis is widely blamed on the economic reform program, rather than on the failure to proceed with real privatization. Many pundits call for a strengthened role of the Ministry of Industry, on the grounds that the "market approach" has already been tried.

The one bright spot is Poland's Mass Privatization Program (MPP), which explicitly abandons the one-by-one approach in favor of a systemic approach.[5] Under the MPP, hundreds of medium- and large-scale industrial enterprises are to be converted, en masse, to corporate form. During 1992, shares are to be distributed, free of charge, to licensed portfolio investment funds. Workers in each industrial enterprise will also be entitled to receive 10 percent of the enterprise shares free of charge. In turn,

[4]The Privatization Law also allows the Council of Ministers of the Polish Government to mandate the commercialization of an enterprise, without the approval of the stakeholders, but the government has been extremely reluctant to use that path, after championing the other "voluntary" route.

[5]For an early description of the program, see Polish Ministry of Ownership Changes (1991). The program has been considerably refined since that time, though the broad outlines remain unchanged. Further details are described in an internal document (Polish Ministry of Privatization, 1991).

the investment fund shares are to be distributed at low cost (or no cost) to Polish households.

The investment funds will provide corporate governance, by appointing supervisory boards of the industrial companies in their portfolios. Households will be free to trade their shares of the investment funds, and the investment funds, of course, will be free to trade the shares of the portfolio companies. The plan is currently being carried forward, though final approval by Parliament will be required in 1992 for some steps of the process.

II. Privatization in Russia

Russia faces problems even more daunting than Eastern Europe in its privatization program, and it could very well fall into the same traps if it fails to draw conclusions from the experience of its neighbors. In the former Soviet Union, there were an estimated 45,000 state enterprises (compared with around 8,000 in Poland). Moreover, the diffusion of implicit property rights among workers, managers, and the bureaucracy that has made a "voluntary, one-by-one" approach unworkable in Eastern Europe is further exacerbated in Russia by the additional claims of regional and local governments. Regional and local authorities are naturally more insistent in a country with a collapsed central administration that extends over 11 time zones. The power of the Russian Federal Government to press for privatization may well be crippled by powerful local politicians more interested in enhancing their political authority than in developing a market-based economy.

Therefore, if the Russian Government is to succeed in achieving widespread privatization of industry, it will almost surely have to adopt several basic strategies in the privatization process. Most importantly, the Russian Government should look for *across-the-board* mechanisms of privatization, in which thousands of industrial enterprises are moved along the privatization process simultaneously, in a manner that reflects the implicit ownership claims that now exist without letting those implicit claims derail the privatization process itself.

For large enterprises, the key initial step should be a mass commercialization of enterprises, in which thousands of enterprises are transformed into joint-stock company form, with the initial claims over the shares reflecting the balance of interests in the enterprises. For example, workers and managers should immediately receive a "tranche" of shares, while the equitable interest in the balance of the shares would be divided between the federal government and the local authorities. This could be accomplished by actually dividing up the equity ownership at the start or by earmarking the revenues from share privatization to the various levels of government in a predetermined pattern. The new privatization program of the Russian government moves in this direction, in part calling for the free distribution of 25 percent of the shares to the workers, though it does not specify whether commercialization will be carried out on an across-the-board basis.[6]

Once mass commercialization is accomplished, and after an initial distribution of shares to the workers and managers, new supervisory boards of the corporatized enterprises could be assigned legal responsibilities for privatizing another tranche of the shares, sufficient to bring the privatized equity to over 51 percent. The Federal Government would establish basic fiduciary responsibilities for the sale of this tranche of shares (including guidelines on conflict of interest, public disclosure, pricing, etc.) and could retain veto power over certain transactions, but the responsibility would lie with

[6]See Decree No. 341 of the Russian Federation (1991). The decree provides some methods of allocating shares and the revenues from sales of shares among various potential classes of claimants, including workers, managers, local government, and the Federal Government. The most noteworthy feature is the decision to grant 25 percent of the shares of workers. The decree will be further refined in a program of privatization for 1992 to be submitted to the Russian Parliament by March 1, 1992.

the enterprise boards to complete the privatization of their designated tranche within a specified time period, say one year. Mass commercialization would enormously improve the prospects for fundamental economic transformation and, quite possibly, the performance of the enterprises even before full privatization.[7] Most importantly, it would define ownership stakes clearly, as a preparation for further privatization, avoiding the kinds of open-ended bargaining and squabbling that have slowed privatization of large enterprises in Poland or the kind of unchecked self-dealing in "spontaneous privatization" processes. It would make possible the rapid distribution of a minority stake, say 25 percent, to the workers, a move that would not only spur privatization but would also help to establish a social and political base for the overall reform program.

Crucially, mass commercialization would also provide a system of enterprise governance, in a situation where no clear governance now exists. A supervisory board would be appointed for each enterprise, bound by the standard responsibilities defined in European and American corporate law. The supervisory board would monitor the manager to prevent self-dealing, to approve management plans, and to monitor compensation arrangements. While the initial Supervisory Board would probably not act with the motivation and authority of a board elected by real private owners, it would still be superior to management by a workers' council (as in Poland) or to management by a completely unsupervised manager, or an intrusive branch ministry subject to strong political or bureaucratic influences.

Under most plausible scenarios, the government will retain a sizable minority equity stake in most industrial enterprises. During 1993 and 1994, it would be possible to divest those equities in a number of ways, including further sales to insiders (workers and managers), transfers of shares to investment funds (as in Poland's MPP), voucher sales (as in Czechoslovakia), or conventional trade sales, public offerings, and joint ventures (as in "British-style" privatization). Assuming that the initial steps are undertaken, the urgency of completing these remaining measures would be somewhat reduced.

For retail shops, Russia should follow the highly successful experience of Eastern Europe, by auctioning the units under the supervision of municipal governments. For small- and medium-size industrial enterprises, worker–management buyouts, on a concessionary and leveraged basis, provide the best hope for rapid progress, as has been seen in Hungary and Poland. Once again, major responsibility for the smaller firms can be left with regional and local authorities, assuming that the strict overall instruction to privatize the enterprises can be monitored and enforced.

Special and urgent attention should be directed to commercialization and privatization of the large state banks. It might be thought, erroneously, that the banks could be among the last enterprises to be privatized, but the experience of Eastern Europe teaches otherwise. Commercial banks have a vital role to play in the governance of industrial enterprises, not only as creditors, but also as equity holders. When an industrial firm falls into financial distress, the commercial banks must have sensible incentives to restrict new lending, to enforce managerial discipline in the enterprise, and if necessary to convert debt into equity as part of a financial workout. When the commercial banks are themselves bureaucratic organs of the state, the incentive to carry out these functions is naturally dulled, as has been seen in Poland during 1990–1991.

[7]It is widely believed that New Zealand's program of mass commercialization of its state enterprises improved their performance markedly (see Robert E. Anderson, 1990).

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