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Myths and Realities of Privatization in Russia

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Privatization is unquestionably one of the most contentious issues facing the formerly centrally planned economies making the transition to a more market-oriented economic system. That there should be such a transition is no longer very controversial; but there is still much debate about the best structure of ownership and control for enterprises in the emerging market system. Among the competing visions are a decentralized system of autonomous public enterprises, various forms of worker control and external shareholder ownership along conventional capitalist lines.

In Russia the debates over privatization policy have been especially intense in regard to the roughly 20,000 medium- and large-scale state enterprises which account for the lion's share of overall industrial productive capacity. There has emerged a substantial consensus that such enterprises should first be "corporatized" — i.e., transformed into independent joint-stock companies. There remain, however, major disagreements over the way in which the ownership of enterprise shares should then be structured.

Two competing models represent the primary dimension of the Russian debate. Those leaning to the Right of the political-economic spectrum hope to assure that enterprise management will be accountable strictly to owners of capital. They favor external ownership, in which a controlling share of stocks is held by outsiders — i.e., people whose attachment to the enterprise is based on an ownership stake rather than on work within the enterprise.[1] Those leaning to the Left hope to assure a significant role for workers in enterprise governance. They favor internal ownership, in which a controlling share of stocks is held by insiders — i.e., workers and managers of the enterprise itself.[2]

The external ownership model has several possible variants, depending on the ultimate locus of effective control and the terms on which shares are made available to buyers. The simplest variant is for the government

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to sell shares of corporatized state enterprises in an open market, with the hope that a "strategic investor" (domestic or foreign) will turn up and take over control or in the expectation that an active stock market would discipline management even in a context where share ownership is widely dispersed among many small investors. A more complex variant involves the establishment of strong financial intermediary institutions (holding companies, mutual funds, etc.), which would be expected to buy controlling packets of shares in companies and proceed to restructure and monitor them.

External ownership means in principle that enterprise decisions will be guided solely by the objective of maximizing the return on investors' capital.[3] The economic case for outsider control is based mainly on its putative advantages with respect to the efficiency of allocation of capital and labor, both across the whole economy and within individual enterprises. Outsiders can be expected to proceed more rapidly and more ruthlessly than insiders to shift capital from one activity to another and to restructure individual enterprises, not hesitating to liquidate unprofitable assets and to dismiss redundant workers. Outsider control is also considered by its advocates to assure better access to capital markets to mobilize new funds for investment, since potential investors (domestic or foreign) are more likely to make available their funds if they can gain control over the way in which they are utilized. Finally, outsider control is considered to be more conducive to technological change — in that outsiders will not be concerned about the potential job displacement implied by the adoption of new techniques of production. All of these efficiency advantages presume that shareholder interests will be effectively brought to bear upon management.

The internal ownership model also comes in several variants, depending on the enterprise ownership structure and the terms on which shares are made available to buyers. Insiders could collectively own all the shares of the enterprise and collectively control the firm, or they could individually own a controlling fraction of separable shares. Insider ownership is consistent with managerial control, with worker control, or with any combination of the two.

Insider ownership means that enterprise decisions will be guided not solely by the objective of maximizing profits but also by the interest of managers and/or workers in assuring the continuity and stability of the enterprise and its work force.[4] The fact that insider control is more conducive to long-term employment relationships brings both advantages and disadvantages with respect to economic performance. The greater degree of enterprise stability associated with insider control may encourage more salvaging of existing capital stock and greater utilization of the accumulated experience and firm-specific knowledge of enterprise managers and workers. More stable employment patterns can enhance worker motivation to work hard and to contribute to the long-term improvement of the firm. On the other hand, insider control will limit the flexibility of reallocation of capital and labor, and it may discourage potential new capital investment. But the case for insider control rests not just on its implications for conventionally defined economic efficiency: greater employment security at the enterprise level contributes to economic welfare at the society-wide level insofar as it reduces the burden of economic dislocation and unemployment.

The external and internal ownership models are embodied, respectively, in the two major privatization options for medium- and large-scale enterprises contained in the Government Privatization Program for the Russian Federation — the document which has governed the process of privatization in Russia since its passage by the Russian Parliament in June 1992.[5] The employees of each enterprise, voting as members of their worker collective,[6] choose among privatization options including the following:

Option #1: Insiders receive 25% of all shares gratis, but these are nonvoting (unless and until sold). Workers have the opportunity to buy another 10% of (voting) shares, and administrative officers have the opportunity to buy another 5% of (voting) shares, at highly concessional rates. The remaining shares — at least 60% of the total and 80% of voting shares — are sold through public auctions in which foreigners as well as domestic citizens can participate.

Option #2: Insiders can buy voting shares up to 51% of the total authorized capital, at a charge of 1.7 times the book value of the assets (a rate that is quite concessional); however, they are precluded from obtaining credit toward such share purchases from any state financial institution. The remaining shares are sold through public auctions. This option can be selected by enterprise employees only if supported by at least two-thirds of the voting members of the worker collective — failing which option #1 goes into effect.

The terms of the two major privatization options reflect the fact that the external control model of option #1 was clearly preferred by the economists within the Yeltsin Administration who first drafted the privatization program. Option #2 resulted from pressure brought by a majority of members of the (old) Russian Parliament who favored insider control.[7]

MYTHS ON THE RIGHT

Many supporters of external ownership cling to comfortable beliefs about outsider control which simply do not stand up to closer scrutiny of the Russian environment. I list below some of these myths and confront each with the corresponding reality.

1. *It is possible in the foreseeable future to convert the bulk of Russia's medium- and large-scale state enterprises into conventional capitalist external-shareholder-controlled firms*. It is certainly possible to transform these enterprises into joint-stock companies, and by the end of 1993, this had already been accomplished for several thousand such enterprises.[8] The main problem in moving to widespread external control is that there are only a limited number of potential investors (including foreigners as well as domestic citizens, investment funds as well as individuals) with both the resources to take over controlling shares and a strong interest in doing so. Interest is lacking among outsiders both because many of the enterprises appear unlikely to be profitable in the foreseeable future and because there is real doubt about whether much profit is likely to be distributed to shareholders even in the case of an enterprise that is doing well.

2. *By structuring the choice of privatization options in such a way as to favor option #1, Russian economic reformers have assured that a majority of the equity in transformed state enterprises will go to private external shareholders*. Contrary to expectations, workers in medium- and large-scale enterprises have been voting heavily in favor of option #2 rather than option #1.[9] In most of the enterprises in which option #2 has been chosen, insiders have acquired at least 50% of the shares; though they can in principle sell these shares to outsiders, there is no sign of an active secondary market. Even where the vote has gone in favor of option #1, insiders have often been able to acquire a significant fraction of voting shares; and in many cases a substantial amount of equity remains in government hands.

3. *Where it can be achieved, external ownership and control of transformed Russian state enterprises will lead to significantly improved enterprise efficiency and productivity*. The economic case for external ownership is based on two important premises: (1) that outside owners and/or active stock markets can discipline managers so that they act in the interests of long-run company profitability, and (2) that company profitability itself is a good measure of enterprise performance. But in Russia capital market institutions are in their infancy, and the economic

environment is replete with noncompetitive and incomplete markets as well as positive and negative externalities. Unless and until these conditions can be significantly ameliorated, there is little prospect that external ownership will have much of a salutary effect on enterprise performance.

4. *Externally owned Russian firms will succeed in attracting much-needed capital investment funds from foreign investors, since these investors will be able to gain some control as well as the prospect of future returns with their investments.* In the current volatile political and economic climate in Russia, foreign investment is — and is correctly perceived to be — extraordinarily risky. Potential investors in Russia therefore look for quick returns (e.g., in trade and raw materials) and are not inclined to commit funds to productive ventures with a long-term payoff. Even if and when the political and economic environment becomes more stable, foreign investors can be expected to play an important role only in a small fraction of privatized Russian state enterprises.

MYTHS ON THE LEFT

Supporters of internal ownership are not without their own illusions about the privatization process in Russia, which also need to be confronted with the corresponding Russian reality.

1. *The evolution of ownership rights over Russian medium- and large-scale state enterprises during the late Soviet period of "perestroika" under Mikhail Gorbachev generated significant momentum toward the establishment of genuine worker control.* Although the establishment of worker collectives in Russian state enterprises in the late 1980s, and the collapse of central state authority in the early 1990s, gave workers more influence over decisions in state enterprises than they had ever had in the past, workers did not come close to exercising real control over management. Leaders of worker collectives typically allied themselves with enterprise managers, and they had some success in enlisting management support for employment maintenance and higher wages. Even in the relatively limited number of cases of state enterprises subject to leveraged buyouts by their employees, however, managers almost invariably emerged in full control of decision-making.

2. *In voting for option #2 in the great majority of cases under the current government program of privatization of Russian state enterprises, workers are clearly laying the basis for a significant degree of workers'*

control. A great majority of the votes have indeed gone in favor of option #2, and this is assuring insider control of the vast majority of medium- and large-scale state enterprises. However, in virtually all these cases it is insider managers who are thereby enabled to maintain control over enterprise decision-making, with the formal or informal support of workers. To be sure, managers have been inclined to support workers' interest in employment security and higher wages; but workers play a very passive role in enterprise governance. As and when management and workers' interests come into conflict, managers will be able to take advantage of their superior resources, knowledge and experience in any contest for enterprise control.

3. *Insider ownership and control of transformed Russian state enterprises will lead to significantly improved enterprise efficiency and productivity.* Because insider ownership is not really empowering workers in any significant sense, it is unrealistic to expect that the motivation for or attitudes toward work will change appreciably. The preservation of accumulated manager and worker skills will enable past performance levels to continue but not necessarily to improve. What insider ownership mainly does is to assure somewhat greater enterprise longevity and job security than would outsider ownership. This may well save some of the external social costs of high unemployment, but it is unlikely to bolster significantly the micro-level productivity of specific enterprises.

4. *Insider-controlled firms will be able to make up for their lack of appeal to potential external investors by getting substantial finance from government agencies to undertake much-needed capital investment.* Russian government agencies at all levels are starved of resources, and their ability to collect taxes has diminished greatly. There are already huge demands on available budgetary resources to meet desperate needs in the areas of both social and economic-infrastructural programs, so it is highly unrealistic to expect much state funding for enterprise investment.

CONCLUSIONS

It appears that the reality of the Russian environment will make it very difficult for the preferred model of enterprise ownership and control of either the Right or the Left to emerge. The strong tendency toward forms of insider ownership and manager control in Russia, notwithstanding policymaker preference for outsider ownership and control, means that hopes on the Right for rapid capital reallocation and ruthless enterprise restructuring will remain unfulfilled. But hopes on the Left for genuine economic democracy appear now to be equally quixotic. What then can we expect of the process of privatization in Russia?

The vast majority of state enterprises will become neither conventional capitalist firms nor worker-controlled enterprises in the foreseeable future. Instead, they will be transformed into joint-stock companies owned by some combination of insiders, outsiders and government agencies; insiders will most often hold controlling shares, and companies will be predominantly under the control of the same managers who have been running them for many years. Some enterprises may be captured by outsiders — often elements of the "mafia," i.e., those merchants and traders who have amassed fortunes unscrupulously, if not illegally, and who are looking for ways to launder their accumulated cash. But a much larger proportion of enterprises will be dominated by insiders — typically members of the "nomenklatura," i.e., the former Communist Party elites who have managed to parlay their privileged positions in government or industry in the old centralized system into advantageous positions of ownership and control in the new decentralized order.[10]

Yet the implications of these developments are not all bad. First, the decentralization of ownership and control rights from central state officials to enterprise managers does constitute one necessary — if not sufficient — step toward improved enterprise performance. Managers will have an increasing stake in the profitability of their own enterprises as a consequence of their insider share ownership. If the greater autonomy and profit orientation of enterprise managers is to lead to overall economic efficiency, however, the state will have to play an important role in assuring that the individual economic interests of managers conform much more closely to national economic objectives.

Second, although workers are unlikely to have much direct involvement in enterprise decision-making, they will be able to exert considerable pressure on management to avoid large-scale enterprise downsizing and layoffs. Insider control will thus slow down the process of restructuring; but it will help to avert what would otherwise be unmanageable social, political and economic problems of labor and community dislocation — for which there simply are not and will not be in the foreseeable future adequate publicly funded "social safety nets."

In general, the economic performance of any given enterprise will depend much more on the wider economic environment in which it is operating than on the particular pattern of ownership and control of the enterprise itself. The economy bequeathed to Russia by the Soviet system was characterized by a multifaceted interdependence of monopolistic enterprises, giving rise to huge coordination problems which were previously resolved by central planning. The wider environment of Russian enterprises now involves highly imperfect markets, rampant externalities, economically arbitrary access to credit and many other symptoms of inadequate labor and capital market infrastructural institutions. The link between enterprise profitability and overall economic efficiency is thus extremely weak, and it is a major challenge to the state to assure that the profitability of an enterprise begins to approximate its contribution to the nation's overall economic welfare.

From the perspective of economic performance, then, it will be far more important to reform the external environment than to alter the internal structure of Russian enterprises. Among the necessary reforms are the development of legal and accounting frameworks, financial intermediaries, regulatory bodies, worker retraining facilities, housing markets and other such capital and labor market infrastructural institutions. Inter-enterprise coordination problems must be addressed by new forms of government intervention (short of central planning), and greater product market competition must be fostered. Government grants and loans need to be provided to enterprises not on an economically arbitrary basis, but so as to assure that these funds create incentives for enterprises to meet important national goals. To restructure the external environment of firms in all these ways will clearly require a very substantial expenditure of public funds; restoring the depleted revenue base of the Russian government is thus an essential element in the overall economic reform effort.

Although the battle over the internal structure of Russian state enterprises appears not to be critical to Russia's economic performance in the coming years, it is still important for other reasons. Whether these enterprises become owned and controlled primarily by outsiders or by insiders will influence the nature of the social system toward which Russia is evolving. If workers end up selling most of the individual shares they now own, then outsider ownership is likely to become the norm and Russia will evolve into a relatively pure capitalist system along Anglo-Saxon lines. On the other hand, if insider ownership continues to predominate, it is more likely that Russia will develop into an alternative type of market system — one in which social restraints on the operation of unfettered markets are more widespread. Insider ownership even holds out the possibility that some kinds of labor-managed firms could evolve in the future — but such a development would require that workers mobilize to transform their currently passive enterprise ownership stakes into a basis for genuine worker control.

NOTES

1. Outsiders may be individual owners or shareholders, or they may be institutional shareholders (i.e., financial intermediaries such as banks, mutual funds, holding companies and investment funds). Although government agencies are technically also

outsiders, in the present context it is best to consider them as a separate category of shareholder.

2. An insider-controlled firm may be effectively controlled by its managers, by its workers, or by some combination of the two; workers can exercise control either directly or indirectly via the election of representatives to a workers' council.

3. See Boycko, Shleifer and Vishny (1992) for a good statement of the case for external ownership.

4. For a broad comparative review of the potential advantages of insider employee ownership, see Ben-Ner (1993).

5. There is also a third privatization option of relatively minor significance. For a more detailed discussion of the whole Russian Government Privatization Program of 1992, see Bim, Jones and Weisskopf (1994).

6. Strictly speaking, a "worker collective" includes all employees working within a given enterprise except for top administrative officers. The Russian privatization legislation, however, defines the term somewhat more broadly to include not only those currently working in the enterprise but also those workers who have retired or been laid off in recent years.

7. For more details on the struggle between the Yeltsin Administration and its parliamentary opponents over the nature of the privatization program, see Bim, Jones and Weisskopf (1994).

8. Boycko, Shleifer and Vishny (1993) report that by July 1993 almost 40% of the roughly 5000 medium- and large-scale enterprises slated for mandatory privatization in the 1992 Government Program had been registered as joint-stock companies; both the number of medium- and large-scale enterprises slated for privatization and the number corporatized have continued to increase since then.

9. According to figures presented in Boycko, Shleifer and Vishny (1993), workers chose option #2 in 79% and option #1 in 21% of the enterprises where voting had been completed by July 1993.

10. See Gimpelson (1993) for an analysis of the backgrounds of Russia's "new entrepreneurs"; he distinguishes between former party-state officials and state enterprise directors, both of whom I include in the "nomenklatura."

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