

Privatization in Russia Offers Lessons for Others

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The Russian privatization program has been highly controversial. Some allege that it has been purely cosmetic, at best meaningless and at worst contributing to the criminalization of Russia's economy. Besides the blatant corruption associated with some transactions, the most criticized aspect of the program regards the massive advantages given to enterprise managers and other employees in acquiring shares in firms in which they work. Indeed, the rate of employee ownership that has emerged from the privatization process is huge by any standard. Given most enterprises' urgent need for extensive and painful restructuring, a program that has so actively promoted inside ownership and discouraged outsiders' entry would hardly seem appropriate.

Other observers have defended Russia's program as the best that was politically feasible. (See, for example, the views of Russia's securities commission chairman, Dmitry Vasiliev, in *Economic Reform Today*, No. 1, 1999.) Taking

into consideration continued communist domination of the Duma and the lack of an organized lobby for outsider privatization—whether through sales to core investors or through a Czech-style voucher scheme—the only alternative to continued state ownership may have been to cede majority control to insiders. According to this view, the program has at least led to improved corporate governance and restructuring by “depoliticizing” the enterprise-state relationship. It has also created some openings for outside investors.

Economic Effects

Leaving aside the question of political feasibility, we can group in five categories the arguments concerning the economic effects of the Russian privatization program. The first is the likelihood that the ownership structure created by the privatization process will persist. If the employee-owners (particularly rank-and-file workers) were to sell their shares quickly to outside investors, then the initial predominance of employee ownership wouldn't matter in the longer run. Post-war Japan is one example of where this has happened. Even without a rapid sell off, the need for the “right kind” of outsiders—who would bring in fresh capital and new technologies and mar-

kets—may gradually persuade the insiders to accept outside participation in decision making as well. This is more likely for the viable firms, however, because the nonviable ones will starve for lack of capital. Likewise, the dispersion of outside ownership, encouraged by the privatization program design, may be rectified by subsequent secondary sales to concentrated institutional investors.

But while Russian policymakers and analysts may have expected *ex ante* that employees would sell their shares quickly, in fact the rate of sale by employees to outsiders and by individuals to institutions has been slow. As a result, there has been little change in the ownership structure created by the give-away phase of the privatization process, which embraced both the early period of lease-buyouts and the subsequent state privatization program (using vouchers; for further details of this program read *Economic Reform Today*, No. 4, 1995, pp. 10-14.)

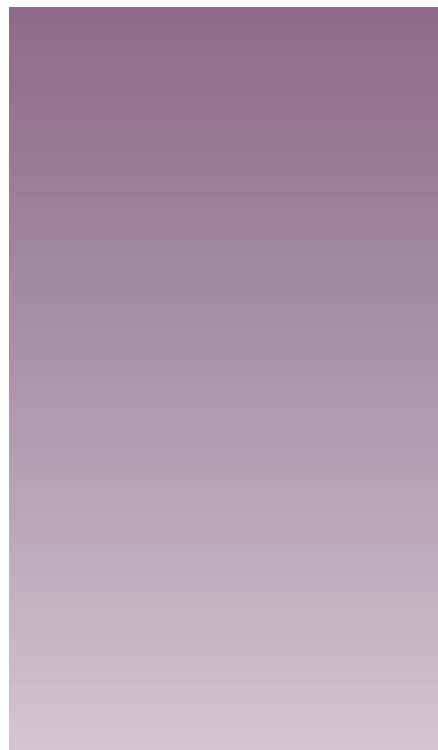
Several factors could account for this. Major ones are employees' desire to retain control of their companies and their lives—an aspect often ignored—the tradition of solidarity among Russian workers and the central place occupied by the enterprise and the employment relationship in society, and the fact

that little would be gained from selling given the poor functioning of Russia's capital markets. Even if the urgent need for fresh capital were to encourage insiders to negotiate, information and governance problems may inhibit outsiders from buying shares.

The ownership structure has changed little since June 1994 because the rate of privatization decreased substantially. After the conclusion of the voucher program, many of the remaining state-owned shares in partially privatized companies were supposed to be sold by tender or auction in "investment sales" to concentrated outside investors. Notwithstanding some highly publicized deals (and scandals), such sales have proceeded slowly, consistent with experience in most East European countries.

Second, proponents of the privatization program sometimes argue that employee ownership is beneficial in Russia because enterprise managers remain in firm control. But the program's detractors may respond that while managerial ownership may solve one kind of governance problem, it also creates others, particularly with respect to providers of outside equity or debt. More seriously, the advantages of managerial ownership entail not only the proper provision of incentives to the existing management, but also the allocation of managerial talent across positions and firms. Even if managerial ownership is sometimes desirable, the inherited stock of Soviet managers may not be the most appropriate under Russia's new conditions. The benefits of improved incentives may pale compared with the costs of entrenching the incumbents. While trade-offs between these two effects may exist in corporations in the industrialized countries, managerial entrenchment may be particularly costly in Russia due to the inherited misallocation of human

capital. Third, promoters of insider privatization may claim that employee ownership offers some advantages, such as improved incentives and opportunities for participation by individuals who know how productivity could be increased. They also can say that workers may be better able to decide where painful cuts are required. But while a case may be made for employee ownership in declining firms (and where employees may choose the optimal rate of shutdown), employees are not the best persons to decide how to re-



structure a viable firm.

In developed market economies, employee ownership works best in relatively small, homogeneous companies, where divisive distributional conflicts are rare. Such conflicts are endemic in the transition, however, if resources have been systematically misallocated and uncertainty about the outcomes from any particular type of restructuring may make agreement impossible. Even if employees could set up a compensation mechanism to ensure that all of the staff would gain

from restructuring (to turn a potential into an actual Pareto improvement), in practice, the transaction costs of carrying this out are likely to be exorbitant. As a consequence, employees may find it difficult to agree on many changes since any change will impose costs on someone, and the uncertainty connected with the distribution of costs and benefits will lead to a status-quo bias.

Fourth, defenders of Russia's insider privatization may point out that outside investors are severely handicapped in an environment where contracts are, at best, poorly enforced and where they may have great difficulty imposing restructuring that hurts the incumbent management and workers. They claim that employee ownership may be better to foster the development of property rights because the ability of outside owners to exercise their nominal rights will be very limited. On the other hand, the program's detractors could respond that the legal environment in Russia has been inhospitable for outside investors anyway. A policy that has ratified and legitimized insider control, making it the norm in the economy, has only bolstered that inhospitality. Not only has the privatization program granted huge preferences to insiders, it has also discouraged the concentration among outsiders of whatever shareholdings remained after the insiders had essentially had their pick.

Finally, the defender of insider privatization may allege that the current pool of potential "outside" owners in Russia is hardly of better quality than the insiders. Even leaving aside the mafia and criminal elements, many outsiders (including banks and other firms) may be just as interested in asset-stripping as in value-maximisation. The opponent might retort that while terms such as "investment fund" or "bank" may have a funda-

Putting Privatization Online

Privatization is well underway in many parts of the former Soviet bloc—in fact, the process is largely completed in many Central and Eastern European countries. Russia, like most countries in the region, has tried various techniques to divest itself of its state-owned assets, with mixed results. Now, however, it is about to try an innovative approach to privatization marketing: Its government will soon join its regional neighbors in offering companies for sale to international investors via the Internet.

Previous privatization efforts have fallen short. The privatization process in Russia can be divided into three major phases. The mass privatization program (1992-94) was the first, when vouchers were issued to all citizens. This actually resulted in most enterprises falling under the control of existing managers and other insiders. In the second phase (1995-97) the emphasis shifted to sales of larger, high-value enterprises to financial/industrial groups and included a “loan-for-shares” scheme. The likely result of this program is the transfer of share ownership—at knockdown prices—to a privileged few when the loans come due in the year 2000.

Considerable criticism accompanied these privatization efforts. Russians actually refer to the process as “*prikhvatizatsiia*”—“grab-ization”—rather than *privati-*

zatsiia. As a result the third phase of privatization, from 1998 on, has seen the government trying various measures to make the process more fair and transparent, including dropping restrictions on foreign participation and instituting the valuation of assets by international advisors. Even so, the Russian government has thus far met with little success in selling blue-chip companies at the targeted price through “case-by-case” privatization.

In 1997, Russia received \$4.2 billion in privatization revenues, according to the World Bank’s *Global Development Finance* report. Although this represented more than a threefold increase over 1996 figures, early estimates for 1998 indicate that trend has not been sustained. Foreign direct investment (FDI) in Russia has also been disappointing, reaching only \$1.5 billion in 1998. This works out to be an investment of \$10 per capita basis, compared to much higher levels of foreign investment in Slovakia (\$350), Poland (\$700), Czech Republic (\$800), and Hungary (\$2,000).

Against this backdrop the World Bank is launching PrivatizationLink Russia. The project will use Internet technology to facilitate continued privatization and to increase the foreign investor involvement in developing the country’s private sector. PrivatizationLink Russia will develop a free, online service pro-

viding updates on privatization-related investment opportunities in Russia, as well as relevant background information for investors interested in bidding for assets to be sold. The ultimate goal is to encourage an equitable and transparent process for future case-by-case privatization efforts in Russia.

The World Bank Group’s Multilateral Investment Guarantee Agency (MIGA) is the lead agency developing the project, and the Central and Eastern Europe branch of the Canadian International Development Agency (CIDA) will provide funding for the requisite field work and software development. Privatization specialists from the World Bank European and Central Asian regions will assist in implementing the plan. In Russia, the Federal Property Fund and the Ministry of State Property will represent the government in this initiative.

PrivatizationLink Russia will broaden access to key data needed by potential purchasers of state properties. It will provide company profiles, requisite legal and procedural guidelines, historic program data, and other business information. The project workplan entails data collection, database development, Web site development, and training in information technology and management. It will also examine environmental and social issues related to privatization. Inter-

mentally different meaning in Russia than they do in a market economy, Russia’s privatization program nevertheless could have done much more to develop institutional and core investors. This brings the

argument back to the question of political feasibility.

Despite the widespread attention paid to these debates, in both Russia and the West and in both policymaking and academic circles, lit-

tle empirical evidence is available to evaluate these questions:

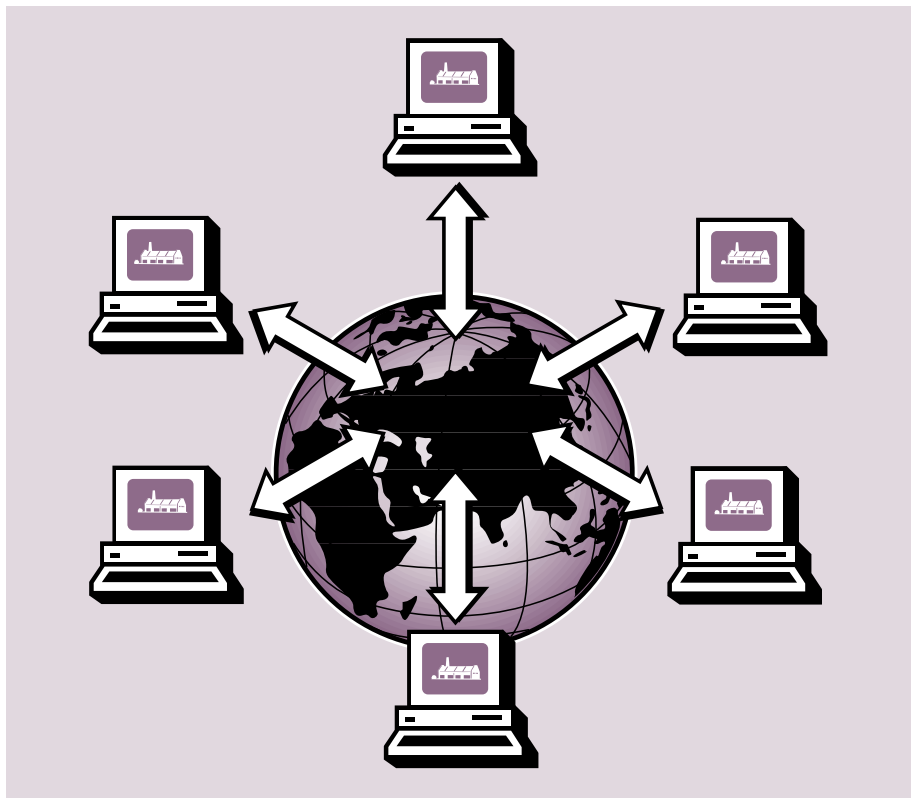
◆ Does the dominance of insider ownership rule out any possible influence of outside owners in Russia?

national conferences and an array of Internet-based marketing initiatives will provide much-needed international promotion of the companies offered for sale.

The PrivatizationLink Russia project builds on MIGA's existing PrivatizationLink service (<http://www.privatizationlink.com>), which has successfully become the leading Internet conduit for worldwide marketing of privatization projects. Launched June 1998, PrivatizationLink regularly hosts more than 300 company profiles from 50 countries, which are broken down by country and sector. In Eastern Europe and Central Asia, privatization agencies in 23 of the 27 countries now have data online, either hosted on their own Web site or on the PrivatizationLink server.

Transaction-related content is complemented by specialized news feeds, directories of major organizations active in the sector, and a virtual library on privatization issues. The service offers immediate worldwide access to data on privatization opportunities and provides privatization agencies a low-cost means of reaching potential domestic and foreign investors. MIGA has been using the Internet since 1995 to disseminate information on investment opportunities, when it first launched the Investment Promotion Network (IPAnet; <http://www.ipanet.net>).

If results from elsewhere in the



region are an indication, PrivatizationLink Russia holds considerable potential for the Russian Federation. In Ukraine, for example, the Ukrainian State Property Fund is one of the pilot agencies participating in PrivatizationLink through a USAID-funded privatization Web site (<http://www.ukrmassp.kiev.ua/>). Pavel Porokhov, the Fund's webmaster, reports a more than 200% increase in traffic in the first quarter of 1999. (The United States accounts for 20% of site traffic.) All information on bid requirements can be found online, and re-

quests for further information can be sent via email. In Georgia and Moldova, the privatization agencies have also found the Internet effective in generating interest in their state companies.

PrivatizationLink Russia is expected to be deployed in the second half of this year.

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- ◆ Relative to continued state ownership, has insider privatization improved firms' performance?
- ◆ Does it matter if the new employee shareholders are relatively concentrated managers or dis-

- persed rank-and-file workers?
- ◆ If private outsiders occupy a significant place in the ownership structures of some firms, do they improve enterprise performance relative to the state, and how do

- they compare with the performance of inside owners?
- ◆ Among outsiders, what is the relative impact of dispersed individuals compared with concentrated institutional investors, and

do different types of institutions (banks, investment funds, other domestic firms and foreign investors) differ in their ability to improve enterprise performance?

- ◆ Does the fact that the privatization process was so strongly biased towards insiders have critical implications in analyzing ownership and performance in Russia?

Ownership Structure

Only limited information has been available concerning the results of the privatization process for the structure of corporate ownership in Russia. The State Property Committee (GKI) released data on the number of privatizations, including some of their characteristics, but little on the actual ownership results. The State Statistics Committee (Goskomstat) records about 122,000 “changes of ownership type,” but the only published classification divides firms only into the very general categories of “state,” “mixed,” and “private.”

Although there have been a number of studies of industrial enterprises in Russia, most of them used small, unrepresentative samples. They also have focused on the firms participating in the State Privatization Program (SPP). The largest and most representative survey was conducted by the World Bank in July 1994 at the close of the voucher privatization process. The World Bank’s findings with respect to the SPP are generally con-

sistent with other studies, and showed a clear predominance of insider ownership at 56.3% of all shares. Outsiders had 23.3% and the state had 20.4%.

The dominance of insider ownership was even greater, however, in those companies privatized through lease-buyout, where the



Photo: Stephen Rogers

average was almost 91% of all shares. Moreover, a substantial number of industrial firms were not privatized at all, remaining wholly state-owned. Taken together, these two expansions of the sample beyond the standard set of firms privatized through the SPP to include lease-buyouts and nonprivatized firms greatly worsen the relative position of outsiders in

Russia’s overall company ownership structure at that time.

Several other factors, however, tend to work in the other direction. First is the existence of nonvoting, preferred shares. The two types of nonvoting shares—type A (given to workers free under the SPP) and type B (limiting the state’s voting rights to no more than 20% of all shares with the exception of companies in certain sectors) both raise the relative influence of *outsiders*.

Moreover, the influence of outside ownership appears still greater when companies are weighted by size. When 1994 employment is the weighting variable, the average outside shareholding rises to 19.4%, while that for insiders falls to 36.4%. Calculated this way, institutional investors actually own more, on average, than do managers: 13.3% compared to 9.7%. A possible reason for this is the greater potential for influence, at a given level of shareholding, in larger firms.

So far we have considered only average shareholdings, thus another factor affecting

the picture of the ownership structure, particularly outside ownership, concerns the dispersion of owner-types across companies. The last column shows how the dispersion matters by displaying the mean percentage of voting shares in firms where the owner-type has a positive voting shareholding. In firms with positive outsider shareholding, outsiders own

32.7% on average, of which institutional investors account for 28.8%. Certain types of institutions tend to concentrate their shareholdings in particular firms, presumably in order to enhance their possibilities for corporate control. For instance, investment funds have an average of 19.2% of shares in companies in which they own shares, suggesting that their investment decisions were driven by “control-oriented” rather than portfolio or “arms-length” motives.

A final factor affecting our picture of the role of outsiders in the ownership structure of Russian enterprises concerns the variation in that structure between firms with significant outside investment and those with little or none. If we consider separately firms with institutional investors owning at least 20% of the shares and those who have smaller institutional stakes, the average institutional shareholding is 38.5% in the former group and only 1.4% in the latter. Interestingly, institutional stakes are larger where managers have significantly fewer shares, but where workers have about the same amount and individuals actually have more. This suggests that institutional investors tend to have larger shareholdings in companies where the other owners (workers and individuals) are dispersed and, therefore, where they are more able to control management.

To summarize, we have shown that the characteristics of the Russian ownership structure vary considerably when a number of factors, which have commonly been omitted, are taken into account. While insiders dominate on average, the data show substantial variation in the ownership structure. This not only suggests a somewhat brighter picture of corporate governance in Russia than is often portrayed, it also implies that the data may be useful for examining the

impact on corporate behavior of several different types of owners: the state, workers, managers, individual outside investors, and concentrated institutional investors.

Impact on Productivity Performance

The real question about Russian privatization, of course, is whether the new ownership structure is having positive effects on enterprise performance, and our analysis of ownership is motivated by a series of hypotheses concerning the ownership-performance relationship. Private owners may be more likely to restructure and to increase profits and productivity compared to the state. Private owners who are insiders in the firm also may behave differently from those who are outsiders, as may those who play different roles: e.g., managers versus workers, and individuals versus various types of institutional investors. Each type of owner may have different objectives and may face different constraints, compared with the others. Voting shareholdings matter because voting shares represent control rights—thus the possibility for owners to influence company behavior. Finally, the implications of a given total ownership by outsiders are very different if the outside owners consist of few entities with large holdings, as compared with a situation where outside holdings are dispersed among a large number of individuals. With respect to each of these aspects of ownership structure, we have found significant variation across the Russian enterprise sample.

One of the difficulties in analyzing the ownership-performance relationship in Russia is finding an appropriate and feasible measure of firm performance. The corporate governance literature in the West has adopted a number of alternative measures of enterprise perfor-

mance: accounting profits, abnormal stock price increases, and Tobin's Q ratio (the market value of the firm divided by the replacement cost of its assets). The literature on private versus state ownership has tended to use accounting measures of profits and revenues due to the unavailability of stock prices for state-owned firms. Empirical analyses of the comparative performance of producer cooperatives versus conventional firms have focused on technical efficiency.

However, applying such performance indicators to economies in transition, is problematical. No reliable measures of firm value are available in the post-socialist countries, where stock markets are just beginning to operate. Similarly, the arbitrariness of socialist prices and depreciation rules implies that historical valuations of capital are meaningless, rendering it impossible to estimate production functions. Measures of value-added are further contaminated by problems in valuing inventories accumulated over periods of rapidly changing relative prices. In transition economies Western accounting systems are poorly developed and inconsistently applied while reported profits are unreliable in the extreme. A current popular saying in Russia is that “the good manager will achieve zero profits,” the implication being that it would be foolish to report profits since they would then be lost as tax payments or as dividends to the state or to outside owners.

One approach to these problems is to use the level or change in the firm's average labor productivity, the ratio of sales or output to employment, as a proxy for its performance. The impact of ownership on labor productivity may of course work through several channels, including actions to enhance efficiency by reducing input waste,

to increase sales by improving output quality, and to augment the quantity and quality of the capital stock and improve the technology through new investment. All of these channels are likely to be relevant, but it is difficult if not impossible to distinguish them. If new owners have made well-chosen investments that have increased labor productivity, then this is a positive development that should be taken into account. If they have improved the quality or variety of a firm's products, enabling them to raise either the quantity sold or the price they are able to charge, that should be taken into account. Thus, we should try to measure the overall impact of alternative ownership forms on firm performance, rather than identify the various channels through which such an impact takes place.

Although it would be desirable to identify those specific channels in the Russian context, it is impossible to distinguish among them. Investment is hard to measure under Russian accounting practices (and indeed, it cannot be reliably inferred from the data set used in this article). Nor, as discussed above, is it helpful to measure the change in real output, to distinguish increases in productive efficiency from other reasons for an increase in revenue. Because of the difficulty of valuing inventories, output is measured less reliably than sales, and price deflators are notoriously unreliable.

These details of definition and measurement, however, have little effect on our conclusions. On average, privatized firms in Russia appear to perform somewhat better than do state firms, but the companies that perform best appear to be those with large, concentrated outside blockholders. This result emerges most strongly when the analysis takes into account the possibility of selection biases in the

privatization process; for instance, that firms of different qualities were more likely to result in different ownership structures. Once such selection effects are taken into account, it becomes clear that outside investors typically received stakes in firms that were relatively poor performers.

Evaluating Russian privatization policies

In some ways, it is reassuring to find that concentrated outside ownership improves corporate performance in Russia as well as in developed market economies. Russian privatization policies, however, have systematically discriminated against outside investors, resulting in a very high rate of inside ownership, and a continuing powerful role for the state. Had these policies been different, many more firms could have improved their performance.

Moreover, corporate governance institutions in Russia function very poorly. Far too frequently, Russian managers have found it easy not only to flout accepted norms but even to violate explicit laws on information disclosure, shareholder registries, voting procedures and board composition. The difficulty of establishing such institutions underlines the importance of concentrated outside ownership in the Russian environment, since only a determined and powerful owner—with an interest in maximizing the value of the firm—has a chance of overcoming the many obstacles to effective restructuring. 🤝