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12 Privatization in Russia: First Steps

Andrei Shleifer and Robert W. Vishny

On 3 July 1991, the Russian legislature passed a law that mandated privatization of most state firms and prescribed methods for doing so. The work on implementation of this law was slow at first and was interrupted by momentous changes in the government in August. Starting from mid-November 1991, the new government resumed work on the privatization guidelines. On 27 December 1991, the Supreme Soviet passed an elaboration of the 3 July law, called the "Fundamental Positions of the Privatization Program." In January 1992, this document was supplemented by several decrees signed by Yeltsin, which explained the various steps of the process. Finally, in late March 1992, the government produced the actual privatization program that it offered to Parliament for approval. Since the privatization itself has not really begun, these documents represent the first steps toward privatization in Russia. Our paper discusses the state of Russian privatization up to the end of March 1992, including the proposed program. In particular, we focus on one key issue that the privatization process confronted: how to reconcile the conflicting claims of the de facto "owners" of assets that must be privatized.

The issue of the initial allocation of property rights in state firms, before they are privatized, rarely receives attention. In many cases, it simply does not arise. For example, in the U.K. privatization, the government clearly owned the shares it sold, so there was no question of who was selling the shares, only how and to whom. Even in the context of Eastern Europe, it is often simply assumed that the government owns the shares and then has to sell or distribute

Between March 1992, when this paper was written, and January 1994, when it went to press, Russia privatized over a third of its industry using the privatization program described in this paper. Boycko, Shleifer, and Vishny (1993) presents an update on the progress of privatization. In all this work the authors have benefited from the collaboration with Maxim Boycko, Jonathan Hay, and Dmitri Vasiliev of the State Committee on the Management of State Property (GKI).

them to the population. The questions that generate intellectual and practical excitement are, first, who should be the eventual owners of the shares and, second, how to sell or allocate the shares from the government to these eventual owners to maximize efficiency? Both these questions presume that the seller of shares is clear, namely, the government.

Yet, as the experience of Poland illustrates, the workers of the companies do not agree that the shares are the government's to distribute as it wishes. Failure to appreciate this point is undoubtedly the most important cause of the delay of privatization in Poland. More generally, companies in Eastern Europe in general, and Russia in particular, do not have an unambiguous de facto ownership structure, in which the government owns the shares. On the contrary, many "stakeholders" have existing ownership rights, in the sense of being able to exercise control rights over assets effectively. Moreover, these stakeholders take both economic and political action to defend their rights. Unless these stakeholders are appeased, bribed, or disenfranchised, privatization cannot proceed.

In Poland and Hungary, the important stakeholders are the workers and the managers. In Russia, they also include the local governments and the branch ministries. These stakeholders correctly see privatization as a redistribution of property rights rather than as a gift from the government. In this paper we ask how the center can reconcile the control claims of these multiple de facto owners and, in particular, how it can reduce the damage they do while competing for the pie? Our answer is to pay off some stakeholders with dividends and privatization proceeds so that they give up the control rights that conflict with those of others.

We develop this answer in several steps. Section 12.1 briefly discusses our theoretical approach to property rights and privatization. Section 12.2 surveys the distribution of property rights in enterprises under socialism and shows how the relatively clear distribution of these rights collapses when socialism does. The decline of the power of the state and the ministries has created an "ownership vacuum" in Russia that was filled by new effective owners: the workers, the managers, and the local governments, whose control rights are often in conflict. Section 12.3 looks at spontaneous privatization, which is essentially a way to cut out the Russian government from its ownership claim. Section 12.4 discusses ways to reconcile the conflicting claims. Section 12.5 examines the likely future of privatization in Russia. Section 12.6 sums up.

12.1 The Theoretical Framework

Coase (1960) has made the profound observation that, once property rights over assets are completely defined between a set of agents, in most circumstances these agents will negotiate an efficient way to use these assets. Coase also argued that many inefficient uses of assets stem from poorly defined property rights. He did not explain what to do when property rights are indeed poorly defined. He also argued that, so long as property rights are in fact well defined, it does not matter exactly how they are delineated. Grossman and Hart (1986) showed, in contrast, that the allocation of property rights is not neutral, as Coase argued, but matters for the ex ante investments that agents must make in human capital complementary with these assets. Thus, a possibly unique efficient allocation of property rights does indeed exist. Grossman and Hart did not treat the case where property rights are not well defined.

This paper focuses on situations with poorly defined property rights. It therefore pays to specify more clearly what that means. When property rights are poorly defined, no agent has unambiguous control rights over assets in uncontracted for circumstances. There are no clearly defined rules of the game about who decides what to do with the asset. As a result, default rules come to be used. One such rule is, First come, first served: the agent who gets to the asset first gets to use it, at least for a time, as he likes and can exclude all the others from using it. Another such rule is that no agent can use the asset, since every agent can exclude others from using it; therefore, the asset stands idle. Hart and Moore (1990) called this arrangement *joint ownership.* A variation of this rule is that no agent can use the asset in a new way, so some status quo other than idleness prevails. A third default rule is that all the agents try to use the asset simultaneously in ways they see fit and cannot exclude others from using it. Some Nash equilibrium in agent's actions obtains in this case. These default rules do not typically lead to an efficient use of the assets. Defining property rights would replace them by efficient negotiations, but can this be done?

State firms in Russia, like elsewhere in Eastern Europe, exemplify assets with multiple owners with overlapping control rights and no procedures for resolving conflicts. The workers, the managers, the ministries, the local governments, and the central government all have some cash-flow and control rights over particular uses of these assets, and in many cases these rights overlap. In this situation, the Coase theorem predicts an inefficient outcome.

Privatization is a way to define the property rights between these various claimants so that efficient bargains could subsequently be struck. The means of doing so is to bribe the various parties by giving them cash-flow rights when they give up some of their control rights that conflict with those of other stakeholders. The workers and the local governments, for example, might be given payments if they commit not to interfere with layoffs. Thus, local governments might be given a share of privatization proceeds in exchange for abandoning their interference with business. Or the workers might be given a percentage ownership in exchange for letting the managers determine employment and wages. Privatization is a mutually acceptable redistribution of both control rights and cash flows between the various claimants.

Overlapping control rights are very costly to the Russian economy, for, while some control rights over assets have been defined informally after central control has collapsed, other control rights are still in dispute. Without settling these disputes, privatization cannot proceed. Moreover, the prospect of reallocation of property rights during privatization gives the stakeholders an incentive to take actions that would increase their ownership claims during privatization even if these actions reduce the size of the total pie. These actions include signaling and positioning to show toughness that would cause the center to give the relevant stakeholder a higher ownership claim. For example, workers might strike and local governments turn off electricity supply to the firm to show how tough they are. Stakeholder activities that destroy value to enhance their ownership rights—perhaps through a large delay of privatization—are an important cost of ambiguous property rights.

This paper tries to describe plausible ways to allocate cash flows and control rights to reduce some of the costs associated with the current disagreements. We first explain, in the context of Russian privatization,who the relevant stakeholders are, what decisions they have control over, and what damage they can do and have done if their ownership claims are not respected. We then propose a way to allocate cash flows in order to contain, if not eliminate, the value-reducing activities of the unhappy stakeholders. We discuss how to pay off the local governments, the managers, and the workers to go along with privatization and restructuring. Importantly, we discuss not optimal schemes but rather schemes that can be easily introduced into the law and therefore guide privatization.

12.2 Ownership during Socialism and after Its Collapse

12.2.1 Ownership under Socialism

Under socialism, the state supposedly owns all the means of production, including the firms. This notion of ownership, however, is not particularly revealing. Ownership consists of a claim to residual profits as well as to residual control rights (Grossman and Hart 1986). The Treasury has some claim on profits or losses of state firms. But there is no "state" that has control rights. These rights instead are shared by the managers of the firm and the bureaucrats in the ministry that oversees the firm. The ministry bureaucrats are probably the more important owners, in the sense of having most of the power to dictate the decisions of the firms. Legally, the ministry bureaucrats have the right to choose the top managers, to determine the production and investment, to set prices, to allocate inputs and buy outputs, to determine the general growth rate of wages, and so on. They do not make micro production decisions, but they control most of the other ones. Most rights of the ministry bureaucrats are enforced through central control, but they also maintain these rights through complete control over the delivery of scarce inputs.

How do the ministry bureaucrats translate these control rights into cash flows for themselves? The ministry bureaucrats use their rights to extract surplus from the firm, subject to attaining some minimal level of profits (or maximal level of losses) for the Treasury. One way to do it is to extract presents and services from the firm. Another way to extract surplus is to underprice the supplier's and the firm's output. By intentionally making the inputs scarce, the bureaucrats can extract bribes from the firm in exchange for deliveries; by making outputs scarce, they can do the same with the firm's customers. Pervasive shortages under socialism result from this profit-maximizing exercise by the bureaucrats of their effective ownership rights (Shleifer and Vishny 1992).

Under socialism, managers of the firm also have some control rights. They have the know-how and the connections to solve the problems of pervasive shortages and breakdowns. This gives them some control over production, investment,and employment decisions as well as over most micro decisions of firms. Their knowledge also makes them valuable to the bureaucrats and hence enables them to collect some of the rents from the firm.

In contrast, workers own nothing under socialism—Marx and Lenin notwithstanding. Workers own the firm only to the extent that they have an influence over its policies or a claim on its cash flows. In Communist Russia, workers' ability to strike and otherwise exercise control rights was severely limited by the central government. They certainly had no control over wages or employment. Also relatively unimportant were the local governments: any attempt by them to exercise control over the firm was certain to invite retribution from the center. With full control over local budgets, the center had local governments under its thumb. The relevant owners, then, were first the ministry bureaucrats and second the managers.

12.2.2 Ownership during the Transition

The control rights over the decisions of firms have changed radically in Russia since 1988, as socialism and central control collapsed. Starting in 1988, the government implemented a range of reforms that transferred many of the decisions over output mix, output level, customer choice, and wages to enterprise managers. The ministries also lost their right to appoint managers, although it is not clear who gained it (the workers began to have some input). The 1988 reforms kept the prices fixed but at the same time allowed firms to sell a small portion of their output at free prices. The reforms also kept most of the input allocation centralized, thereby letting the ministries keep most of their effective control rights.

Over the subsequent three years, the ability of the center to enforce the planned allocation has collapsed. The Communist party enforced deliveries to the state, and that mechanism simply failed. As a result, enterprises refused to deliver their products to the state at low prices and instead began selling them at market prices to whomever they pleased. What began as a Chinese-style experiment with capitalism on the margin transformed itself into a collapse of the central allocation mechanisms. This collapse of socialist coordination greatly damaged state enterprises and may have led to aggregate output declines in 1990 and 1991.

These changes deprived the ministries of most of their control rights. First, they could no longer dictate to firms what to do, and, even if they tried, they had no law or force to support their orders. More important, when the ministries lost control over the outputs of some enterprises, they also lost control over firms for which these outputs were inputs. When the ministries could no longer assure supply deliveries, managers had to find inputs, which often meant barter and other market transactions. To the extent that the control rights of the ministries depended on supply assurance, these control rights have diminished a great deal.

The control rights of the ministries have not disappeared completely. Because ministries still have control over some industry assets, such as research institutes, information networks, and export licenses, they continue to exercise control over firms. Perhaps more important, branch ministers from the old regime continue to sit on the council of ministers and in fact have more votes in the aggregate than do the members of the reform team. They use this power to influence the course of privatization in two main directions. First, they argue that many state firms are too vital to be privatized or even to be transferred to the jurisdiction of the local governments. The ministries want to keep government control over assets because control brings the ability to extract cash flow and services from these firms in the future as well as continuation of ministerial jobs. Second, if privatization is to take place, the ministers want it to take the form of free distribution of shares along vertical production chains so that firms own shares in their suppliers and customers. The ministers prefer, but do not insist, that they actually supervise this allocation of shares. The ostensible reason for such privatization is to preserve supply links and to avert the further collapse of the economy. It is obvious, however, that preserving the existing supply relations through cross-holdings is largely a way to preserve existing industrial structures and ministerial oversight. The ministers thus accept privatization only if it preserves their control over firms.

Some of the arguments that the ministers make to slow down privatization seem absurd yet are sustained by the political process. In one meeting, the food minister argued that yeast factories, while quite small and numerous, should remain under central jurisdiction lest the politicians in the areas where these firms are located force them to refuse to sell the yeast just to blackmail the rest of Russia. The minister of publishing demanded that all the publishing houses should remain in state hands because "publishing is our ideology" and hence cannot be given up either to the private sector or even to the local governments. And the construction minister has insisted that all the trucks used in construction remain in state hands because they are critical to the war mobilization effort. Even more radical have been the proposals of the minister of industry, who wants to distribute 70 percent of enterprise shares along the vertical production chains. Despite these efforts to stop reforms using both influence over firms and votes in the government, the power of the bureaucrats is nowhere near what it used to be.

As the bureaucrats partly lost their control over enterprises, who gained it?

In Russia, this control has reverted to stakeholders who previously had virtually no power. These stakeholders include the workers of the firm, the managers, and, perhaps most important, the local governments. To understand who de facto owns the firms before privatization begins, we must clarify the control rights of these stakeholders.

Consider first the workers. Today, the workers have influence over employment, wages, and the choice of managers. After liberalization, the workers got a right to negotiate collective bargaining agreements and to strike. This and the influence over the choice of managers gives them control over employment and wages. Even where the workers do not select the managers, managers recognize that privatization will in many cases formally allocate voting rights to the workers tomorrow. This, of course, gives the workers many effective control rights today.

In addition to these economic sources of worker power, workers represent a substantial number of voters, in the Russian as well as local elections. The democratic political process thus naturally favors the allocation of the control rights over the firms' assets to the workers. An important political formation in the Russian Parliament supports workers' rights. Compared to the regime prior to reforms, changes in Russia have led to a large increase in the control rights of workers—similar to although not as dramatic as what has occurred in Poland. Workers are beginning to exercise these control rights. They have started to strike, particularly in the coal and other natural resource industries, demanding not only higher wages but also explicit ownership rights to the assets with which they are working. In many firms, workers have voted to replace the managers by those who are more sympathetic. The extraordinary wage explosion in Russia since 1988, in which most of the extra profits of enterprises were passed on to the workers in higher wages, is clear evidence of the increased power of the workers. The surprising slowness of layoffs in Poland and Czechoslovakia after the reforms is also strong evidence of the control rights of workers. East Germany, where the managers and the foreign buyers kept the control rights, provides a striking contrast because layoffs have been huge.

Workers are also expressing clear claims on the assets of the state firms. Worker groups have demanded complete ownership of the assets of their firms. Larisa Pyasheva, the head of Moscow City privatization, has formally endorsed this strategy as rapid and fair. The 3 July privatization law allows for a sale of some government shares to workers at a 30 percent discount, but that is clearly considered to be insufficient. The initial demands have been much more extreme. An interesting illustration along these lines is VAZ, the giant automobile manufacturer that has been negotiating a sale of 33 percent of its shares to Fiat for a price between $1 and $2.5 billion. The proceeds from the sale are to be invested in upgrading VAZ. In late November 1991, the workers of VAZ addressed an open letter to Yeltsin and the prime minister of Italy, demanding that they immediately get a 51 percent share in VAZ before any discussions of sale take place and that some of the revenues from the sale be allocated to them as shareholders. They have also threatened industrial action should their demand be rejected. Since the Fiat investment is the best hope for these workers regardless of whether they own any shares, their demands are a clear illustration of the vastly increased control rights of the Russian workers. Interestingly, as of this writing, the VAZ deal is still up in the air.

The control rights of managers have also increased tremendously. First, the existing law gives managers a lot of discretion over what to produce, what price to charge, and to whom to sell the output. The legal control rights over firms are therefore largely theirs. Second, even when the ministries have retained legal rights, they are no longer obeyed, and hence the control rights by default revert to the managers. Managers also have some control rights over employment and wages, which conflict with those of the workers on these decisions. Third, the managers have the network of contacts and the personal relationships that are essential for barter and for the procurement of inputs. They have thus inherited from the bureaucrats their most important control right. Like the workers, managers have been trying to use their political influence, with the local governments and especially with Parliament, to translate the effective control into the ownership of cash flows as well. They favor worker-management buyouts at low prices, where they often get large ownership stakes in exchange for promising high wages to the workers. They also prefer these buyouts to take a partnership rather than a corporate form, mostly to avoid possible control challenges in the future.

Last but not least, the local governments also gained many new control rights. After the demise of the Communist party and of the central control over government more generally, the local governments have found tremendous room to govern their localities. Because the local governments are typically democratically elected, they have some legitimacy as representatives of the local population. In addition, they have received control over some key local assets, such as electricity, water, and other utilities, and can translate this control into influence over firms.

Not surprisingly, the local governments have demanded a share of the revenues of the enterprises in their areas, particularly in the oil and other natural resource rich areas. They have also demanded and received a say over those with whom the firms can enter joint ventures, what they can produce, and what they can barter. Many localities went on to demand that large state enterprises be made responsible for the procurement of foodstuffs for all the residents in their areas. They have also attempted to change firm policies toward pollution and other public goods. Many of the control rights of the ministries have thus been transferred to the local governments.

In the privatization area, the local governments have demanded both the right to privatize and the revenues from privatization. Since December 1991, the Moscow and the Russian governments have fought over the speed and the mechanism of privatization in Moscow. In demanding all these control rights, the local governments realize the inability of the center to enforce Russian laws. They also make effective threats: to turn off water and electricity at factories that do not cooperate. Even more effective are the threats from the republics on the Russian territory inhabited by ethnic minorities to declare independence unless they receive control over firms on their territories. But the most serious problem is that the local governments often do not want to privatize at all. Instead, they want to use prospective privatization as a mechanism to transfer control over firms from the ministries to themselves so that they can continue the *upravleniye,* or management, on their own. In many cases, the ability of the local governments to assure the supplies of goods to their areas, as well as power and bribes for themselves, relies on retaining control over firms rather than privatizing them.

The remaining stakeholder in the Russian firms is the Russian "state," the nominal owner of these assets. Traditionally, the state exercised its control rights through the ministries and the Communist party. In light of the decline of both, "the state" has no clear residual control rights at all, although it nominally has all the residual cash-flow rights.

Formally, the state is represented in the privatization process by GKI, the State Committee on Property. This committee is supposed to oversee privatization and take care of the state property before it is privatized. While the committee is quite small, it is supposed to have regional representatives who do its job in various regions. In practice, the local governments have already demanded control over appointing the local representatives of GKI, even though GKI is an explicitly federal organization. The functioning of the local GKIs is severely handicapped by such intergovernmental conflicts. This is only one example, of course, of the ruinous conflicts between the stakeholders.

The greatest power of the state comes, as always, from its ability to make general laws and enforce them in some cases. This, in fact, is what the privatization program as written by GKI is. Even so, most realistic privatization schemes, including the one that is being introduced in Russia, institutionalize the actual fact of nonownership by the center. Luckily, the people running the privatization program in Russia accept the decline of the control of the center over firms, although they do not want local governments to step in its shoes.

In summary, the situation in Russia early in 1992 fits nicely into the general model of multiple owners with overlapping and conflicting control rights. Unfortunately, the cost of these conflicts is the delay of privatization since a typical consequence of disagreement between the stakeholders is inaction. When privatizations do occur, they look a lot like theft, as our next section illustrates. The immediate objective of government policy, then, is to compensate the stakeholders to reconcile these conflicting claims and so to allow legal privatization to proceed.

12.3 Spontaneous Privatization

Spontaneous privatization in some forms began in earnest in Russia in 1988, when the state relaxed the close monitoring and direction of enterprises. Initially, it took the form of simply diverting the profits from the firm so that the government could not capture them. An enterprise manager sets up a parallel private firm or a cooperative next to the state firm or even inside it. That private firm then buys the output of the state firm at the official controlled price and resells it at the market price. The profits are in part kept by the managers, who of course are the owners of the private firm, and in part distributed as higher wages to the workers.

The enormous recent growth of cooperatives in Russia largely reflects this mechanism for diversion of profits from the state and their distribution as wages, not the private productive initiatives that many Westerners hoped to see. The formation of these private ventures to syphon off profits from the state was made possible by lax enforcement of laws and state orders by the center since output could be sold only on the market if it was not delivered according to the plan. The process was speeded up by paying off local authorities, who frequently shared in the spoils of theft from the center. Informal reports indicate that most state enterprises that produced desirable output have engaged in at least some form of such profit diversion. Gains for all parties at the expense of the central government made spontaneous privatization very popular in Russia.

While the initial spontaneous privatization has focused on the diversion of profits, more recently, as the control of the center has deteriorated further, it evolved into the transfer of state assets to private firms and cooperatives. Initially, these transactions took the form of leasing, where buildings or machines were leased part time from the state firms but were in fact used full time and more extensively than the lease allowed. More recently, the private daughter firms set up by the managers have begun simply to buy "redundant" assets from the state firms at negligible prices, often using the profits earned earlier from leasing. Of course, these assets often turned out to be not redundant at all but in fact quite essential. In this respect, asset diversion has naturally followed output diversion.

This type of spontaneous privatization, initiated by the managers with consent by the workers in exchange for higher wages, has accelerated sharply in 1991. These deals are usually accompanied by purchases of approval from the local governments and sometimes the ministries in Moscow as well. Rumored bribes in Moscow average 10 percent of the value of diverted assets and are often taken in dollars. Spontaneous privatization thus partially recognizes the ownership rights of the ministries and the local governments while transferring wealth from the Russian "state," which cannot monitor these transactions.

The more complete form of spontaneous privatization, which is beginning to appear in Russia, is a worker-management buyout (W/MBO) at the book value of assets. Book values of most assets in Russia are extremely low relative to their market values, a fact that has become even more extreme thanks to the rapid recent inflation. In a typical MBO, managers raise some funds from other state firms or from commercial banks that get their capital from state firms, add a trivial amount of their own and worker's money (perhaps R 10,000 altogether for a R 10 million firm), and buy their firm's assets at book value. In such a deal, managers might own 30 percent of the stock and the workers 70 percent. In many cases, the assets of the firm include a large amount of liquid funds, which are not typically counted in the calculation of book value. Because the book value is so low, and because many of the firm's assets are not even counted, the privatized firm can typically repay the loans within a few months, if not immediately. The managers and the workers then end up with the assets of the firm in exchange for a close to zero commitment of their own funds. These MBOs are virtually never contested, especially if the right local and federal officials are paid off. Moreover, the assets are usually acquired through a closed company (*tovarischestvo*) that does not have traded shares. As a result, once the loan is repaid, the control of the managers—and to some extent the workers—over the assets of these companies is complete. Until now, only a few managers in Russia have begun to take advantage of this way to privatize, but the practice is likely to grow.

Spontaneous privatization has many benefits. It gives the managers and the workers financial interest in the firm and therefore solves some of the incentive problems that state firms cannot overcome. In particular, manager-owners have a tremendous personal incentive to find foreign or other partners to help them restructure the firm. Spontaneous privatization is extremely rapid, especially if the local government officials are bribed to go along, since the managers themselves initiate and push forward the transactions. Spontaneous privatization also separates the firm from the state and hence hardens the budget constraint. Last but not least, it respects the ownership claims of all the stakeholders other than the Russian government or bribes the ones whose control rights are diminished to go along. At best, the Russian government gets the extremely low book value of assets and no control rights. Of course, the whole point of spontaneous privatization is to reduce the Russian government's claim.

The low prices and nontransparent deals endanger spontaneous privatization because it will become wildly unpopular as soon as some organizers openly become very rich. This problem is especially severe in Russia, where the privatization law explicitly states that firms must be sold through competitive processes, such as auctions. In spontaneous privatizations, in contrast, no competition for assets ever takes place. As the experience of Hungary demonstrates, popular backlash can derail the whole privatization process, not just spontaneous privatization. In fact, the talk of reversal of the deals of the last two years is already quite loud in Russia. For this political reason, spontaneous privatization is dangerous.

It may also be inefficient. First, the ownership stake that workers get in these transactions is typically very large, which might preclude efficient layoffs and wage control. Second, these deals typically isolate the managers of a privatized firm from all capital market pressures since there are no shareholders or effective bankers to monitor them. Of course, product market competition and ownership incentives still provide a lot more incentives than government control. Nonetheless, complete entrenchment is too much to give the managers in privatization. Third, only the better companies are typically involved in spontaneous privatization. The real losers that need to be shut down remain in state hands and are not restructured.

In sum, spontaneous privatization represents one way in which the competing ownership claims can be reconciled, namely, by a substantial exclusion of the nominal owner from privatization. Spontaneous privatization will remain very important in Russia, for, even if this process is somewhat regularized and firms are put up for competing offers, potential bidders will usually have to make peace with the incumbent management. The smaller firms will eventually go to the managers and the workers at very low prices anyhow. The relevant question, which we address below, is how to make this process more efficient and sustainable politically.

12.4 Privatization Strategies

The previous section has described the conflicting ownership and control claims of the stakeholders of Russian companies. For many important decisions, such as employment, wages, product sales, the appointment of managers, and investment,more than one stakeholder wants to influence the decision. In many cases, their interests conflict, particularly when decisions concern the restructuring of their companies. In the current situation, no clear rules for resolving these conflicts exist.

The present status quo has two implications for privatization. First, the usual way of resolving disagreements now is to do nothing. Each stakeholder has an effective veto power over any changes. In the context of privatization, this means that any proposal is vetoed and privatization delayed. What makes this problem worse is that some stakeholders, such as the local governments and many corporate managers, are quite happy with the status quo since it gives them enormous control rights. There is little hope for extensive privatization until at least some stakeholders get very strong incentives to move away from the status quo.

Second, because the stakeholders have enough effective control to veto any changes, no restructuring can take place. That means no layoffs, no wage restraints, no plant closures, and no management changes until a way of resolving conflicts between stakeholders is found. The local governments, the workers, and the managers can always use their political and economic influence to stop any changes that do not meet their wishes, and their wishes are inconsistent with restructuring. Like privatization, restructuring cannot proceed under the current situation.

To achieve privatization and restructuring, the Russian government must find ways to provide very strong incentives for the existing stakeholders to move to a governance structure that is consistent with fast privatization and restructuring. This objective suggests a two-pronged strategy, which we discuss in this section. First, enterprises should be commercialized or corporatized so that they are separated from the government and their formal governance structure becomes more clearly established. Second, stakeholders should receive strong command and financial incentives, in the form of shares and privatization proceeds, both to preserve the assets of the corporations today and to accede to privatization. Some steps in this direction have already entered the government's program; others are still being debated. It makes sense, therefore, to lay out the issues behind this high-pressure approach to privatization.

12.4.1 Corporatization

In the last two years, many control rights over the assets of state enterprises have been transferred to their managers. In many cases, these managers enjoy their new power and independence and are in no rush to privatize. When they do consider privatization, it often is spontaneous privatization that completely entrenches them at the helm. In addition, the Russian privatization program transfers the control over the privatization of many enterprises to the local governments. Many of the local administrators view this control as the right to manage the state enterprises rather than privatize them. Today, Russia is in the grave danger that firms will move toward local administrative control rather than private ownership.

The first essential step to prevent this tide is mandatory commercialization (or corporatization) of all the enterprises. This means that, within six months, all large state enterprises should be converted into joint-stock companies with publicly traded shares and boards of directors. Initially, all the shares would be held by the central government, but, as the privatization process unfolds over time, they will be given away or sold to the various stakeholders and investors. The board of directors would initially consist of the representatives of GKI, the managers, the representatives of the workers, bankers, and perhaps others involved with the corporation. After privatization, it would be elected by shareholders as in any private company. The idea is to make the state companies resemble private companies from the start. Such mandatory extensive commercialization has been advocated by Lipton and Sachs (1990) first for Poland and more recently for Russia.

Immediate corporatization accomplishes some of the goals of organizing corporate governance and resolving conflicts before privatization. To begin, it creates boards of directors charged with a fiduciary responsibility to maximize the wealth of the shareholders. These boards will serve several functions. First, because of directors' liability, directors will at the least try to prevent the blatant theft of assets by the managers. In some cases, directors will even provide more stringent checks on the management. In contrast to spontaneous privatization, boards of directors institutionalize the possibility of replacing the managers and thereby prevent complete entrenchment. Second, boards become a formal mechanism whereby the relevant stakeholders can exchange information and views. The workers' representatives will both be informed about the affairs of the companies and have the opportunity to express their positions formally. When they can do that, they are less likely to resolve conflicts through strikes. Finally, and perhaps most important, boards formalize the fact that shareholders—not the workers or the local governments—own companies and therefore have the formal right to run them. Disputes are resolved by votes on the board rather than by other means. The hope is that this approach will also reduce the destructive competition for rents.

Corporatization also creates tradable shares in the companies and hence outside shareholders. Initially, the shares will be owned by GKI, which will reinforce the central government's ownership claim. As we discuss below, some shares will immediately be allocated to the workers and the managers, which will clarify their ownership claims as well and provide them with some incentives to increase the value of the company. Other shares will be sold over time, which will create outside shareholders with value-maximizing objectives. Perhaps even better, the stage is set for GKI to sell control of some of these companies through a sale of controlling blocks of shares. By creating a potential market in the shares of state companies, corporatization moves companies a step closer toward privatization.

Unfortunately, the realization that corporatization redistributes control rights has not escaped the managers and the local government officials. Boards of directors and outside shareholders are not their idea of independence. Initially, this lobbying has derailed mandatory corporatization, and conversion into a joint-stock company was made voluntary. More recently, the government realized that giving (or even selling) shares to the workers and to the public as a whole cannot proceed without corporatization. This pressure to distribute shares—rather than an interest in governance—has lead the government to include mandatory corporatization of large companies into the privatization program. In that program, all large companies must convert into joint-stock companies by September 1992, which means issuing shares as well as appointing boards of directors.

12.4.2 The Workers

To avoid massive resistance to privatization, the government must pay off the workers. It is important not only to give workers stakes in their companies to make them feel like owners right away but also to provide them with strong incentives to want to see privatization accomplished. At the same time, GKI must deal with a legitimate and important concern that worker control is inconsistent with efficient corporate restructuring. The privatization program is a significant compromise in that it gives the workers substantial ownership and returns from privatization without giving them control.

Specifically, the privatization program gives workers 25 percent of the shares of the state companies for which they work, up to a certain ruble limit (approximately R 7,000 in March 1992). Initially, these shares will be nonvoting and will also pay a fairly high dividend. The idea behind making shares nonvoting at the beginning is to prevent worker control before firms are privatized. The law allows workers to trade shares from the start. The idea is in part to enable the workers who want cash to benefit from this transfer immediately and in part to limit the eventual voting power of the workers. There remains a serious question—still unaddressed—of how workers will be given tradable shares unless all large firms corporatize immediately.

The government is still debating the question of whether workers' shares should ever become voting. The correct answer is yes—for several reasons. First, workers' shares will become an important part of the float of publicly traded shares in the companies and may help active shareholders accumulate large stakes. If the shares are nonvoting, active shareholders will not be interested in them. Second, in countries with undeveloped securities regulation, nonvoting shares typically sell at large discounts to voting shares, even if the nonvoting shares have dividend protection. The reason for this is the large benefits that those in control can appropriate for themselves. In nonvoting shares sell at large discounts, the workers will be extremely disappointed in privatization and either resist it or demand further concessions.

But perhaps the most important concern about worker ownership is that voting shares will enable the workers to get significant representation or even control of the board, which will prevent any restructuring of the company. Worker representation on the board will probably be extremely beneficial to most Russian companies. The law provides for some worker representation on boards during the interim period before privatization. If such representation continues after privatization as well, workers will be better informed about the true financial situation of the company and will therefore be more likely to go along with the required tough restructuring steps. Board representation also gives workers a voice, which is a better way for them to be heard than through strikes and political action. At least in the near term, most dramatic changes in Russian companies will have to be made with the consent of the workers, and board representation is the most attractive way of gaining such consent.

At the same time, complete worker control of boards can prove disastrous as workers prevent restructuring from taking place and decapitalize companies. But it is hard to believe that, even with 25 percent of the votes, the workers will control the board. Some workers, particularly the poorer and the more redundant ones, will probably have sold their shares already. Some of the best workers might not even vote for directors who oppose restructuring. And the management might get the votes of the outside shareholders and the GKI if alternative directors do not want companies to change. In sum, giving workers votes and some board representation has a lot of advantages and few risks.

For these reasons, workers should have an option to convert their nonvoting shares into voting shares as soon as the government gets rid of enough shares. For example, when government ownership falls below 50 percent, the workers get the conversion option. Giving them this option also has the advantage that some workers will choose the dividend advantage of the nonvoting shares and will not convert. At the same time, the workers who want to sell their shares will convert and sell them at higher prices. In equilibrium, only a few workers might actually convert their shares and keep them so as to vote against restructuring. It might be better to have more worker representatives on the board than the workers could actually elect.

These grants of shares to the workers give them something regardless of whether privatization is accomplished. To give workers an extra incentive to favor privatization, the law provides them with further benefits. The workers get 10 percent of the government's privatization proceeds. They also get the option to buy 10 percent of the shares of privatized companies at a 30 percent discount to book value, which in most cases is a trivial fraction of true value. Importantly, getting anything out of these programs requires that the government's stake fall below 50 percent. One hopes that this will provide enough of a privatization sweetener. The Russian privatization program thus gives the workers the dual incentives that are required to get them to go along with privatization and to pressure other stakeholders to do likewise.

12.4.3 Local Governments

In the former Soviet Union, tensions between governments are not restricted simply to those between the former Soviet republics or those between local governments in Russia and the central Russian government. Tensions also exist between city and republic (*oblast*) governments, *oblast* and central Russian, and many other layers. In particular, Russia has several ethnic republics on its territory that are laying claim to the property on their territories and threatening to declare independence from Russia if these claims are not respected. In this section, we use the term *local governments* generically and focus on their relationship with the Russian center.

The strategy toward local governments should co-opt them into supporting privatization and relinquishing their control rights over firms. Given that their claims are often as strong as those of the workers, they will not be cheap to convince. At the same time, they should not be given shares, no matter when these shares become voting, since this strategy makes them large shareholders with a substantial interest in active control. While workers' shares are dispersed, local government shares are concentrated. In many cases, local governments would use their ownership rights to derail privatization and to continue managing the state firms. For this reason, the only feasible way to pay off local governments is by giving them privatization proceeds rather than shares.

Fortunately, the Russian privatization program recognizes this and is in fact extremely generous to the local governments. It gives them both a chunk of privatization proceeds and a role in privatization, but not shares.

The program divides firms into those under federal, *oblast,* and municipal jurisdiction. The exact division is still being negotiated. One proposal is to classify as federal only firms with more than 50,000 employees, or more than R 200 million book value, or otherwise large or strategic, for a total of about 2,000 enterprises. Municipal enterprises would be the ones that sell only to highly localized markets, and the rest would be *oblast* level. In all likelihood, pressures from the ministries will expand the list of federal enterprises.

Having classified firms, the Russian program gives *oblasts* and municipalities the responsibility to privatize the enterprises under their respective jurisdictions and assigns to the Russian government the right to privatize the federal ones. It is not clear who retains ownership in the meantime. Not surprisingly, the question of how much management rights the local governments actually have has become the most important point of disagreement between them and the center. The center wants to keep management to a minimum, while many localities are more interested in management than in privatization.

The law gives local governments several privatization techniques to choose from, including auctions and competitions. The latter allow sales based on criteria other than price. The book value is used as the reserve in these auctions and competitions. The law also specifies ways of dividing privatization revenue between the federal, *oblast,* and local governments. The principal objective of this division is to prevent conflict in the allocation of firms between levels, which would arise if the split of privatization revenues varied greatly depending on who privatized the firm. One important source of tension in the choice of privatization techniques has been the insistence of some local governments that they be able to exclude nonresidents from participating in auctions for small firms. This preference is driven mostly by the desire to keep auctions thin and so to collect more bribes. While this conflict has not been resolved, the center has been caving in to this pressure from local governments. Whatever the final outcome, giving the local governments a substantial financial incentive to privatize has been the cornerstone of the Russian privatization program.

This decentralized approach to privatization has several advantages. First, it provides local governments with substantial financial incentives to privatize. It also greatly reduces the burden on the central government of finding some privatization arrangements for a large number of enterprises. Since the managers and the workers are likely to get along with the local governments better than they do with the center, they are more likely to find an acceptable solution. Last but not least, the transfer of control over privatization of some firms to the local governments eradicates the role of the ministries in these privatizations virtually completely.

The greatest difficulty with privatization from below is that local governments may simply refuse to privatize and try instead to keep control over firms. After all, the bureaucrats in the local governments get bribes and presents only as long as they keep control over firms. In fact, many local governments have expressed a clear view that they will privatize sometime in the future but in the meantime have to manage the firms for the benefit of the local populations. If privatizations in some areas become successful, even the recalcitrant local governments might see the benefits of privatization in the regions that have moved fast and so feel compelled to follow suit. Competition between regions for foreign investment and for domestic funds might also accelerate privatization. Yet probably the strongest pressure toward privatization might be the desire of the workers and the populations of these areas "to get their cut," which will force many of the local governments to privatize so as to satisfy their voters.

A second problem with privatization from below is corruption. While the coffers of the local governments benefit from privatization, the pockets of the bureaucrats do not. Pushing privatization down to the local level will create tremendous corruption problems, as the local bureaucrats try to get a cut. This problem is rendered much worse by the fact that the law allows the local governments to use criteria other than price for privatization. Why not, then, sell a firm cheap in exchange for a promise to build a park in the city, or procure food for the town, plus a bribe? In fact, it is often in the interest of the local governments to choose privatization schemes that commit firms to doing things for localities rather than maximizing privatization revenue. To some extent, this problem is smaller when localities keep a lion's share of privatization proceeds. Even then, the potential for corruption is truly enormous.

While local control spells corruption everywhere in the world, some steps can be taken to reduce this problem. Most important, nonprice methods of allocating firms should be restricted where possible, and auctions (including auctions where each buyer must meet certain terms) should be used instead. Auctions reduce corruption relative to more discretionary forms of sale. Second, the government should require the maximum publicity about firms that are being privatized. Some transparency will prevent the blowup of the privatization process as corruption becomes exposed.

All things considered, putting more pressure on the local governments to privatize is highly desirable. Starving the local government budgets by not allocating funds from the center might provide them with a strong incentive to try to raise money, including by means of privatization. In addition, pressure from the workers is likely to be extremely important since workers in state enterprises represent many of the voters in the local elections. For this reason as well, generosity toward workers in accomplished privatizations is desirable.

12.4.4 Managers

Enterprise managers can easily sabotage privatization by refusing to cooperate with either the buyers or the government, and their claims are therefore the most important to respect. Most managers have considerable control over assets now and will retain most of it no matter what form privatization takes. The privatization program recognizes the power of the managers by giving them the right to choose privatization plans for their companies. The options among which they can choose include auctioning off the shares after corporatization, the sale of a control block to a large investor (through some competitive process as well), or a worker-management buyout. If the company is privatized through a worker-management buyout, as most companies undoubtedly will be, the managers will be completely in charge. But, even if the company is privatized through a substantial investment by a foreign or a domestic buyer, in almost all cases these buyers will seek the cooperation of the incumbent management both to privatize and to run the firm. In this case as well, the control rights of the incumbents will be largely preserved.

Managerial control is not as bad as is commonly supposed. The Western literature is fixated on the non-value-maximizing conduct of corporate managers. Most of that conduct results from having excess cash flows to waste (Jensen 1986). At least in the near future, free cash flow will not be nearly as large a problem for the Russian firms as outright theft. Moreover, even with all its imperfections, control by the managers is much less evil than the control of either the workers or the local governments. When the Western literature criticizes managerial control, the usual comparison is to active governance structures, such as large shareholders, banks, or takeovers. The emergence of these active governance structures is unlikely in Russia in the near future. Moreover, the gains from these structures are much smaller than the gains from replacing worker or government control with managerial control. In short, managerial control is not a very severe problem (although it is best to avoid governance structures that completely entrench the managers, such as closed companies). If anything, the best prospect for a rapid restructuring is a transfer of most control rights to the managers and active outside shareholders, as opposed to the workers and the local governments.

Because the managers have such strong control rights, they are unlikely to get shut out from the corporate cash flows, no matter what the public sentiment against them is. In worker-management buyouts, they are likely to get nontrivial ownership stakes. If companies are bought by outsiders, they will get finder's fees, bonuses, severance pay, or ownership stakes anyway. In all these cases, the managers have a substantial financial interest in the success of privatization since, particularly after prices are liberalized, their ability to profit from continued government ownership is not likely to be as great as their ability to profit from privatization.

The greatest danger is that in some companies, particularly the rich ones, managers might get enough benefits from their current control that they do not want to privatize at all. The oil companies, for example, can now retain enough earnings that they can buy all the equipment and expertise they need, without privatization or even joint ventures. The managers of these companies can consume tremendous perquisites now, yet risk a substantial loss of control if these firms are privatized. At the same time, it is not clear that they can get many shares of such valuable companies in the case of privatization. As a result, these managers might simply prefer the combination of state ownership and substantial earnings retention.

To provide further incentives to privatize, the government can enhance the managerial ownership of cash flows through stock options and other means to make it more politically acceptable. In fact, some companies have begun to institute small management-ownership schemes. Unfortunately, compared to what the managers can get for themselves from spontaneous privatization or management buyouts at ludicrously low prices, these schemes offer them fairly little. It is much better to be more generous to the managers in legal and open privatizations than to face the consequences of a mass spontaneous privatization.

12.4.5 Branch Ministries

The one stakeholder whom the Russian government probably should fight rather than appease is the branch ministries. The workers, the managers, and the local governments seem to be united in trying to diminish ministerial control since it directly conflicts with their rights. Moreover, from the long-run-efficiency viewpoint, any control by the ministries is bad for the simple reason that the ministries are a substitute for market transactions and giving them a role would reduce the role of the market. In particular, privatization is strictly against the interests of the ministries. If the ministries get control rights, they would use them, not to facilitate transactions, but rather to entrench themselves.

Of course, as we have already mentioned, the ministries still have some control over enterprises and voting power in the government. Excluding them from the privatization process will be costly. The current privatization recognizes this and concedes to the ministries in two important respects. First, they will be able to review and perhaps reject privatization plans for large federal enterprises. Second, some of the shares will be distributed along the vertical production chain, as the ministries like. So far, the government has resisted giving a large role in its privatization program to sectoral privatization plans that will be developed by the ministries. Resisting the sectoral ministries on this and other issues might well be worth the fight, for the ministries have no real interest in long-run decentralization and efficiency.

12.4.6 The Public

One important stakeholder whom we have not discussed so far is the public, which includes several important categories of people who do not benefit from the free handouts or subsidized sales of shares. The public includes pensioners, students, invalids, and others citizens supported directly by the state budget. The public also includes doctors, teachers, professors, and others who do not work at firms that will be privatized. Perhaps most important, the public includes the army, which is very hungry and very angry. All these members of the public have some political power and want to benefit from privatization like everyone else. They are represented in Parliament, are ready to demonstrate in the streets, and, in the case of the military, offer a potentially much greater threat to the government. Like every other privatizing country, Russia must give something to the public for privatization to succeed.

The privatization program incorporates a voucher scheme similar to that used in Czechoslovakia. In this scheme, members of the public will be given individual vouchers that will give them claims to shares of privatizing companies. Individuals will be able to sell these vouchers for cash, to turn them over to mutual funds that will use them to buy shares of privatizing companies, or even to use the vouchers to bid for shares directly. While the government is very sympathetic to the idea of having private mutual funds to collect or buy vouchers, it is resisting the idea of Polish-style state-sponsored mutual funds, which might prove difficult to separate from the government in Russia. Details of this voucher scheme remain to be worked out, and it is likely to be introduced late in 1992. The government feels the urgency of at least announcing some future giveaway to the public to avoid resentment of privatization.

12.4.7 Summary

In this section, we have outlined some strategies of the Russian privatization program. These strategies invite the workers and the local governments to give up their control rights, allocating them to the managers and the new investors. But, even if all the steps described in this section are taken, conflicts over privatization and restructuring will remain. Nonetheless, the legislation should continue to move in the direction of providing compensation for the stakeholders in return for cooperating in privatization.

12.5 The Future of Privatization

With a high probability, there will be very little privatization in Russia in the near future. Too many local governments, ministries, and even enterprise managers are opposed to privatization, and it is much easier to stop privatization than to move it ahead. Nonetheless, in many regions, the pressure to privatize from below will be high enough that some privatization, particularly of small firms, will take place. In this section, we discuss what will be the likely privatization scenarios. We consider small-scale privatization (meaning that of firms to be privatized by the local governments) and large-scale privatization (meaning that of firms to be privatized by the Russian government, separately).

12.5.1 Small-Scale Privatization

Some manufacturing firms, as well as many shops, bathhouses, and movie theaters, will be privatized locally. These firms will be sold on some terms, although not necessarily to the highest bidder. It is virtually certain that the management and the employees of these firms will be substantially involved in these sales. In some cases, particularly of smaller or of unprofitable firms, the employees and the managers will get together and simply acquire the firm in an auction or a management buyout. They will subsequently try to find partners to help them with restructuring, and perhaps even do it themselves. In fact, some auctions of shops have successfully taken place in Nizhny Novgorod in March 1992, with many more still to come.

Prices paid in these transactions are likely to be very low. The starting values in the auctions and competitions are book values of assets, which because of fast depreciation and a rapid inflation are usually only a trivial fraction of firm values. Moreover, there will not be much competition for most of these assets. First, local governments are not required to conduct auctions and so will probably use less transparent privatization techniques. If their efforts to restrict participation in auctions succeed, in many cases the local governments might simply be able to decide the winners of the auctions themselves in exchange for bribes. Second, the managers and the workers will obviously strongly oppose competition for the assets if an MBO is an option. If outsiders are involved, they will become partners of the MBO organizers rather than making competing bids. With little competition and low starting values, equilibrium prices will be low. The bureaucrats will get bribes to grease the wheels of this process and are therefore likely to go along. In this way, the local governments will give up control rights in exchange for payments to the bureaucrats, a nontransparent procedure but one that works. Small-scale privatization will not raise much money.

Some of the money for the worker-management buyouts will undoubtedly come from the cash reserves of the firms, which typically are not accounted for completely in the calculations of book value. The Russian law explicitly allows the use of these cash reserves for the purposes of buying firms from the state. In fact, many firms have been preparing for this strategy by accumulating cash reserves. In addition, if the credit policy allows them to do so, many MBOs will use bank loans to acquire the firms. The banks lending to these activities are likely to be the so-called private banks, which in fact take the deposits from other state enterprises and lend them out, usually for trade. Given the low prices in the worker-management buyouts, these loans will in most cases be repaid in a few months. In the cases where the WMBO organizers need additional funds, they will probably turn to some of the existing businessmen to participate in the acquisitions. This strategy will be most prevalent in firms that can profitably produce some goods for the local market or for export. For example, many of the stores in Moscow are attracting such investments because their retail space can be used for selling imported consumer goods as well as whatever these stores have been selling traditionally. The firms that attract such outside money will restructure most rapidly and efficiently, in part because the managers will have large shareholders breathing down their necks. These WMBOs with the participation of outside money are most similar to the typical Western MBO.

Very few of the smaller firms will be sold outright to buyers who are not insiders in the firms. A few auctions will be won by outsiders. Sometimes, outsiders will pay local bureaucrats higher bribes than the insiders do and will gain control in this way. These cases will be the exception rather than the rule since the built-in procedures strongly favor the insiders. Similarly, foreigners will rarely get involved in smaller firms, except through joint ventures with the insiders, since typically these firms are too small and too unlikely to export in the short run to interest them. Overall, small-scale privatization will be a slightly more transparent and regularized version of the spontaneous privatization that has already begun in Russia.

12.5.2 Large-Scale Privatization: Who Will Be the Buyers?

Some of the intermediate and large enterprises in Russia are too large and have too much capital per worker, even at book value, to be privatized through worker-management buyouts. Even if the sector ministries get their way and the suppliers and customers are allowed to participate in the MBOs, the combined resources might still be insufficient to buy out the largest companies. Also, since the largest companies are being privatized from the center, their privatization will require considerably more transparency to avoid bad publicity. Transparency, of course, also raises prices as long as they are not pinned to book values. Nor will it be easy to conduct MBOs with the participation of local investors since again there is simply not enough private capital in Russia today to acquire more than a few of its large enterprises. The most likely alternatives for small-scale privatization are often not open for large-scale privatization.

One potential hope for large privatization is foreign buyers. Unfortunately, the foreign buyers are interested in many natural resource industries in Russia, but not much else. Even when they are interested, they face several obstacles. First, current laws require the agreement of too many people, including the local government, GKI, the sectoral ministries, and the Committee on Foreign Investment, for an acquisition by a foreigner to take place. With so many approvals required, most proposals are likely to be rejected or sink in infinite negotiations, like VAZ. Second, Russia still lacks laws regulating business activity in general and foreign investment in particular. Except in the sectors where foreigners can take stuff out of the ground fast and export it, the absence of laws will slow down foreign investment. Third, in many cases, the managers of the Russian companies are not eager to give up control to foreign investors. Since these investors will often insist on control, few actual privatizations to foreigners might actually be accomplished.

The difficulty of finding buyers for large companies suggests that Russia will need to use its large-scale voucher privatization scheme aggressively to allocate the shares of the largest firms to the public. The success of this scheme will depend crucially on the technological feasibility of introducing vouchers as well as the possibility of running auctions in which both vouchers and cash can be used to bid (perhaps for different blocks of shares). If these technological difficulties can be overcome, the voucher scheme will become the central element of the Russian privatization. If technological problems become too severe, the government will move to a simpler method of allocating shares to the public, perhaps through state-sponsored intermediaries such as the mutual funds used in Poland. As of this writing, the details of the voucher scheme in Russia are too vague to be discussed more concretely.

12.6 Conclusion

In this paper, we described privatization as a redistribution of existing control rights over company assets between its stakeholders. To get the stakeholders to agree to this redistribution, they need to be compensated in terms of dividends and privatization proceeds. We have discussed some schemes of providing this compensation to the workers, the managers, and the local governments, the three principal forces that might oppose privatization. While these schemes will not stop all resistance to privatization, they might well reduce it. Luckily, the Russian privatization program in most instances tries to reconcile conflicts between stakeholders.

It is impossible to tell how fast privatization will proceed in Russia. Many bureaucrats, politicians, and managers oppose it and have enough political clout to slow it down. Even after privatization, restructuring need not come. Despite all these concerns, it is obviously essential to push for privatization and to grease the wheels when they turn slowly.

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Comment Jacek Rostowski

The authors describe one of the key microeconomic problems of the Russian economy: the failure of property rights over the vast majority of nonhuman assets to be properly defined. Instead of clearly defined owners there are stakeholders whose rights to decide what to do with assets are unclear. Moreover, there are no clear procedures about what to do if stakeholders disagree. As a result, by Coase's theorem, assets are used inefficiently. Therefore, privatization is seen above all as a way to define property rights.[1] However, because privatization takes time, stakeholders are motivated to undertake action that will increase their claims during the privatization process, even if these actions reduce the value of the assets being contested. This is what I call *property rights–seeking behavior.* It is rational to pursue such behavior as long as its costs—in terms of the resulting value destruction that is borne by the stakeholder concerned—are smaller than the expected benefits.

Shleifer and Vishny believe that the Russian privatization program, which transforms managers and workers into (minority) shareholders and grants local authorities an important share of privatization proceeds, will work to neutralize the opposition of these key groups to privatization. Also, by providing an initial definition of property rights, the scheme is likely to reduce destructive property rights–seeking behavior, as it is worth engaging in such behavior only if one's expected increase in wealth (compared to the allocation imposed by the state), less the costs of achieving it, is positive. Without such an "external" definition, some stakeholders may get nothing if they fail to assert their claims through destructive action. Nevertheless, it remains the case that, if the allocation of property rights resulting from the Russian government's privatization program is very different from that which corresponds to stakeholders' perception of the allocation that would result from a period of property rights–seeking behavior, such behavior is still likely to take place. A key question is therefore how close the proposed Russian allocation is to such a "perceived equilibrium" allocation?

An alternative approach would be to find an "uncontestable" allocation—one that, once made, could not be resisted by stakeholders, even if it were not necessarily the same as the equilibrium allocation. Given the strength of egalitarian and "workerist" sentiments in Russia, I believe that such an allocation would be one in which the bulk of the shares in most state-owned enterprises (SOEs) was given to the employees.[2] Such an allocation need not ex-

1. Privatization could also be used to allocate assets to those who need to make ex ante investments in the human capital that is complementary with these assets, along the lines of Grossman and Hart (1986). Privatizers would thus attempt to achieve an allocation of property rights as close to the efficient as possible. However, the authors do not pursue this interesting strand in their analysis far.

2. Exceptions could be made for natural monopolies such as railways and power transmission.

clude the other stakeholders. Central and local governments could retain their stake in each enterprise in the form of shares that would be nonvoting as long as they remained in public hands but that would recover their voting rights when sold.[3] Each share sold by employees would require the simultaneous purchase of a proportionate number of public-sector shares. Managers would obtain shares as employees and also often be able to use their prestige and greater understanding of the business to convince workers to agree to management buyouts.

This approach abolishes all ownership rights held by local and central government at a stroke, giving these rights to a group that ought to be capable of defending them in practice. It is far from clear that the supervisory boards of commercialized firms advocated by the authors, which would consist of representatives of the State Property Agency (GKI), managers, workers' representatives, and banks, would have the power to resist the local authorities. Given the extremely dangerous propensity of local governments in Russia to replace the old branch ministries as the controllers of the activities of state enterprises on their territory, such an "intraenterprise revolution" is vital. The experience of Eastern Europe suggests that the only force within the enterprise capable of standing up to the planning bureaucracy is the workers.[4] However, it is critical that the shares should become the property of employees as individuals (and not as members of a collective) and that they should from the start be tradable (i.e., "closed" companies must be banned).

A number of advantages relating to privatization technique stem from the approach that I am suggesting. First, the authorities are not obliged to organize auctions of enterprises (as is foreseen in the Russian program) but can leave the choice and organization of the privatization technique to the enterprise itself. While auctions would continue to be possible, trade sales, flotations, and management buyouts could now also be used. Given the "administrative fragility" of the Russian state, this is a not inconsiderable advantage. More important, under the Russian scheme, GKI has to decide on whether and how to break up the enterprise before privatization. It seems plausible that the managers and workers in the enterprise will know better how to do this, and the "employee-centered" scheme gives them the incentive to do it relatively efficiently.

Furthermore, the profitability of SOEs typically collapses after macroeconomic stabilization in post-Communist economies.[5] Many loss-making enterprises will be impossible to sell. Domestic and foreign capitalists will be willing to pay only very small amounts for marginally profitable enterprises, which may require a large injection of capital and a huge reorganization and restruc-

3. To the best of my knowledge, the originator of this proposal is Tomasz Stankiewicz of Warsaw University, the deputy minister of privatization of Poland.

4. If the workers decide to allow themselves to be led by the managers in determining the firm's policy, that can be all to the good.

5. In Russia, it seems to have collapsed before stabilization.

turing effort if they are to have a long-term future. Unlike in the auction-based scheme, employee-owners can help resolve this problem by increasing the capital of the firm by admitting outside capitalists. Sale to foreign investors becomes far harder to oppose on nationalist grounds when the sellers are the workers rather than the government. The employee-centered approach also ensures that, whatever the profitability of the firm, there always exists a group of owners whose future is bound up with the enterprise for at least a time. And, unlike worker-managed firms, employee-owners do not have the disincentive to invest that results from the knowledge that the enterprise will ultimately be privatized, with the proceeds going to the state.

Last, but far from least, Polish experience since 1990 shows that, even in the almost complete absence of divestment of organized businesses by the state, one can have extremely dynamic private-sector development as long as the commercial property market is decontrolled and SOEs have the right to sell their physical assets. Capitalists prefer to buy (or hire) the assets and work force they actually need and to combine them in ways that correspond to their requirements rather than to take over organized businesses created in completely different circumstances and adapt them. There is some concern that the Russian auction-centered approach to privatization will make it harder for SOEs to sell their physical assets, as a result of a desire by the authorities to prevent insiders from stripping the assets of SOEs at the expense of the formal owner (the state). The employee-centered approach, like worker management in Poland, frees the enterprise to do as it sees fit with its assets.[6]

Reference

Grossman, Sanford, and Oliver D. Hart. 1986. The costs and benefits of ownership: A theory of vertical and lateral integration. *Journal of Political Economy* 94, no. 4 (August): 671–719.

Discussion Summary

Jan Svejnar argued that a lack of human capital would make it difficult to hire enough qualified board members to implement the corporatization proposal. *Andrei Shleifer* responded by noting that many of the board members would come from the current group of managers.

Simon Johnson discussed the role of managers in Ukraine. He said that the transfer of control rights from ministries to managers has led to greater efficiency. He noted that, in Kiev, managers effectively control the local govern-

6. Part of the proceeds of the sale would go to the state, in a proportion corresponding to its share in total ownership. This is a good reason for keeping the share of the state low on privatization via distribution to employees.

ment and the workers by using side payments. He noted, however, that, while many managers have effective control of the firms they operate, they do not have the ability to sell those control rights legally. Finally, he predicted that the next step for Ukrainian managers will be to undertake leveraged management buyouts.

Richard Layard suggested that the Russian government should undertake a mass privatization plan. He said that Shleifer and Vishny's corporatization plan would actually create hurdles for the privatization process since worker-controlled board members would prevent rapid restructuring.

Michael Dooley suggested that in addition to the four groups that Shleifer and Vishny had identified—the central government, local governments, workers, and managers—the bureaucrats in state-owned banks would also try to grab control rights of newly privatized firms. Dooley argued that the lack of a private capital market would enable the banks to make this demand.

Dmitri Vasiliev also suggested that Shleifer and Vishny had ignored some important participants in the privatization debate. He highlighted the roles of the army and the new business class.