Working Paper

Enterprise Behavior and Privatization of the Large Enterprises in the Russian Federation

ETI Project

WP-93-70
November 1993

IIASA

International Institute for Applied Systems Analysis □ A-2361 Laxenburg □ Austria

Telephone: +43 2236 715210 □ Telex: 079 137 iiasa a □ Telefax: +43 2236 71313

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Foreword

The Economic Transition and Integration (ETI) Project at the International Institute for Applied Systems Analysis (IIASA) has built on the institute's tradition of promoting collaborative research between East and West. The ETI Project's proven ability in dealing with issues pertaining to the transformation from central planning to market economics has been valuable for policy-makers and scientists alike. As a result, the governement of the Russian Federation turned in 1992 to the ETI Project to organize a series of seminars and provide reports on topics of concern to the government. The Ford Foundation and the Pew Charitable Trusts have generously provided financial support for the seminar series.

This report summarizes the contributions of participants at two related seminars held at the request of the Russian government at IIASA in the summer of 1993: Enterprise Behavior under Conditions of Economic Reform and Privatization of Large State Enterprises, both in the Russian Federation.

Enterprise behavior, particularly of the large state enterprises that continue to dominate the Russian industrial and service sectors, is a crucial factor determining the success of economic reform. Somewhat surprisingly, the changing economic conditions have as yet to be accompanied by similarly sweeping alterations in firm behavior. The first of the two summer seminars focussed on why and how managerial attitudes and objectives, enterprise relationships, financial issues and taxation, foreign trade, and social welfare were significant in explaining present trends in enterprise behavior. Seminar participants searched out alternatives that would make these factors more conducive to promoting economic recovery and growth, and also compared the behavior of Russian enterprises with experiences in Poland and the Czech Republic.

Privatization of large state enterprises is an integral part of the Russian economic transition. Vice Premier Anatoly Chubais opened the second workshop by reviewing the economic and political history of Russian privatization efforts, summarizing recent developments, and outlining future plans. Potential and actual privatization influence managers' and firms' behavior before and after the process is undertaken. Further discussions were devoted to the legal and institutional environment, the restructuring and privatization interface, and a review of privatization techniques and experiences from Central and Eastern Europe.

Once again, the seminar revealed an intense willingness of experts from Russia, Central and Eastern Europe, and the West to share their valuable experiences in an effort to find approaches to more optimally encourage the successful transition to a market economy.

Contents

Introduction

This paper is the product of an on-going research effort based on an agreement between the government of the Russian Federation (RF) and the International Institute for Applied Systems Analysis (IIASA) in Laxenburg, Austria. The report endeavors to summarize presentations, papers, and discussions from the seminars *"Enterprise Behavior under Conditions of Economic Reform in the Russian Federation"* and *"Privatization of Large State Enterprises in the Russian Federation"*, both organized by the Economic Transition and Integration (ETI) Project at IIASA in the summer of 1993. As was the case with the other seminars in this series, this meeting responded to a request of officials from the Russian government and fulfilled a policy oriented need.

The conduct of enterprises during the transition to a market economy and the fluctuating conditions delineating motivations and incentives for enterprise managers are crucial elements determining the success of economic reform. As the conditions transform, so too must an enterprise's activity adjust over time. Decentralizing decision-making, abolishing strict central control, and liberalizing contracting, price setting, use of revenues and foreign trade are all new phenomena for enterprises, their management and employees.

As if this were not challenging enough, it is simultaneous to the stagnation or recession of the Russian economy, the collapse of the Soviet Union and the Council for Mutual Economic Assistance resulting in a severe deterioration of the general economic climate to previously unknown magnitudes for the population. In addition, potential or rather imminent demonopolization, the related split-up of large firms, their corporatization and privatization create emerging uncertainties and possibilities that will inherently shape the pattern of enterprise activity and behavior. Relatively little is known of how firm managers perceive all these changes, which options they may consider in the decision-making process, and how they form policies when their firms are undergoing transition. In this paper we attempt to summarize these issues as they were presented and discussed by Russian, Western, and East European policy-makers and scholars at the first ETI summer seminar.

In this frame, we do the same for the second seminar, which was organized for the purpose of investigating the more specific topic of privatizing large state enterprises in Russia and followed the first in both theme and time. These enterprises dominated and continue to dominate the nation's industrial and service sectors. While many researchers and policy-makers agree that the first step in the complex process of transformation should be commercialization and corporatization, it is, in fact, the subsequent move of creating ultimate responsible owners via the distribution of shares which is more difficult and controversial. The main reasons being the public's unfamiliarity with shareholding, few if any real financial intermediaries, low levels of savings by the population, and reluctancy of foreign investors to enter the unstable Russian market. The terms manager and owner, and the type of relationship and division of responsibilities will take on a whole new quality and significance

-- certainly distinct from their Soviet definitions but presumably not identical to their standard market meanings. The problem is further compounded by disputes as to which level of government (national, regional, or local) should be the initial owner. Needless to say, the potential and actual effects of the privatization process seem quite unpredictable given these many items of concern. The small East European countries that have embarked on privatizing large state enterprises earlier provide evidence of the different possible approaches and the various expected and unexpected (both positive and negative) outcomes of their respective programs.

Although all the sessions were taped and a complete set of papers contributed by the participants was collected, this report is presented in a more concise manner. It is a summary of the key issues and a description of alternatives for the policy-makers. The structure of this report largely follows that of the seminars. The accounts of the various national experts and officials as well as the ensuing discussions during this seminar have been complemented with background material (these are listed in the references). The authors of this report and organizers of the seminar, all members of the ETI Project[1], wish to thank all the participants in the seminar for their contributions. Their names are listed in the Appendix.

[1] Vít Bárta, János Gács, Il'dar A. Karimov, Merton J. Peck, Martin Rein, Christoph M. Schneider, and Tibor Vaško.

General Issues of Enterprise Behavior

State enterprise behavior during economic transition in Russia

The present behavior of the enterprises can be characterized with a changing mixture of old and new behavioral patterns. Many basic features of the old system of central planning disappeared, a new paradigm, however, has not yet evolved. Different scholars use different terms when they describe the system that characterizes the behavior of enterprises over the last two years. One of these terms is 'socially based market'[2].

After universal administrative coordination has been abolished, many enterprises find themselves in a novel situation in which a very low share of their production is covered by orders, while financing current operations has become strict. Consequently, the extensive use of long-established links amongst enterprises has increased significantly. Despite liberalized prices and greater freedoms for most enterprises than ever before, the solidarity among long established partners became more typical than new, market based initiatives and ties. Moral considerations and loyalty is often placed before the profit motive. The legacy of blurred property rights also contribute to this pattern of behavior. Following the liberalization of prices, many enterprises could exploit shortages or utilize their monopoly position to increase product prices; yet they have been reluctant to do so even when price increases of input prices could fully justified such a move. As surveys revealed, many of the managers consider it amoral to respond to opportunities by overpricing. There is also a widely used practice of price discrimination between old and new, state and private buyers (customers), usually for the benefit of the former in each case. These features justify the designation of the emerging market as socially-based market.

Several seminar participants, like Randi Ryterman, interpret this phenomenon differently: they assert that cooperative behavior of enterprises which have long lasting relationships is not a symptom of moral behavior, but is serving the self interest of the firms themselves. Enterprises that are operating on imperfect markets are at the mercy of their long established suppliers and customers. It is only natural that they do not start adjustment by severing the vital ties with these partners. Essentially, the enterprises are preoccupied with their own survival, but at the same time also with the survival of their major partners. This is all the more important because recent research also indicates a high level of vertical dependence: most enterprises have only one or two major suppliers and one or two major customers.

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[2] The term and the explanation was presented at the seminar by Viacheslav Shironin. See also his paper: *State Enterprise Behavior under Economic Reform - Changes in Managerial Attitudes and Objectives.*

One of the reasons for the lack of competition in the already liberalized Russian markets is the perceived high level of concentration in Russian industry. While earlier studies[3] have asserted that the concentration of Russian industry is extremely high (much higher than those of mature market economies), Randi Ryterman and Barry Ickes reported about their World Bank study presently in progress (led by themselves and Valery Makarov of CEMI, Moscow) which reveals startling results. Namely, the level of concentration in Russian industry is much lower than previously claimed, in fact lower than that of the USA, and military industry is showing even lower concentration in Russia than production for civilian purposes.[4] In order to explain the behavior of enterprises in light of these new results, Ryterman argued that enterprises have been isolated from one another causing an absence of essential information regarding their real choices and the real market structure in the national and even local context. The technical possibility to select alternative suppliers/customers actually existed, but the lack of information, incentives, and central licenses prevented enterprises from considering these alternatives. Thus, the cause of imperfect competition is not the previously perceived high actual level of concentration, but rather the belief of the enterprise managers that they face large concentration by way of rigid supply structure and market segmentation. Nevertheless, other participants were more ready to accept earlier statistics on the concentration in Russian industry, partly on the base of their experience concerning strong technological interdependence of firms.

As opposed to arguing that the rational behind current Russian firm behavior is the protection of moral values, some seminar participants felt that a more adequate description of the situation is enterprises operating in flux and oriented to survival. The highly uncertain environment and the lack of consistent regulations drive the behavior of these enterprises. As a consequence, firms have a very short time perspective. The tools for survival involve, among others, heavy reliance on government soft credits and the provision of informal commercial credits to customers.

The tasks of policy-makers to create an environment in which enterprises revert from the survival mode to the market mode are multifarious, including efforts to reduce the enormous transaction costs enterprises are forced to bear when seeking new suppliers and customers in the new environment. The 'policy actions' of the government should include the two following crucial points: provision of information for alternative trading partners about the real structure of the market and regional and local authorities should cease restricting trade and should open their markets to the rest of the economy. Good and equal opportunities should be provided to new and distant agents to enter local markets. The transportation

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[3] See *The Economy of the USSR: Summary and Recommendations*, a study undertaken in response to a request by the Houston Summit (Washington D.C.: International Monetary Fund, International Bank for Reconstruction and Development, Organization for Economic Cooperation and Development, and European Bank for Reconstruction and Development, 1990), and Peck, et al (eds.): What is to be done? (Yale University Press, New Haven, 1991).

[4] One reason for the differences of earlier and recent studies may be that earlier investigations took into account deliveries to the Gossnab only, i.e. those covered by the centralized system of material allocation. The coverage of military related production activities, as well as the level of disaggregation are also important factors in choosing from competing measures of industry concentration of Russia.

system, including train and road transport, should be developed, and adequate storage capacities should be established. The payments and settlements system should be improved by making it faster and more reliable. The enforcement of contract law would also enhance adjustments corresponding to the market system. In the framework of perfect competition, these kinds of advice would be unconventional, however in the Russian situation they are appropriate.

Both scientific analysis and policy making would benefit from a proper classification of enterprises according to the differences in their behavioral pattern. Most seminar participants asserted that new private enterprises follow more market-like behavior than state owned firms, especially in decisions on current operations. In contrast to this, behavior of privatized state companies has not changed significantly from the time under state control. Due in part to the uncertain environment, criminal behavior is widespread in the private sector and the effects of increasing criminal activities are reducing budget revenues and jeopardizing macroeconomic performance.

In Russia, private firms seem to target government support to their commercial activities, simply stated as squeezing money from the government, to the same degree as traditional state owned enterprises. This is true for private banks as well: they appear convinced that they are not going to make money without the government. However, notwithstanding the more rapid adjustment in the private sector, the behavior of most state enterprises also underwent considerable changes during the last two years. These changes can be analyzed by different methods like surveys and deep interviews.

New behavioral trends[5]

Regarding the perception of changes in the economic environment, the majority of enterprise managers find the position of their enterprise financially uncertain (70%), rather than financially stable (23-25%), or potentially bankrupt (5-6%). The share of enterprises that feel financially stable is higher in heavy, material based industries (like energy generation, oil, chemicals, and building materials industry) as well as in small and medium size enterprises (under one thousand employees), while those that consider themselves potentially bankrupt mostly belong to industries producing more processed output (machinery and light industry) and are large enterprises (one to five thousand employees).

As in other East European economies, price liberalization and stabilization measures substantially curbed earlier pervasive shortages. As for sources of current problems, only 7% of managers in the test sample refer to the unsatisfactory supply of inputs and 13% to labor related problems, while 61% mentioned that the lack of money is the major factor inhibiting enterprise operation.

[5] The following paragraphs summarize the findings of the paper by Sergey Alexashenko and Elvira Nabiullina: ***Enterprises in Transition - New Models of Behavior***, prepared for the ETI seminar.

All of the managers who have evaluated the financial state of their enterprises as potentially bankrupt believe that their main goal is the preservation of the working collective. From the wider sample, however, 30% of managers are ready to reduce the work force by firing employees. Paradoxically, due to the special incentive of the excess wage tax they are also interested in retaining unproductive, low paid staff members in order to pay higher wages for essential employees. 92% of the managers are not ready to economize on wages and 60% are not ready to restrict or terminate financing social programs.

Pricing and investment are also viewed differently depending on the managers' perspectives. With respect to pricing practices, 58% of the enterprises use cost-plus pricing as their sole method, while 28% establish prices according to the demand for their products. Investments became more decentralized than before, but are less and less efficient because enterprises have no financial means to complete and fully employ them.

A considerable part of the enterprises have become more active in restructuring their organization. Examples include: granting financial, managerial, and market independence to sub-units; separating and privatizing their highly profitable units, while liquidating the non-profitable ones; and reducing the size of traditional departments (like planning, labor, wages and training departments) and expand others (like sales, marketing and advertising). The choice of the enterprises to opt for market- or non-market behavior is customarily influenced by objective conditions like ownership, extent of monopoly, industrial affiliation, foreign trade dependence, inter-republican cooperation, burden of non-productive expenses, and the existing level of foreign competition. Yet, even more crucial factors influencing the behavioral style are personality of enterprise managers, and the signals that economic policy sends to enterprises.

Alas, these signals were not at all unambiguous in the last two years and gave rise to a general atmosphere of uncertainty. Enterprise managers complain about inconsistent government policies and the introduction of regulations that have been unclear, unstable, and lacking enforcement. According to views of the management, government has done very little to prevent economic misconduct and breach of rules and contracts.

Enterprise relations

Changes over the last few years considerably reshaped the vertical and horizontal links of the enterprises with the authorities or control agencies and their partners[6].

As far as the committees (departments) that became successors of the ministries are concerned, most enterprises no longer regard them as proper authorities *per se*. Individual enterprises are no longer accountable to these large administrative organizations, though a certain degree of dependence prevail. Obtaining soft credits continues to be one such area

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[6] The following paragraphs are summarizing the paper Tatiana Dolgopiatova prepared for the ETI seminar (title: *Enterprises' Relations*), and the discussions that followed the presentation of the paper.

in which support of a given committee or department is required;[7] another is the active participation in or even control of the ownership transformation of the enterprise, where these committees are quite openly and aggressively pressing for the adoption of their own ideas and schemes.

Seminar participants expressed diverging opinions about the role local authorities currently play in the operation of enterprises. On the one hand, local authorities are not of much concern for enterprises since good relations are not difficult to maintain if so desired. In fact, local enterprise managers are part of the local establishment. On the other hand, after central control declined to a minimal level, control of local authorities took its place and became increasingly strict. The whole complexity of constitutional discussions reflects the endeavor of local authorities to take the power from the central government and conduct their own market interventions. If managers do not speak about frictions with local authorities, the real query is what makes managers accept the harsh interventions of local authorities? The imposition of diverging or additional local regulations where central controls already exist, the frequent neglect and arbitrary suspension of central government guidelines by local authorities, and the imposition of regional and local trade controls multiply the inconsistencies that the general framework of economic activity already exhibits. Further fields where local authorities seem to intervene is employment, production plans, and pricing policies. Local authorities try to convince slumping enterprises to hold and even take redundant labor in order to keep local unemployment low. These authorities also issue "official forecasts" that virtually work as plan targets, and pressurize enterprises to keep down prices of some consumer goods for "social" purposes.

When the Soviet Union collapsed, branch ministries were abolished. Many of them, however, were already reorganized as corporations, joint stock companies, and associations embracing producers that used to be subordinated to them under the former regime. The relations of enterprises to these vertical hierarchical associations is now improving. Some may interpret the reluctance of enterprises to terminate membership in such associations, in spite of new freedoms to do so, as an indication of the better relations. Given the benefit these associations can provide, many smaller companies join even two, three, or more such associations. The latter offer the former the opportunity for greater economic and political power, particularly in lobbying more efficiently for soft credits and subsidies and building economic links with enterprises in other countries of the former Soviet Union. Horizontal associations also provide benefits for their members; however, disputes over reallocation of assets are not rare.

The experiences of production enterprises with banks gave rise to substantial distrust on the part of the former. During periods of rapid inflation, enterprises are convinced of opportunistic misuse of their transfers and deposits by the banks. Most enterprises, however, have traditional connections to some banks, and these links constitute the basis of preferential

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[7] According to the wording of one seminar participant, "Now the state is no more allocating material resources, but is doing the same with financial resources and the system of bargaining with the enterprises is the same as earlier".

credits granted to them. A characteristic indicator of the spread of preferential credits is the variation of annual interest rates on credits. This was 10-20 percentage points in 1992, but climbed to 100 points by 1993 (the lowest interest rates being 10-20%, while the highest 120-140%). The most advantageous terms are usually granted to enterprises who are co-founders of the given bank. While the participation of production enterprises in the ownership of banks is frequent, the opposite, namely the ownership of enterprise shares by banks, is rare. According to current practices, credits are "softened" not only by friendly banks but also by the state, which assumes responsibility for repaying part of the credit.

Seminar participants also discussed the question why were managerial attitudes so different in Russia and Ukraine on the one hand, and in other countries of Eastern Europe like Poland, Czechoslovakia and Hungary, on the other. One of the main reasons was that macroeconomic stabilization in the latter countries was more effective. This established a less uncertain environment and harder budget constraint for enterprises. Many analysts think the adjustment of enterprises in Russia was tardy not because there was no capacity for adjustment, but because the pressure on the enterprises was not strong enough. They could blackmail the government to obtain soft credit, thereby achieving an exceptionally extreme softness of the budget constraint.

Another characteristic feature of transformation in other East European countries was a unmistakable turn away from the previous political system, implying replacement of the former communist-technocratic elite both on the level of the government and management. This has not happened to anywhere near such a degree in Russia. In Eastern Europe, earlier organizational decentralizations also contributed to the break-up of old monopolistic structures as did the uncompromising opening of the domestic markets to the world market. As opposed to this, the monopoly position of old specialized foreign trade organizations has been effectively maintained in Russia.

Financial Reform: Policy Options

The lack of financial development in Russia is one of the most problematic issues in transition. As it was widely recognized, imposition of the hard budget constraint on enterprises has not been successful in Russia so far. In market economies, multiple financial institutions channel enterprises' borrowing from other sectors of the national economy. Such a mechanism does not exist in Russia: enterprises, experiencing severe shortages of working capital, either have to plead for government subsidies, or finance themselves by stockpiling payments arrears. Once emerged, arrears become a very popular source of enterprise finance simply because nobody can be properly punished for overdue payments in a situation when everyone owes everyone. General confidence in the impunity makes arrears nearly unavoidable and this situation seriously undermines government attempts to carry out financial stabilization and accomplish other essential parts of the reform.

Although improving the flexibility of the economy to some extent, enterprise arrears generate additional costs of transition for two reasons: 1) they allocate available capital in an extremely inefficient way, and impose an additional ''inflation tax'' on potentially viable enterprises; and 2) they distort information on the financial status of enterprises. In this sense, the arrears in a transition economy fundamentally differ from widespread trade credits that enterprises lend to each other in developed market economies. The difference is that in a market economy lenders usually have an idea of how to get the money back since strong competition makes creditors and debtors inclined to closely adher to terms of repayment agreements, and there is a reliable legal enforcement of contracts as a last resort. In a transitional economy, performance of enterprise managers can no longer be judged on the basis of balance sheets, since there are too many exogenous factors affecting the flow of revenues, and too much uncertainty in available information. Moreover, even if the accounts are potentially receivable, there is no reliable enforcement of a desirable transfer.

Since financial status becomes unimportant, enterprises develop peculiar attitudes towards their suppliers and customers. Rather than cost-minimizing, survival becomes the main priority for enterprise managers. The best way to guarantee survival is to invest in suppliers and customers -- rather than to invest in machinery and technology, since there is no way to calculate the true profit generating potential of machinery and technology. In order to make such an ''investment in their partners'', enterprises simply order inputs from suppliers in quantities exceeding their actual ability to pay (with the reasonable hope that the government will cover the difference), and let customers borrow-in-kind by delaying payments and hence keeping those customers from facing difficulties. As an important by-product, such a strategy enables enterprise managers to borrow in return from suppliers and customers when their own enterprise gets into trouble.

A more efficient functioning of the enterprise sector in Russia would require the re-orientation of enterprise directors from ensuring the survival towards improving the financial performance. This reorientation is particularly difficult because of the low probability that the government would take a tough stance towards highly indebted enterprises: the government simply cannot afford the entire industry to go bankrupt. There has been a policy mix of contradictory measures that the government pursued: in order to solve arrears the government had to ease its credit policy, which however, substantially destroyed the efficiency of the efforts to impose hard budget constraints to avoid arrears in the future.

It does not take many really insolvent enterprises to generate widespread arrears in the entire economy, especially in the payment system that is very lax in making payments between enterprises. In such a system, the ability of one enterprise to pay its arrears depends not on its own financial ability, but rather on the general standing of the entire chain of customers and suppliers. It is very difficult to distinguish between enterprises that are potentially solvent but just struck with bad debts, from those enterprises that have to be closed in transition since they cannot be efficient in a new market environment. Anti-inflationary measures are still very risky in such an environment. Drastic across-the-board tightening of credits can cause detrimental financial strain for otherwise potentially solvent enterprises. Subsidies are probably unavoidable in transition until an appropriate financial system is built.

However, efforts should be made to alter enterprise behavior. A few policy options can be recommended in such a situation:

1. The government should distinguish between subsidies ex ante and subsidies ex post. Subsidies should not be based on individual enterprise performance but rather on a general structural approach. Doing this, the government creates clear incentives for enterprises to minimize costs, while simple ''making-up'' the actual losses never brings about such incentives.

2. Since financial markets do not automatically identify insolvent enterprises, all efforts should be made to separate a few hundred candidates for bankruptcy from the rest of the industry, and either close them or restructure them by administrative measures. The important consideration is to guarantee that restructuring always involves a replacement of an enterprise manager who led the enterprise into bankruptcy: without such a provision, restructuring will have no effect on the behavior of enterprises at large.

3. The government should encourage decentralization of payment settlements and take measures on the general reduction of average payment time. This will strip potentially insolvent enterprises of the perfectly ''objective'' justification for their poor financial standing. This will also enable the government to focus on the institutional part of the problem of arrears rather than on its pure technical part in the future.

An Effective System of Taxes: Relevance for Enterprise Behavior[8]

In general, the businessman in a Western 'market economy' wants the government to minimize its interference with the businessmen's day-to-day life, reduce the rate of corporate tax and the costs of hiring labor, and give more generous allowances and credits against tax liability. Seventy years of communist rule has made the implicit contract between the taxpayer and the government in Russia different from that in Western society and a new social contract has yet to be fully articulated and accepted. Since the responsible authorities had first call on bank accounts by direct debit, enterprises had little direct contact with the tax administration and were consequently unfamiliar with standard concepts of taxation.

As the transition to a market economy proceeds, allowing competitive commercial banking to emerge and relinquishing the powers of the former central authority due to liberalization, deregulation, and privatization, the concepts of tax filing, tax returns, assessment, tax audit, standardized transparent tax rates, and hard budget constraints have all taken on a new significance. Clearly, the issues of tax morality have become of paramount importance, especially considering the continued belief (derived from the past society) that one measure

[8] A summary of the paper and presentation by Alan Tait and the ensuing discussions. The title of the paper is *Enterprise Behavior under the Conditions of Economic Growth in the Russian Federation: Taxation.*

of entrepreneurial success in a planned economy was the ability to get around or manipulate government regulations or government planning requirements. Indeed, the transition has greatly changed the latitude of enterprise managers to delay returns and payments and to challenge assessments. The lack of enforceable penalties and the persistence of gentlemanly bilateral deals severely undermine tax morality and cheat the authorities out of revenues.

In addition, the continued existence of daunting uncertainties due to tax changes not only intimidates and discourages entrepreneurship but simultaneously increases the motivation to mount efforts to avoid taxation. Many Russian managers have the same concerns as their Western counterparts but it is likely such concerns will be magnified and are probably more serious in impeding adjustment. A real dilemma has materialized on the reform road to a market economy in the Russian Federation. On the one hand, Russian managers beseech government to reduce tax rates, increase tax credits and subsidies, and implement protectionist measures to preserve them from the threats of international competition, while on the other hand they call for the state to avoid intervention in the business world as much as possible. The defensive mechanism utilized by entrepreneurs to deal with the uncertainties are likely to distort taxation. The enterprise profits tax, the excess wages tax, and the value-added tax are examples of tax regulation burdened by all the afore-mentioned problems.

Each tax and tax policy more generally should be compatible with the goals of the overall reform. Many lessons can be drawn from the discussion of the difficulties associated with taxation in the transition in a way that should not negatively influence enterprise behavior, particularly regarding the three examples identified above. The following eight lessons will help in developing a taxation scheme that secures government revenue, encourages tax morality, and does not unnecessarily burden enterprises with unreasonable costs during the otherwise already difficult time of transition.

First, a crucial prerequisite is to draft clear and unambiguous legislation with well established priorities and objectives. The appropriate taxes must be selected to achieve satisfactory redistributional aims and other social ends while insuring tax revenues and compliance and reducing tax administration complexity. Second, the new tax system should greatly reduce, if not in many circumstances eliminate, bureaucratic intervention. Third, if the government should wish to continue granting subsidies to target groups of enterprises or industries, these should be completely divorced from the tax system. The fewer special rules and exceptions, the clearer the tax scheme remains and the less the chance for evasion. Fourth, do not create opportunities for connivance to avoid tax liability, for instance, connivance between managers and workers to evade the excess wages tax. Fifth, refrain from introducing taxes that will result in confusing signals at the enterprise level. Sixth, all parties, whether from the private or public sectors, should be treated identically under the tax code with no special advantages for either. Seventh, tax liability and tax rates should be characterized by geographic uniformity. It is probably better to use targeted transfers if a serious need for assistance or relief in a particular region or municipality arises, than differentiated tax rates. Finally, market-oriented business, whether public or private, sets forth the existence of properly presented profit and loss accounts, as well as balance sheets. Consequently, accounting concepts and abilities are of great importance both in tax administration and in enterprises now and in Russia's market economic future.

Following these eight fundamental lessons should result in a tax system that will positively orient enterprise behavior in a manner to promote economic growth during the transition in the Russian Federation and thereafter. Nevertheless, its affects will achieve little alone. The new taxation scheme must be accompanied by the other crucial aspects of reform such as legal reform, deregulation, free prices, privatization, and clear ownership rights.

Enterprises and Foreign Trade: The Impact of the Reforms

Foreign trade reform, although one of the most advanced parts of Russian economic reforms at large, has probably the least significant impact on enterprise behavior in comparison to the other reforms. It would be wrong to say that the opening of the economy, introduction of tariff regulation, and establishment of currency markets did not affect enterprise behavior at all, but their impact was fairly different from what economists would usually expect from such radical changes in conditions of trade.

In advanced market economies and in most developing countries, industries are very sensitive to changes in conditions of trade: in response to changes in tariff regulation, exchange rate regimes, and administrative controls of trade, enterprises either diminish or broaden the international division of labor, attract foreign investments or move production overseas, slash production costs, fire redundant labor force, adjust output, and even change the entire profile of production. These responses, however, were either not happening in Russia during the first one and a half years of reform, or were occurring at a much lesser scale than conventional wisdom could have suggested. At the same time, the most visible and drastic changes in enterprise behavior in response to the foreign trade liberalization -- except for obvious cutbacks in imports and growth of some categories of exports -- developed along two major directions until now: ''informal'' trade activities and capital flight.

Despite radical opening of the economy, rapid development of currency markets, remarkably inexpensive labor, and the unfolding lack of decent environmental protection, the changes in enterprise behavior were rather slow. There was radical adjustment in trade volumes, but it should rather be called ''adjustment without positive restructuring in production''.

Russian enterprises have been exporting greater quantities of goods (i.e., non-ferrous metals), since the borders had been opened and administrative restrictions had been lifted by Gaidar's government in 1992. But higher exports did not generate higher investments and rather resulted in excessive exploitation of already nearly exhausted production capacities. Moreover, the loosening of export control stimulated under-invoicing or simply smuggling of exports, capital flight, tax evasion, corruption, and violation of trade regulations of advanced industrial countries.

Mostly due to the collapse of CMEA trade, Russian enterprises drastically reduced exports of machinery. But this has not resulted in desirable re-distributions of resources within the manufacturing sector towards production demanded on the world market: whole branches of manufacturing exports simply vanished (often together with domestic production: a good example is the Russian computer industry), and respective production lines were either shut down or conserved. No workers were laid off or at least re-trained, no new investments made, and no new technologies developed. Thus far, opening of the national economy did not result in positive achievements in overall productivity or better utilization of the country's comparative advantages, nor did it make domestic industries more efficient and competitive.

Many Russian enterprises exporting raw materials got relatively rich. But additional wealth (which came to a great extent through illicit channels) went to purchases of fancy cars and TV sets for workers and managers, rather than for new technologies and machinery, spare parts or packaging materials. Better financial standing of enterprises did not encourage enterprise managers to increase investments and improve technologies or products, and did not induce enterprises to further penetrate foreign markets.

Foreign exchange is easily available in internal currency markets. Nonetheless, the bulk of foreign currency still covers purchases of consumer goods rather than those of machinery and technologies to support more efficient domestic production. The relatively inexpensive and well-educated Russian labor force is still waiting for better use by 'reluctant-to-change' enterprise managers.

At the macroeconomic level, the country's general trade orientation is slowly drifting towards the classical pattern of a developing country in its early stage of industrialization: the country exports raw-materials in exchange for consumer goods and services. If this will be the major long-term result of opening the country, such an opening was not worth undertaking. However, it would be wrong to blame the trade reform for these undesirable outcomes: trade reform just uncovered diseases caused by years of distorting administrative control.

There is a number of reasons why Russian industries do not react "appropriately" to trade liberalization. One group of reasons is purely "technical". "Technical" reasons either make civilized restructuring too complicated and costly, or, alternatively, make unlawful practices impunitive and very profitable. Among these reasons are, on the one hand, the generally high level of instability, underdeveloped financial markets, high transaction costs, poor telecommunications, corruption of authorities, strong "socialist" traditions of labor force, and, on the other hand, loose capital controls, poor fiscal discipline, transparent borders, corruption of authorities, and generally low business moral. The task of the government is nothing but to undertake efforts to improve the situation surrounding the first sub-group of reasons, while fighting the second sub-group's rudiments of administrative controls with all possible means.

However, such work alone would be unsuccessful unless more fundamental changes, going far beyond the trade reform, are guaranteed. Among these changes, the most important ones are fast privatization and establishment of civilized property rights. This will give Russian enterprises real owners who will be more capable of thinking about costs, productivity, investments, technologies, than current old-fashioned managers.

Another necessary change would be the enforcement of the bankruptcy law. This will allow for more efficient use of resources, higher capital mobility, and better utilization of the country's comparative advantages in the international division of labor. This should also be accompanied by the promotion of labor mobility, development of financial markets, and fiscal incentives for small businesses.

Last but not least, conditions for both domestic and foreign investors should be improved. This would generate the necessary resources for a trade-driven adjustment of the national economy.

Social Welfare and the Enterprise[9]

The present system of enterprise social protection

The components of enterprise social protection fall into two main categories: those that are legally mandated and those pursued at the discretion and initiative of the firm and sometimes as an outcome of collective bargaining agreements. The mandated system is financed from payroll taxes and is earmarked to a Social Security Fund, but administered by the enterprise. One quarter of the payroll contribution was allocated to the center and the remainder was absorbed by the enterprise. This implies that the lion's share of the 5.4% of total payroll used to finance social services is retained at the enterprise level. The funds combined with general government subsidies helped create a public network of week-end retreats, sanatoria, health resorts, vacation facilities, etc. In addition the funds covered sick pay, maternity, child care leave as well as pension and other social benefits. Many observers believe that the Russian system of social protection placed the firm in a more strategic role in the social care system than other former Communist countries. The author of the background paper accepted this view by strongly asserting that "the entire system of social benefits in the Soviet Union was geared to enterprises."

Historically enterprises could not in principle reallocate social functions to other purposes. However, the enterprises could reallocate among the social functions for example, in the balance between sick pay, sports and other social functions. But the much more interesting source of flexibility was the enterprises' ability creatively to draw resources from the Social Fund and effectively to cross-subsidize the wage fund. It is important for any discussion of reform to recognize that these sources of flexibility helped make the system work in practice. However, the system is now in transition as more and more benefits are distributed independent of the former employer and out of the centralized component of the Social Security Fund. Old company-based benefits are increasingly ceded by enterprises back to off-budget social security funds, and the state has to take on the most relevant social benefits.

9 This summary is based on Alexander Telyukov's paper (*Social Welfare and the Enterprise*), the comments of the discussant and the audience.

The listing of non-mandated social benefits sheds light on how widespread their use have become. The background paper by Telyukov lists 12 different cash benefits including items such as additional old-age pensions, severance pay on retirement, educational scholarships, cash grants to offset increased cost of firm based meals, etc. In addition, there are at least 8 different benefits in-kind including subsidized kindergartens, preschool facilities, transportation subsidies, etc.

One of the important questions in judging the significance of an enterprise as a source of social protection is to assess the level of non mandated social spending. According to estimations in the late 1980s, about 20% of the whole network of social service facilities was owned and financed by enterprises. Another characteristic estimate for the value of the property used by enterprises in providing social services such as polyclinics, nursery schools, etc., suggests that in the early 1990's social benefits accounted for 14% of the entire depreciated stock of fixed assets in enterprises of the mining and manufacturing sector.

In the past, the Social Security Fund was managed by the labor unions assuring relative harmony between the federal level, the unions, and the grassroots organizations in the enterprises. The mandated system provides for uniformity of coverage and of benefits and assures an equal financial burden on all enterprises. By contrast the non-mandated system, because it involved firm discretion, was unevenly distributed by industry and presumably by occupation as well. In this sense, social benefits (even in the old system) was a means of widening the narrow earnings range of Soviet workers. This interpretation is different than the conventionally accepted hypotheses that in the socialist system, social protection by enterprise was more or less inclusive and rather egalitarian. In a transitional system or a market system, the social provisions of firms are much less inclusive, and aimed at increasing the remuneration difference in favor of higher and scarcer categories of employees. Thus, in the transition, even if the total level of social spending remains stable, enterprise social protection will create more income inequality and increase the need for more public social protection to act as an offset. Understanding the distributional consequences of social protection is therefore clearly important.

In the absence of satisfactory statistical information it is rather the inferences based on the understanding of the institutional structure and the logic, than hard evidence, that helps drawing up the possible characteristics of current enterprise behavior with respect to social welfare. One could assume that there is a high degree of continuity in the provision of enterprise social protection despite the financial constraints and organizational chaos.

The arguments in support of this hypothesis are the following. First is the paternalistic commitment -- the sense of obligation and responsibility managers felt to social objectives. Second, since managerial authority is most likely to be challenged by work collectives, managers have a clear interest not to antagonize this constituency by cutting back on benefits. Third, there is the pragmatism of limited alternatives. Three-quarters of the urban population lives in small localities with a single large state enterprise. The sole employer is the only institutional structure for providing social services, with municipal services playing only a modest role. Closing the enterprise cripples the social structure of the whole community making the cost of shedding social protection socially very high by increasing the risk of politically destabilizing the society. Fourth, both non-wage fringes and the wide spread practice of retaining unneeded workers can be used as a means of tax and regulation avoidance. For example, when the government introduced the excess wages tax, the enterprise responded by switching the surplus of the wage fund over the cap to non-wage benefits. This move increased employer provided social benefits for rent, utilities, life and property insurance, etc.

In the course of the discussion of the background paper it was pointed out that if the social functions of the enterprise are divested, local government, if it assumed these functions, might tax the enterprise to cover the costs under a different auspices. Whatever firm specific benefits accrued when the provision of social protection was under firm auspices are thereby lost. It was also observed that social protection, by its nature, involves high fixed costs. This has the obvious disadvantage of making cost reduction difficult for the firm. But it also has a social advantage, since it creates an environment where the incentive to shed workers is weak, since the cost of adding an additional or loosing a worker is relatively low.

Finally, some participants took the position that the state would in practice not do anything. Still others took the stronger view that the state should do nothing and moreover in the present chaos the state can do nothing. This theory of the state in transition implied that the enterprise was the only viable arrangement for social protection. It was also argued that in hyper-inflation workers might in fact prefer benefits to wages.

The drawbacks of enterprise sponsored social protection

The summary of enterprise tactics leading to the maintenance of social protection lead many in the audience to respond with words of caution about the desirability of pursuing this course of action. For example, drawing on western experience it was pointed out that mandating reduces labor mobility and decreases the flexibility of labor markets to adjust to changes in product demand and new technologies. Moreover, enterprises vary in their capacity to maintain the social commitments they make. The USA auto industry is based on a 'pay as you go' scheme. This implies that current workers must pay for those who retire. As the industry is retrenched the pool of current workers available to undertake this task is sharply reduced, thus making the entire system of financing unfeasible from an economic perspective. Historically this happened in the American railroad industry, a sharp reduction in the size of the labor force left the industry unable to pay for the system of generous pension benefits it had undertaken to provide. As a result there is a historic anomaly. The Federal government runs the social security system for the railroads, because at that time there was no other politically acceptable option other than the state or local government to take over these social functions. The lesson is clear. If Russian industries maintain their social protection the risk of economic collapse cannot be far behind.

Some participants of the discussions asserted that wages are the important component that provide the incentive for high productivity. Non-wage labor costs tend to be interpreted by workers in non-incentive terms as an entitlement or obligation. If this argument is correct then low wages are the main cause of low productivity.

The transition

How can one get an enterprise out of the social functions it historically performed, if divestiture or shedding cannot be done instantaneously by fiat? Clearly some period of transition is needed. Two views emerged. The author of the background paper believes that divided government is a danger and a threat to reform. Government must be integrated and the autonomy of regulatory ministries seeking a social function must be curbed. Others assumed that shedding social functions of enterprises is naive, in the absence of a serious and sustainable reform of the system of taxation, medical care and housing.

Enterprise Behavior: Polish and Czech Experience

The behavior of enterprises in **Poland**[10] during the transition period has been influenced by two parallel processes. The first is stabilization and marketization of the economy and the second is privatization. Each process has a particular impact on the decision-making of firms, but are sometimes very difficult to discern from one another. It is useful to realize that before real privatization can occur (i.e. the transfer of shares of formerly state owned enterprises into the hands of private owners), the pre- or quasi-privatization stage precedes. This is a stage when state enterprises are being prepared (through commercialization, corporatization, separation of some units, and the elaboration of privatization projects) for the transfer of property rights. The behavior of firms is different in these two stages.

Behavioral patterns of enterprises are strongly influenced by the attitudes of insiders to privatization. Two groups of agents inside the enterprises are interested in privatization. These are managers, who hope to have more freedom in controlling the enterprise, and workers' councils, that also hope to benefit. Trade unions usually take a stance against privatization.

On the basis of surveys carried out on a sample of enterprises going through privatization, some interesting developments can be identified. A striking fact of the Polish transition is the decrease in net profit margins in recent years. While it amounted, on average, to 29% in 1990, it declined to about 7% by the end of 1992. There are various reasons behind this decrease. The highest profit margins were achieved in commercialized firms because only the best firms (about 200) were chosen for commercialization at the beginning of privatization. The lowest profit margins were displayed by the leased firms (leased by workers for about 10 years) and firms selected for liquidation.

It is also noteworthy that privatized firms show lower economic efficiency than state-owned firms. Privatized and private firms are exposed to a certain standard way of auditing and have to show a more transparent accounting than state owned firms. Since they face up to

[10] This section is based on oral presentation by Władysław Jermakowicz and the following discussion.

40% corporate income tax, they attempt to lower the net profit margin by, expanding production costs or paying out special benefits to employees. This may be one explanation for the fact that firms with more publicly owned shares report higher profits, and those with more shares in private hands show lower profits.[11] If this tendency continues, it will have a fatal impact on public finance because the more the economy is privatized the fewer revenues will be collected by the budget.

Undeniably, the export of Polish industries increased substantially during the transition period. But as analysts determined, exporters mostly increase the quantity of exports and do not alter the quality: they neither change the structure of exports nor do they penetrate into new markets. The only exceptions here are firms taken over by foreign investors.

As far as the level of employment is concerned, the aggregate number of employees decreased, but quite unequally. While employment dropped most in privatized firms, it remained nearly constant or declined negligibly in enterprises that went through the process of commercialization only. A similar pattern emerges in the case of wages. These rise more in privatized firms (especially in leased firms -- usually by employees) and less in non-privatized enterprises. In state-owned firms the difference between the highest and lowest salary was 6:1, in private firms it increased to 15:1. In the overwhelming majority of cases, privatization has not caused changes in composition of the management personnel of the firms: essentially the same people remained in the executive boards after privatization occurred.

A characteristic difference arises among firms with respect to investments. While both private and leased firms carry out some new investments, this is not the case with commercialized firms. Moreover, the latter have less access to new bank credits because of their worse credibility.

Organizational changes also show different intensity in the two groups of firms. These changes are quite substantial in privatized firms but rather minimal in commercialized firms. Privatized firms sell those parts of the enterprise that are not profitable or are not connected with the main activity of the enterprise. Marketing and sales departments are expanded within the firms, while the extent of purchasing departments is reduced. Organizational structures are becoming flatter and less hierarchical.

A passive wait-and-see approach is typical for commercialized firms: they make less changes, increase wages by a smaller extent, and reduce employment slowly. In the case of leased firms, the employees (also quasi-owners) are much more interested in increasing wages and in preventing lay-offs. They are much less interested in either profits or dividends.

Two general conclusions can be drawn from the Polish experience: 1) While the relations between the government and the enterprises were more centralized in the old system, the

[11] A crucial point is, whether the private firms really are inefficient or whether they only display low efficiency for whatever reasons. Hungarian experience seems to indicate that the latter alternative is often the case.

relations inside the enterprise were relatively relaxed. After privatization government-enterprise relations become relaxed, while the hierarchical relations within the enterprise become substantially more autocratic; and 2) the more privatized the firms are and the smaller the number of the owners of the company (i.e. more concentrated ownership), the more active strategy is developed in production, investment, organizational changes, etc.

Any insight into the current transformation of the economic system in the **Czech Republic**[12] should take into account the extremely strong position of the state sector in the economy at the outset of the reform. A highly centralized system aimed at ''industrialization and concentration'' had been systematically developed for four decades without any major detours or reconsideration. It ended up with 96.7% of total GDP being produced in state owned companies in the middle of 1980s. Strong monopolies, a high share of the employees in large firms, and informal ways of allocating the resources (i.e. of barter character) were typical phenomena. As the institutional complement to this *sui generis* establishment, a hidden structure of different coalitions (not necessarily driven by profit motives) existed. Owing to their long-lasting existence, numerous coalitions between ministries and companies survived and form the landscape of today's everyday activity despite the abolishment of many government agencies.

In the former ČSFR, the original conception was to privatize the enterprises as quickly as possible and exclude the government from the ensuing restructuring as much as possible. Restructuring was carried out in two waves. In the first wave, which started in 1990, companies themselves reacted to the above mentioned over-concentration of industries. Many enterprise managers came to ministries and submitted proposals for splitting up the firms so that the original number of companies doubled or tripled in a short time. This ''spontaneous de-monopolization'' transformed into the second - more systematic - wave in 1992-93 that corresponded to the wave of privatization (most notably the voucher privatization). In the course of this phase, even outsiders were allowed to make proposals for further de-monopolization and splits. While in 1989 there were 430 large industrial trusts, the numbers grew to 16,852 incorporated companies with more than 5 employees, and 2,258 incorporated companies with more than 25 employees in 1992. As an illustration for the pace of de-monopolization one may refer to the construction industry, where the average size of companies decreased from more than 3,000 to 250 employees. This process was also purposefully promoted by the abolishment of the barriers to entry and easing the start-ups of new companies.

Small-scale privatization helped, among others, to select and separate those small ''operational units'' from the large companies which were maintained by the mother company for reasons not directly related to the businesss activity (for example, recreation facilities, hotels, etc.). Currently 4,000 out of 6,000 large firms are being privatized in the first and second waves of large-scale privatization. Also the participation of foreign capital was encouraged. The number of sizable joint ventures rose from 116 in 1990 to 5,490 in 1992.

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[12] This section draws from oral and written presentation by Michal Mejstřík and the following discussion.

It seems that the noticeable increase of exports to western markets is to a large extent the result of the strategy of those producers who concentrated on liquid customers of established markets (despite low profit margins), and who, at the same time, took some risks by introducing new product lines. This seems to contrast with the behavior of Polish managers who are very active in marketing, but more risk averse in restructuring production. Generally, the trade reorientation of Czech companies toward western markets and especially the EC continues unexpectedly well. However, the pace of penetration into western markets is hindered by rising protectionism in the West. On the import side, trade liberalization undermined the monopolistic structure of the domestic market and accelerated several liquidations of some old-fashioned producers, especially in the electronics industry.

Managers of many state-owned enterprises originally expected that privatization (and especially voucher privatization) will facilitate easy survival. In many cases, they are now surprised that the investment privatization funds, which hold a decisive share of their property, are trying to execute corporate governance and impose ownership rights fairly rapidly and forcefully. Shortly after investment privatization funds obtained shares in the enterprises, many managers were fired and replaced. Despite these examples for active behavior by some investment funds, their eventual and real impact on the performance of enterprises is still in doubt; pessimistic views that they will not act as active investors are widespread, but not yet confirmed.

As in other economies in transitional countries of Central and Eastern Europe, inter-enterprise indebtedness also became pervasive in the Czech Republic. Recently it reached CK 200 billion (USD 7 billion). This phenomenon illustrates the specific way of enterprise adjustment to the existing conditions. On the one hand, it is definitely a consequence of restrictive macroeconomic policies, but, on the other, it is also a result of deliberate strategies and expectations of the managers derived from the pattern of privatization and ensuing personal benefits. Managers expect that decisions as to whose firms' bills will be paid are being made on the basis of anticipated debt/equity swaps which will transfer parts of the companies to major creditors or suppliers.

In an effort to prevent a massive chain of bankruptcies several schemes were developed by the Czech government. They consisted of: 1) transferring the so-called "working capital loans" (inherited from the past) to a specially established "Consolidation Bank" and easing the conditions of these loans; 2) cleansing bank portfolios of bad debts of enterprises which were to enter voucher privatization (with the help of issuing a large amount of bonds by the Fund of National Property); and 3) tracing the chains of indebtedness and ensuing mutual debt clearance. The purpose of these measures was to identify and extinguish the sources of the "infection of illiquidity" without providing a continued subsidization to poorly performing enterprises. Surprisingly enough, the number of bankruptcies is very low until now.[13]

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[13] The bankruptcy law was put into full effect in April 1993.

From the labor point of view, the restructuring of companies is not reflected in the respective growth of unemployment. Until recently, all laid-off people were quite smoothly absorbed by the newly created private sector which generated (or to which were transferred from the former state sector) roughly 1.5 million full-time jobs in the Czech Republic. Unemployment is currently about 2.6%, the lowest in Central and Eastern Europe. By the completion of the first wave of privatization, the rate of unemployment is expected to increase to about 5-8%. This level is considered, however, as a necessary condition for the better functioning of the labor market.

Last but not least, labor skills inside enterprises are being upgraded. For some time now, previously neglected activities like marketing, financial management, cost accounting, etc., are systematically developed. Also the managerial mentality and behavior of enterprises is changing from a production orientation to marketing orientation.

Whether companies will follow traditional behavior (muddling through), or an innovative style (actively reacting to changing market conditions) depends on many factors. One of the most important factors is the personality of managers. It can be claimed that in many cases, the quality of managers, their dedication and responsibility are the major explanatory variable of enterprise performance.[14]

The transformation of a supply-driven (excess demand) to a demand driven (excess supply) market had a strong influence on enterprise behavior. According to business tendency surveys carried out in Hungary, the shift from a situation, where the shortage of input materials used to be the major impediment to production to a situation where the lack of demand for output is the predominant impediment is explicit in the last few years.[15] Comparable surveys for Russia[16] indicate that this trend is weaker in the case of Russian enterprises, most probably because pressing shortages in many areas still exist. Nevertheless, one puzzle arises here: while the emergence of excess supply contributed to generally a harder budget constraint, it did so without generating a sweeping wave of bankruptcies.

Attention must be paid to the contemporary position of the former nomenclatura and communist party bureaucrats. While many representatives of this group were replaced in top positions of the government and parliament bodies after the political landslides in Poland, Czechoslovakia and Hungary, this was not carried out in Russia and other successor republics of the Soviet Union. As a reflection of the changes in the higher echelon of the hierarchy in Central Europe, the enterprise level nomenclatura was also replaced, or at least the old nomenclatura has either a low profile or completely changed its face. In Russia changes in this respect seem to be minimal. It is true that the more the economic environment deviates

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[14] The following section reflects the summary remarks given by János Gács at the ETI seminar.

[15] The changing importance of purchase versus sales departments is also evidence for the shift from a supply constrained to a demand constrained system.

[16] See the background paper by Alexashenko and Nabiullina.

from a standard market one (disruptions of trade leading to barter; enterprise arrears calling for softer credits; etc.), the more relevant will be the informal connections built up under the former regime. It is undeniable that the former nomenclatura has, from this point of view, a more advantageous starting position than those who were not involved in party and bureaucratic structures. It can be even assumed that due to the acquired knowledge of the contemporary post-socialist situation, local managers are, for the time being, more qualified to solve everyday problems than western managers would be. Nevertheless, in order to generate a criteria for managers which would reveal how to carry out restructuring consistent with the market paradigm, external corporate governance should be imposed on them.

General Issues of Privatization: Statement by Vice-Premier Anatoly Chubais[17]

At the outset Mr. Chubais stated that, as an active participant, he could not be an objective observer of Russian privatization. However, his experience leads him to stress that privatization has both political and economic aspects: political limits on privatization were dominant in shaping the program, while economic factors were secondary.

When privatization began in January 1992, there were only 38 private shops and restaurants in all of Russia. By June 1993, there were 63,000 private Russian enterprises. Most were small firms, but 4,500 large and medium-sized firms have been transformed from state enterprises into joint stock companies. There are now 20 million shareholders in Russia, most holding shares in the enterprises in which they work. By July of 1993, more than thirty-five percent of all employees in Russian industry were working for joint stock companies; according to estimations by the end of 1993, fifty percent of all Russian employees will work in the non-state sector.

Stages in the Creation of the Privatization Process

It is crucial to understand the political reasons underlying economic decisions in the privatization program. There were five stages in the evolution of the program.

1. In 1990, a privatization law passed, but it had no method for implementation. Submitting a more effective program to the full Parliament in the fall of 1991 was likely to result in months of debate and long delay. The government wanted to move quickly, and submitted the "Direction of Privatization of State Enterprises" to the Presidium of the Parliament rather than to the full body. By the end of December 1991, this document was approved and became the starting point of the privatization process.

[17] This section is an edited version of Mr. Chubais' remarks made at the seminar. Chubais has been the leader of the Russian privatization program since its inception.

2. In January 1992, the Ministry of Privatization (or, as it is called, the Committee for the Management of State Property) was established at the Federal level and, more importantly, privatization offices were created at the local level. By mid-1992 there were departments of privatization in every district of Russia.

   Simultaneously in the first months of 1992, there were extensive discussions about privatization in the Parliament and in the press. In fact, all the major social groups were opposed to the government's concept of privatization: the worker's collectives because the program gave too much of the property to the managers; the managers because too much of the property would go to the workers; the business people because too much of the property would go to workers and managers; and the rest of society because they felt that they would gain little from privatization.

   Discussions overcame these objections so that by June 1992, the Parliament approved a reasonable plan. The plan reflected a balance among the main political forces and the dominant social groups. The Communists continued to disapprove, but they could muster no more than thirty-five percent of the votes in Parliament.

3. There were now two months - from July to September 1992 - in which Parliament was not in session. This time was used to move quickly on privatization. On 14 August, a presidential decree introduced privatization vouchers to be distributed to all Russians. This significant step converted privatization from a topic people read about in newspapers to one that became part of everyday life. The shift in public attitudes during the first half of 1992 was very important and made privatization irreversible.

   As the general public became more favorable, the Parliament became less so. Some members became concerned and began to plan how to stop the privatization process. In the fall of 1992, perhaps no more than ten percent of Parliament members would have voted for privatization.

4. Between January and April 1993, Parliament began to recognize, however, that it was impossible to block the on-going privatization process. Such an action could alienate voters and undermine Parliament's remaining power.

5. The last stage began after the April referendum on Yeltsin's leadership. There was a change in the internal structure of Parliament and in the Committee on Economic Reform that made these bodies more anti-reformist. The formal attack on privatization began in May and June. Parliament demanded a resubmission of the 1992 privatization program or it would declare the program to be invalid. The people, however, were now firmly supporting privatization. The millions who had become shareholders would never accept the idea of giving up their ownership.

To sum up, Mr. Chubais considered timing to be critical. If the government had not acted when it did in late 1991, there would never have been privatization in Russia. From December 1991 to mid-1992, there was a narrow window of opportunity for Parliamentary approval of privatization. The window opened after the August 1991 coup when the Communist party had been absolutely discredited and destroyed. However, the window closed again when the party was reorganized in the summer of 1992. If privatization had not been started quickly by the executive, and if it had not given immediate benefit to millions of people, the process would have failed. The only chance to have privatization successfully introduced to Russia was during this small window of opportunity.

Choices in the Privatization Program

The economic decisions were largely shaped by the political situation. A few of the decisions are outlined here. The first decision was the choice between a case by case approach and simplified procedures. With moving quickly, the choice was clear: Russia needed fast and simple procedures for privatization.

The second decision was the selection of the method to value the property for privatization. Western accountants provided considerable advice on how to value property, but their various methods were time-consuming and expensive. Simplified rules were needed and hence, it was decided to use valuations based on book values recorded in existing accounting records and then sell property through competitive procedures.

A third decision was selecting a means of payment. Should privatization agencies accept only money or other forms of purchase as well? Using only money would have resulted in the privatization of only 50 to 100 companies because few Russians had enough cash assets to participate in money-only privatization. The use of vouchers made possible the privatization of the several thousand firms mentioned earlier.

Vouchers also permitted all 150 million Russians to participate. This popular involvement created political pressure at both the Federal and local levels. Even a totally communist local government or regional council had voucher-holders in its territory. If the local governments tried to stop privatization, they would have had to explain to the media and to the voters why they would not allow people to use their vouchers.

A fourth decision was whether to make vouchers tradable or to use individual privatization accounts as required by the 1991 privatization law. That law prohibited the sale of vouchers for three years. This restriction would have resulted in fragmented ownership. The sale of vouchers allowed the development of owners within the fifteen or twenty percent of the shares of a company. These large shareholders can play an active role in the decisions of the company.

A fifth decision was the choice between a bottom-up or top-down process. Again there was only one sensible choice: a bottom-up approach. The initiative for privatization would come from the enterprise. The current law allows everyone to apply to the local office of the Privatization Ministry with a plan to purchase an enterprise. The application could come from an enterprise director, workers, or outsiders. There are only a limited list of reasons to reject a privatization proposal.

Indeed, privatization is not a decision of the government, but rather a decision of the Privatization Committee of each enterprise. Any company can be privatized unless it is on a short list of companies excluded from privatization. No special decision of the Privatization Ministry is required.

A sixth decision related to the status of the Privatization Ministry: should it be a "normal" ministry or one holding all state property, able to make final decisions and have its own network of local offices all over the country? Again, the right answer was the latter alternative: the Privatization Ministry should not be bound by the restrictions of other ministries.

This list of significant decisions could be expanded. The general point is that in these and other decisions, the political situation was the dominant factor. In discussing the economics of privatization, it is important to keep in mind political factors. Otherwise, the discussion is just theoretical.

Criticisms of Privatization

There have been several criticisms of the privatization process that are not valid.

Most often mentioned is the contention that privatization increases the level of crime and leaders of criminal organizations will become major owners of some companies. It is true that crime has increased in Russia. Yet comparing radical privatization with a gradual process, it does not seem to be sure that gradual privatization would result in less crime. A gradual process would allow ten or fifteen years in which there would be a potential for extensive corruption.

There is also criticism that the privatization process interfered with foreign investment. It is said that a number of opportunities for foreign investment were lost because they did not fit into the privatization program. There are instances in which this is true. For instance there was a case in 1992 when a joint venture was stopped because the foreign participants wanted an individual decision from the government, and such an individual decision would have contradicted the general approach. In this example and in others, the privatization process may have delayed rather than stopped foreign participation. If this is so, the criticism loses some of its importance.

A third criticism is that the privatization program did not create strategic investors, owners who would be active in the firm and bring new skills or capital to the enterprise. This criticism is heard every day in the Parliament. This criticism is not justified. There are many opportunities for strategic investors and there are numerous examples of strategic investors in particular companies. For example, one company just bought ten percent of the stocks in an auction of 500,000 shares.

Future Problems

In Mr. Chubais' view, the main danger to the privatization program is the risk that some, or perhaps many, of the newly privatized enterprises will become bankrupt in the future. These bankruptcies will set off a new fight about whether privatization is a sensible policy for Russia. The Communists will say a bankrupt private company should be taken back by the state and subsidized to create a good company.

It would be beneficial to create a privatization fund, an independent, non-governmental source of investment funds to tackle this problem. The Russian government now has a negative attitude towards supporting privatized enterprises, yet private firms face a more difficult economic situation than state enterprises. It is necessary to address this problem now before it becomes a major one. Investment funds for private enterprise would be a way to help privatized companies become more economically viable.

The general point is that the only way to find the right answers about privatization is to recognize fully the importance of politics while maintaining a realistic economic program.

Restructuring and Privatization in the Russian Federation

During the present transition to a market economy in Russia, managers of large state enterprises are facing new challenges. The incentive structure, planning, and pricing strategy have all changed in one way or another with the collapse of the command economy. One of the major economic alterations that managers of state enterprises must face is privatization. With this fundamental reversion from past ideology, the motivation and consequently behavior of state managers changes both before their enterprises are privatized and after, should the same managers still be leading the firm as often proves to be the case in Russia. Without a doubt, all sectors will consequently undergo significant restructuring.

Privatization: contribution to a new enterprise structure

From an outsider's perspective, the privatization process of large Russian state enterprises may appear somewhat erratic, even haphazard at times. Nevertheless, both Westerners and Russians agree that the program is both amazingly swift and unprecedented; not to mention that it continues at an accelerating pace despite being besieged by opposition forces in the parliament.

The final objective of privatization is to create effective market participants, who are profit-maximizers allowing the market to rely on their self-interest as private owners, in the Russian economy. This results in a crucial issue (as yet even unresolved in the West) - the separation of ownership and control. The problem arises due to the fact that a large enterprise needs to collect capital from a large number of individuals inevitably creating a sizeable body of owners. These owners cannot operate or control the enterprise themselves and thus delegate this to managers they hire. The owners and managers must work together to be effective market participants. But this raises the next question of how a multitude of diverse shareholders (owners) can ensure managers act in the best interest of the group rather than follow tactics for individual success. There are a number of measures used in the West that include linking managers' incentives to those of owners, reliance on institutional investors, leveraged buy-out, and others, though none are without drawbacks.

In essence, the whole system of privatization to facilitate restructuring relies on the assumption of well-developed financial markets both in the form of the stock market and availability of financial institutions that are willing to make large loans. The hardest problem for Russia is probably not privatization in the sense of transferring titles, but how to develop the set of allied institutions in making the post-privatized world work. This is a major determinant of the extent of restructuring one can expect.

Due to the very rapid pace, the time is extremely limited for restructuring enterprises before privatization. In fact, this should turn out to be an advantage as the new structures will only be subsequently determined on the basis of market principles assuming, of course, the development of the necessary market conditions, incentives, and corporate governance. Ex-post restructuring based on market forces is clearly better than ex-ante *adjustment* in the administrative style characteristic of the Soviet past. The latter is simply a waste of scarce resources as it is impossible to precisely plan how the new market conditions will influence the existing structure, and the administrative modifications would also be subject to market orientation after privatization.

At the ETI seminar, an evaluation presented by the Russian economist Sergey Vasiliev shed light on two main patterns of industrial restructuring presently taking place in the Russian Federation. The first pattern is the result of government policy and characterized by substantial direct intervention. The policy-makers are providing enterprises in several selected priority sectors with subsidies, special credits, and soft loans. Not only has this method proven to be inefficient, but the enterprises have begun to abuse the privileges rather than utilize the resources for restructuring purposes. The second pattern of restructuring is one characteristic of enterprises that do not have access to any directed state allocations or even preferential treatment by commercial banks. However, according to Vasiliev, it is this group of enterprises that has been more successful in restructuring and adapting to the new and continually fluctuating market conditions emerging in the Russian economy.

One measure used to identify the extent of restructuring is the share of investment in gross domestic product; this ratio has reached a favorable 20% already. Although this figure may instill some assurance in the minds of Russian policy-makers, several Western economic analysts at the seminar questioned whether it may be inflated due to the investment in unneeded or involuntary inventory increases as a consequence of the sluggish development of reliable market environment and distribution channels, as well as of excessively high inflation.

Obstacles influencing the impact of privatization

There was a general feeling at the seminar that privatization of large state enterprises in Russia has not been able to substantially influence the behavior of many managers to make their firms more market responsive or, even more fundamentally, to act according to market principles.[18] Neither was there the impression that privatization had achieved the extent of restructuring of industry that was previously expected, at least not until this time. The reason for this is the reliance of the success of privatized firms on the success of the overall economic reform. The latter is proceeding, but not without problems, contradictions, and often hesitation.

Russian experts have identified four obstacles that are perceived to be chiefly responsible for the lack of impact privatization has had on inducing industries and enterprises to restructure.

Firstly, there is the issue of property rights, both physical and intellectual. These rights must be clarified, expressly defined, and protected. They must be anchored in and supported by the necessary changes in the legal and law enforcement systems. Without adequate respect for property rights, real ownership and the motivations associated with it will continue to elude the enterprise entrepreneurs. Additionally, privatization continues to be slowed by uncertainty concerning actual ownership and the rights and obligations that go with it; the result often being a type of informal privatization that is frequently subject to corrupt activities. Furthermore, much needed long-term and especially foreign investment will be reluctant to materialize as long as rights and practices concerning property remain questionable and unpredictable. So, if ambiguity regarding property rights persists and thus inhibits privatization and investment, then restructuring will have a more difficult time to become pervasive throughout the economy.

The need for a legal framework conducive to the functioning of a market economy is not only a prerequisite for successful privatization, but also for life after privatization. Laws and strict enforcement, probably combined with penalties of differing severity depending on the offence, are desperately required to induce entrepreneurs to honor contractual agreements. The lack of such laws and even more the ability of offenders to avoid punishment or just getting caught, using bribes and other illicit means, has led to a substantial amount of barter trade and informal agreements. All are factors that prevent restructuring due to the reduced willingness of managers to put gentlemen's agreements, which may be their only (though unstable) source of supply, at risk.

The second obstacle is the absence of an all-encompassing financial environment that is required by enterprises in a market economy. While it is clear that such institutions and infrastructure cannot appear overnight, it is certainly impressive how quickly such institutions have developed in Russia since President Yeltsin's reform effort began. Yet, there is a long way to go. Reducing inflation and eliminating subsidies to enterprises are essential as one fuels the other. Besides, the subsidies are frequently cited as the reason for non-market

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[18] Probably not surprising considering the inconsistent legislation and the pubescence of the market system.

restructuring of industry, indicating that enterprises responding to these signals will become increasing inviable in the future market economy and forcing them to request always more subsidies to survive. Of course, cutting subsidies and restrictive monetary policy calls for a functioning banking system in which commercial banks will base loans on the creditworthiness of clients rather than on traditional links or their perceived importance for national esteem. Reduced inflation will lower lending rates and allow long-term planning, both ingredients for industrial restructuring after privatization. Also, there will be less support for the privatization process on the part of managers if they see their opportunities to obtain investment loans deteriorating once they are a private firm.

Thirdly, all remaining price distortions must be removed. These currently exist in the transition phase of development due to some remaining regulation of foreign trade and some remaining fixed prices. The distortions not only hamper the ability of potential investors in the privatization of an enterprise to conduct a meaningful evaluation, but also impede the potential for full-scale profit-oriented management under the then only quasi-market conditions. At the ETI seminar, some Russian economists stressed that the lasting unpredictability of price distortions is now one of the main obstacles to active restructuring.

Fourthly, a high priority is the creation of a competitive environment which entails equal business opportunities for all market participants. Surprisingly, the main obstacle to the creation of competition is not the high degree of monopolization in the Russian economy. If a so-called administrative monopoly is not directly granted special authority by the state, the former usually has too little power to impose its will on participants of the market. The Russian state cannot and should not hope to create competition for various monopolistic producers that still do exist by establishing additional state enterprises in the same sector. Nevertheless, in an effort to decentralize the decision-making authority and encourage increased entrepreneurial activity, the latest decree of the Russian government gives local authorities the power to grant licensing of economic activities in almost all sectors with localized markets. Russian experts predict that with the appropriate market conditions most privatized enterprises will adjust and even move into new fields of activity, creating competition for other enterprises already active in that particular branch.

The Russian experts at the ETI seminar believed that the great majority of restructuring would take place without having to revert to bankruptcy. In fact, the law on bankruptcy was only implemented on 1 March 1993. As yet the courts have little experience with the bankruptcy procedures and the process could take up to 3 years to complete. However, it is not only unique to Russia that creditors do not usually jump at the first chance to take advantage of bankruptcy of an enterprise that owes them substantial sums. In fact, Western economists at the seminar stated that bankruptcy may not in itself be as important as the threat of bankruptcy in influencing the incentive structure. This impact would make enterprises focus on the profit rather than on the output, and on the longer rather than shorter term outlook for restructuring.

Privatization in Eastern Europe: Relevant Experiences

Privatization, when studied in the three countries which have advanced most in this effort (the Czech and the Slovak Republics, Hungary, and Poland), conveys important examples of privatization practices. There are interesting systemic similarities, but also significant differences.

In theory, all the privatization methods or techniques were available. However, since privatization was an important part of the overall reform package, which differed from country to country, the portfolio of methods used also differed. For example, in the former ČSFR where over 95% of the enterprises were state owned (in this respect similar to Russia) and where no large attempts were made under the command economy to commercialize the enterprises, a political decision was made to radically privatize "en masse" by issuing vouchers.[19]

In Hungary on the other hand, all methods of privatization were accepted except voucher privatization because of the valid dictum "that a new real owner should pay for the acquired property".[20] In Poland, where several different methods of privatization have been used since 1986, it took several years of discussion until the President signed the creation of National Investment Funds and their privatization act in the scope of the Mass Privatization Program.

It is interesting to note that those countries which already began to experiment with the "de-etatization" (i.e., disengaging the state from business affairs) before 1989 (Hungary and Poland) were more cautious with privatization than a country which applied the command economy until the last moment (ČSFR).

Czech and Slovak Republic[21]

Privatization in the former ČSFR was seen as a crucial component of the reform package (together with stabilization and liberalization). The most important constituents of the privatization strategy were restitution, small scale privatization, and the privatization of large state enterprises. In the course of restitution, more than 100,000 restitution claims were settled, while in the framework of small-scale privatization close to 30,000 small firms were auctioned.

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[19] See the paper by Michal Mejstřík (*A Rapid Privatization as a Vital Part of Czech Transformation*) prepared for the seminar.

[20] See the paper by Mihály Laki (*The Post-socialist State as Seller of Enterprises and Other State Owned Assets*) presented at the ETI seminar.

[21] This part of the report is based mostly on the paper by Michal Mejstřík.

For large scale privatization, all methods were eligible (competitive bids, direct sales, public auctions and tenders, etc.) but most specifically the voucher system was developed. This system was selected because, according to the results of discussions between "gradualists" and "radicals", the other methods even when combined could not secure the requested speed of privatization and/or could have passed a significant portion of the state property to politically unacceptable groups of the population. The Czechoslovak government passed a law on large privatization in February 1991 which intended to privatize 4,000 out of 6,000 large state enterprises and state farms in two waves.

Much popular support was given to voucher privatization. In this scheme, each citizen over 18 years of age had the opportunity to buy investment vouchers: 1,000 points of investment money with limited maturity for a fee of CSK 1,000 (USD 34 at the time). This entitled him or her to bid for the ownership of shares of any company privatized by the voucher method or allocate his/her points to an investment fund. Investment funds in turn would make investment decisions for their clients and hold a diversified portfolio.

The response to this privatization opportunity was twice as large as originally anticipated by those who elaborated the scheme: nearly 75% of the eligible citizens participated (8.56 million). Needless to say that such support also had a significant political impact and consequences.

The privatization of large enterprises had two phases:

1. Elaboration, evaluation, and approval of privatization projects under the control of the Ministry of Privatization;
2. Implementation of approved projects by the government or the Ministry of Privatization.

The property of an enterprise with an approved privatization project was transferred to the specially created Fund of National Property (FNP) which has the responsibility to manage the enterprise until the ownership is transferred to private owners.

In order to ensure greater objectivity, anyone could submit a privatization project. Thus, for the privatization of some companies many projects have been proposed for selection. As of mid January 1993, the Czech Ministry of Privatization evaluated nearly 8,600 of the 11,300 submitted projects in the first wave. Approximately 2,000 projects have been approved for privatization in the first wave, creating nearly 4,000 new business units. Out of this total, 8.6% have been approved for public auction, 7.9% for public tender, 25.7% for direct sale, 26.3% for commercialization into joint-stock structure, 4.9% for the privatization of existing state-owned joint-stock companies, and 26.6% for unpaid transfer to municipalities, pension funds, banks, etc.

The Slovak Republic received about 1,500 privatization projects for 736 firms in the first wave, of which 430 have been approved. By late November 1992, 879 projects were approved. 188 of these were selected for direct sale, 20 for public auction, 10 for public tenders, 7 for restitution, 95 for unpaid transfer, and the remaining 544 were singled out for voucher privatization. Projects which were not approved in time for the first wave will be included in the second wave.

A lesser known core of the voucher privatization process is the large computer network supporting various rounds of the first wave. Because citizens were free to select companies to which they devoted their vouchers, it was likely that some companies would not get enough investment points while others would face oversubscription. On the base of excess demand and excess supply recorded by the computerized network, share prices were adjusted for the second round (prices for undersubscribed companies falling and rising for those oversubscribed) by a special price-setting committee appointed by the Federal Ministry of Finance. This was an important auxiliary activity substituting for the non-existent stock exchange. The first wave of voucher privatization needed five rounds which lasted from May 18 to December 2, 1992.

By and large, voucher privatization can be described as being successful. Nevertheless, some interesting experiences have been acquired which could be of interest to other reforming countries.

1. Because the process was new, it could not be legally prepared to the last detail and many laws and regulations had to be amended or newly created in the course of the process.

   For example, it was a great surprise that Investment Privatization Funds (IPF) (private joint-stock companies themselves) mushroomed and played a dominant role in the allocation of investment points. Two-thirds of the citizens involved in the voucher scheme transferred all their points (and an additional 420,000 of citizens transferred their points partially) to various IPFs. The combined ratio of points allocated to IPFs amounted to 72% of total points. About 56% of all the points were allocated to the ten largest funds. Originally there was no regulation on the behavior of IPFs. Only as late as April 28, 1992 was a law passed that set forth some rules (disclosure rule, diversification requirements, prevention of conflict of interests, etc.).

2. A key step in the privatization process is the elaboration of the projects. Here management was in an advantageous position: they could hide crucial information concerning their enterprise from others who wanted to prepare competing projects. Therefore, an amendment to the Law on Large Privatization was prepared and passed in February 1992 to make similar conduct punishable. By that time, however, two-thirds of the projects approved had been submitted by enterprise managers.

As could be expected there were many other problems such as the evaluation of firms' market value, transparency of rules for projects evaluation, etc. All these experiences were used to improve the second wave of voucher privatization starting in September 1993.

Hungary[22]

The pressure to privatize large companies in Hungary was not a result of popular desire but influence coming from abroad, and competing programs of newly emerging political parties played a predominant role. It was clear that Hungary's chance to join important international organizations (EC, EFTA) depended, among others, on the position and role of the private sector. Also, promises and programs of the political parties, as well as the growing budget deficit, contributed to the desire to privatize. The current government of Hungary declared a target to reduce the share of the state sector to below 50% by the end of its mandate (April 1994).

Indicators of privatization show that privatization gained momentum in Hungary after 1989. The number of private firms (mainly small artisans) increased from 32,000 in 1989 to 600,000 in 1992. At the same time, the number of limited liability companies increased from 14,400 to 62,200. The majority of these are small companies with no growth potential. The number of so-called "shadow firms", which serve for tax evasion only and have no producive activity at all, is also large.

The privatization of large and medium size state owned companies started in 1987-1989. This early privatization was not much more than "rough privatization"; a situation in which the creation of joint stock companies were a reincarnation of the state owned original, or various state owned companies, banks, and local governments would retain a dominant share. Out of approximately 2,000 companies in 1988, 602 were transformed by the end of 1992, and the State Property Agency (SPA) has a 60% share in the assets of these companies.[23] The foreign investor's share in these companies is 5%. Accordingly, in spite of an increasing private sector, a decisive part of "privatized" large and medium size companies have in fact a mixed structure of property with a majority share held by the SPA.

As far as the further progress of privatization is concerned, it is difficult to make predictions. There are several factors negatively influencing privatization like the deep economic recession with a dramatic decline of industrial output and an increasing number of enterprises finding themselves in the red. Also, the impact of less controllable factors such as tradition, ideology, availability of entrepreneurial skills, and the benefits of the illegal economy have been growing. A warning signal on the performance of the privatization process is that the total budgetary revenue from privatization in 1992 was only 57.1% of the level expected, and the SPA expects even less revenue in 1993.

In order to understand the forces at work in privatization without a formal model it is useful to use behavioral analogies. These can be applied for the description of the potential behavior of the actors in privatization, especially the government.

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22 This part of the report is based mostly on the paper by Mihály Laki.

23 The coverage of originally state owned firms is not complete, since some firms ceased to exist, some were split up, and some were completely privatized, so that the SPA has no share in them at all.

One can use the analogy of:

(a) going out of business, and/or

(b) testamentary dispositions for ownership transfer.

The first analogy is relevant because the state has to sell its enterprises in a worsening market position announcing the necessity of selling certain assets by a particular date, as is common in clearance sales. In this case buyers expect extra discounts. The Hungarian state announced the time period (2-4 years) and volume (at least 50% but not more than 70% of state assets) for sale. Huge enterprise debts, immobile stocks, underutilized capacities and efforts to avoid bankruptcy all substantiate the "going out of business" scenario as a relevant analogy. The clearance sale position, however, contradicts many targets the Hungarian state seeks to follow during privatization such as the maximization of revenues from privatization. Given the multitude of conflicts between aims and reality we can safely assume that the going out of business would be a much longer than envisaged process, most probably at least a decade, for the Hungarian government.

The analogy of the testamentary dispositions can be substantiated if we take into account how many details are prescribed for the new (private) owner by the old owner (the state) about the way he is supposed to run the privatized property. The most frequent dispositions are to maintain the former pattern of production, to prescribe where to buy inputs, and to prevent lay-offs. The SPA can designate many other targets for privatization like the creation of a more competitive market. The formulation of a multitude of dispositions, while understandable, spoils the transparency of the privatization process. It also creates a situation that attracts subjectivism, corruption, and non-accountability of the privatization agency.

Poland[24]

During the first stage of privatization in 1986--89, the objective was to break up the monopoly of state ownership. Practical steps to achieve this met strong opposition because of unclear selection criteria for privatization, unclear asset valuation, and hidden preferences for management, party members and state apparatus.

In October 1989, the comprehensive program for transformation and stabilization, the "Balcerowicz Plan", assumed a fast and radical ownership transformation. Despite expectations for radical changes, the corresponding measures were delayed for almost a year. In the discussions that were the cause of the delay, four privatization methods were considered:

1. Commercial privatization through the capital market;
2. Privatization through employee ownership;
3. Privatization through citizen ownership; and,
4. Privatization by institutional investors.

[24] This part of the report is based on the paper presented at the seminar by Marek Dabrowski (Barbara Blaszczyik and Marek Dabrowski: *The Privatization Process in Poland*).

Meanwhile, actual privatizations were started along the different paths of privatization: on the capital path, two different paths of liquidation, and commercialization. Only later did the focus of interest shift from commercial privatization to the concept of citizen ownership with the goal of speeding-up privatization. When the Mazowiecki government was replaced with the Bielecki government (in January 1991) a compromise project was worked out which combined the idea of citizen ownership with the role of institutional investors. After some modification, Minister Lewandowski (Ministry of Ownership Changes) presented the Mass Privatization Project (MPP) based on this principle.

This project gives all adult citizens the opportunity to own an equal stake in privatized companies through the acquisition (for a nominal fee) of certificates which are later convertible into the shares of the National Investment Funds (NIF), organized as joint stock companies. There will be a maximum of 20 investment funds. Several hundreds of large and medium sized companies will be involved with a total book value of PLZ 150 trillion, approximately USD 150 billion. The selection of companies for this type of privatization will be approved by the Council of Ministers.

The shareholding structure will be as follows:

33% held by "lead" NIF;
27% distributed equally to all NIF's;
25% retained by the State Treasury; and
15% distributed free of charge to employees.

The MPP was approved on May 18, 1993. However, the real start of the program needs further decision by the parliament.

As far as already implemented privatizations are concerned, the transformation of 2,387 (out of 8,454) state enterprises was started from the beginning of privatization (August 1990) to the end of November 1992; four-fifths of them were non-agricultural firms. Out of this number of enterprises 481 (24.6%) are being transformed into capital companies (commercialized) and the rest (1,474 companies) are to be privatized through liquidation.

Out of the 481 commercialized enterprises, 298 were selected for individual capital privatization and 183 for mass privatization. Privatization was completed in only 49 cases by the capital method and 500 through liquidation. In the rest of the enterprises, transformation is either in a transitory phase or has achieved only formal changes. The latter applies mostly to companies that were commercialized, but all the shares remained in the hands of the state treasury. Capital privatization is most used in industry (53%), while in trade and construction privatization through liquidation dominates (60% and 56.4%).

With the mass privatization just beginning and re-privatization legislation pending in Poland, interesting developments are to be expected. As the general economic situation improves, public opinion slowly shifts in favor of privatization. Public surveys record, however, that a decisive part of the population is against the privatization of the largest enterprises and is hostile towards foreign ownership. While the more entrepreneurial behavior of privatized business is detectable, it is still premature to forecast whether the expected microeconomic, macroeconomic, and societal goals of privatization will be fulfilled.

Appendix:

Papers Presented at the Seminars

Enterprise Behavior under the Conditions of Economic Reform in the Russian Federation
and
Privatization of Large State Enterprises in the Russian Federation

held at IIASA on 6--8 and 9--10 July 1993

Alexashenko, Sergey and Nabiullina, Elvira: *Enterprises in Transition: New Models of Behavior.*

Boffito, Carlo: *Outline of the paper on Financial Structure and Privatization.*

Dabrowski, Marek and Blaszczyk, Barbara: *The Privatization Process in Poland.*

Dolgopiatova, Tatiana: *Enterprises' Relations.*

Ickes, Barry W. and Ryterman, Randi: *Roadblock to Economic Reform: Inter-Enterprise Debt and the Transition to Markets.*

Ickes, Barry W., Ryterman, Randi and Brown, Annette N.: *The Myth of Monopoly: A New View of Industrial Structure in Russia.*

Kiselyov, Denis: *Enterprise Response to Changes in the Foreign Trade Regulations in the Course of Russian Economic Reform.*

Laki, Mihály: *The Post-Socialist State as Seller of Enterprises and Other State Owned Assets.*

Mejstřík, Michal: *Enterprise Restructuring and its Economic Precondition in the Czech Republic.*

Mejstřík, Michal: *A Rapid Enterprise Privatization as a Vital Part of Czech Transformation.*

Shironin, Viacheslav: *State Enterprise Behavior Under Economic Reform. Changes in Managerial Attitudes and Objectives.*

Tait, Alan: *Enterprise Behavior Under Conditions of Economic Growth in the Russian Federation: Taxation.*

Telyukov, Alexander: *Social Welfare and the Enterprise.*

Thieme, Jerzy: *The Polish Mass Privatization Programme: Overview.*

Uno, Kimio: *Competitiveness of Russian Industry and Conditions for Sector-Specific Policy Measures.*

Uno, Kimio: *On "Suggestions for Economic Reform in Russia".*

Vasiliev, Sergey A.: *Environmental vs. Institutional Factors of Restructuring.*

Programs for the Seminars

Enterprise Behavior under the Conditions of Economic Reform in the Russian Federation

Seminar Room, IIASA, 6–8 July 1993

Tuesday, 6 July

13:30 REGISTRATION
14:00 OPENING REMARKS
Peter de Jánosi, Director, IIASA
14:15 INTRODUCTION
János Gács, Economic Transition and Integration Project

SESSION I: General Issues --- *Chair: János Gács*

14:30 CHANGES IN MANAGERIAL ATTITUDES AND OBJECTIVES

- Managers' Views on Reform: Price and Trade Liberalization. Abolition of Central Planning, State Allocation of Materials and Mandatory State Orders
- Enterprise Activity in Emerging Commodity and Currency Exchanges
- New Managerial Goals and Priorities
- New Concepts of Ownership; Who is Possessing Ownership Rights?

Paper: Viacheslav Shironin Discussant: Randi Ryterman

16:30 ENTERPRISE RELATIONSHIPS

- Interactions with Banks, Local Authorities, Legislative and Executive Branches of Central Government
- Role of Employer Association, Trade Unions, and Extra-Republic Partners
- Characteristics of Buyer, Supplier, Customer, and Distributor Relations
- Emerging Competition on the Product Market

Paper: Tatiana Dolgopiatova Discussant: John Anderson

Wednesday, 7 July

SESSION II: Financial Issues --- *Chair: Petr Aven*

9:00 FUNDING THE ENTERPRISE

- Types of Money and Credit, the Role of Earmarked Credits
- Budget Constraint on Enterprises
- Credit and Property Relationships vis-à-vis the Banking System, Ownership Ties Among Enterprises and Banks
- Payments Arrangements and Inter-Enterprise Indebtedness
- Investment by Enterprises into Assets, Hard Currency, etc.
- Sales of Assets to Finance Current Activities

Paper: Barry Ickes Discussant: Anders Åslund

11:00 TAXATION

- Efficiency of Various Taxes in terms of Incentive and Distribution Impacts. Value Added, Social Security, Enterprise Profit, and Export Taxes
- Further Factors in Evaluating Various Taxes---Political Acceptability, Legislative Approval, Ease of Administration and Collection
- Role of Central and Local Governments in Enterprise Taxation
- Enterprise Tax Avoidance and Evasion

Paper: Alan Tait Discussants: Sergei Alexashenko and Marek Dabrowski

12:30 Lunch

SESSION III: Foreign Trade --- *Chair: Anders Åslund*

14:30 ENTERPRISE RESPONSE TO CHANGES IN FOREIGN TRADE REGULATIONS

- The Impact of Export Taxes, Licenses, Surrender of Export Revenue, Tariff Exemptions, and Bilateral Agreements
- Access to and Utilization of Hard Currency
- Capital Flight
- The Effects of Foreign Trade Regulations on Structural Change
- The Exchange Rate
- The Openness and Accessibility of Foreign Markets, the Infrastructure of Foreign Trade

Paper: Denis Kiselyov Discussant: Petr Aven

SESSION IV: Social Welfare and the Enterprise --- *Chair: Anders Åslund*

16:30 SOCIAL ISSUES

- Enterprise Provision of Housing, Health Care, Canteens, Stores, and Other Social Services
- Unemployment and Social Infrastructure, In-house Unemployment
- Role of Families, Unions, Worker Collectives, and Local and Central Governments in the Provision of Social Services as an Alternative to the Enterprise

Paper: Alexander Telyukov Discussant: Martin Rein

Thursday, 8 July

SESSION V: Enterprise Behavior in a Comparative Perspective
--- *Chair: Il'dar Karimov*

9:00 THE EXPERIENCES OF POLAND AND THE ČSFR

- Decline in Output and Employment
- Inflation and the Enterprise Response to Stabilization Measures
- Structural Adjustment of Industry to the Free Market
- New Managerial Priorities

Papers: Władysław Jermakowicz and Michal Mejstřík

11:00 SUMMARY: LESSONS FOR RUSSIA AND OTHER "NEWCOMERS"

Presentation: János Gács

12:00 Close of Seminar

Privatization of Large State Enterprises in the Russian Federation

Seminar Room, IIASA, 9–10 July 1993

Friday, 9 July

8:45 REGISTRATION
9:00 OPENING REMARKS
Peter de Jánosi, Director, IIASA
9:15 INTRODUCTION
Merton J. Peck, Economic Transition and Integration Project

9:30 **SESSION I:** GENERAL ISSUES --- *Chair: Sergei Vasiliev*

- Large State Enterprises in Russia: Recent Developments
- Present State and Recent Developments in Privatization
- The Official Doctrine and Alternative Proposals
- Plans and Forecasts for Future Progress

Presentation: Anatoly Chubais
Paper: Alexander Abramov
Discussants: John S. Earle and Ardy Stoutjesdijk

12:30 Lunch

14:30 **SESSION 2:** LEGAL AND INSTITUTIONAL ENVIRONMENT --- *Chair: Kimio Uno*

- Major Players and their Interests: Managers, Workers, Independent Participants, Local and Central Governments, and the General Public
- Who Initiates the Privatization: Bottom-up or Top-down?
- Nominal and Real Property Rights
- Egalitarian Principles and Effective Corporate Control

Presentation: Jerzy Thieme
Paper: Alexander Ageev
Discussant: Barry Ickes

Saturday, 10 July

9:00 **SESSION 3:** RESTRUCTURING AND PRIVATIZATION --- *Chair: Marek Dabrowski*

- Split-up and Spin-off
- Promoting Competition
- The Role of Credits and Subsidies
- Sequencing Bankruptcy in the Process of Privatization

Paper: Sergei Vasiliev — Discussant: John Anderson
Paper: Carlo Boffito — Discussant: Il'dar Karimov

12:30 Lunch

14:30 **SESSION 4:** EAST EUROPEAN EXPERIENCES --- *Chair: Petr O. Aven*

- Privatization Techniques
- Building Political Support
- The Role of Foreign Capital
- Behavior Patterns of Newly Privatized Enterprises

Paper: Michal Mejstřík — Discussant: Andreas Wörgötter
Paper: Marek Dabrowski — Discussant: Gábor Hunya
Paper: Mihály Laki — Discussant: April Harding

18:00 Close of Seminar

Final List of Participants for the Seminars

Enterprise Behavior under the Conditions of Economic Reform in the Russian Federation
and
Privatization of Large State Enterprises in the Russian Federation

Seminar Room, IIASA, 6–8 and 9–10 July 1993

Dr. Alexander Ageev
Head of Department
Ministry of Foreign Economic Relations
Moscow, Russia

Dr. Sergei Alexashenko
Russian Union of Industrialists and Entrepreneurs
Moscow, Russia

Dr. John Anderson
Department of Economics
Harvard University
Cambridge, MA, USA

Professor Anders Åslund
Director
Stockholm Institute of East European Economics
Stockholm, Sweden

Professor Carlo Boffito
Dipartimento di Economia
Facoltà di Scienze Politiche
Università Torino
Torino, Italy
and:
Banca Commerciale Italiana
Ufficio Studi
Milano, Italy

Ms. Karla Brom
Project Manager
Institute for EastWest Studies
New York, NY, USA

Dr. Anatoly Chubais
Vice Premier, Chairman
Committee for State Property Management
Moscow, Russia

Dr. Marek Dabrowski
Chairman
Center for Social and Economic Research (CASE)
Warsaw, Poland

Dr. Tatiana Dolgopiatova
Head of Laboratory
Institute for the Economy in Transition
Moscow, Russia

Professor John S. Earle
Central European University
Prague, Czech Republic
also:
Stanford University, USA

Dr. Lev Freinkman
The World Bank
Moscow, Russia

Dr. April Harding
The World Bank
Moscow, Russia

Dipl.-Ing. Peter Havlik
Vienna Institute for Comparative Economic Studies (WIIW)
Vienna, Austria

Dr. Gábor Hunya
Vienna Institute for Comparative Economic Studies (WIIW)
Vienna, Austria

Dr. Barry Ickes
Department of Economics
Pennsylvania State University
University Park, PA, USA
also:
Research Department
International Monetary Fund
Washington, DC, USA

Dr. Władysław Jermakowicz
School of Business
University of Southern Indiana
Evansville, IN, USA
currently:
Chairman of the Board of Directors
Pomorski Bank Kredytowy S.A.
Warsaw Office
Warsaw, Poland

Dr. Denis Kiselyov
Unit Chief, Current Analysis and Information
The World Bank
Moscow, Russia

Dr. Mihály Laki
Institute of Economics
Hungarian Academy of Sciences
Budapest, Hungary

Dr. Michal Mejstřík
Head, Institute of Economic Studies
Faculty of Social Sciences
Charles University
Prague, Czech Republic

Dr. Elvira Nabiullina
Russian Union of Industrialists and Entrepreneurs
Moscow, Russia

Dr. Alexander Paskhaver
Program Director
Market Reform Center
Kiev, Ukraine

Dr. Randi Ryterman
The World Bank
Washington, DC, USA

Professor Thomas C. Schelling
University of Maryland
College Park, MD, USA

Dr. Viacheslav Shironin
Deputy Head of Department
Working Center for Economic Reforms under the Government of Russia
Moscow, Russia

Dr. Ardy Stoutjesdijk
Director
The World Bank
Moscow, Russia

Dr. Alan A. Tait
Deputy Director
Fiscal Affairs Department
International Monetary Fund
Washington, DC, USA

Dr. Alexander Telyukov
Head
Department of General Social Problems and Public Policy
Economic Research Institute
Ministry of Economics of the Russian Federation
Moscow, Russia

Dr. Jerzy Thieme
Chief Adviser to the Minister
Ministry of Privatization
Warsaw, Poland

Professor Kimio Uno
Faculty of Policy Management
Keio University at Shonan Fujisawa
Fujisawa, Japan

Dr. Sergei Vasiliev
Director
The Working Centre of Economic Reforms in the Russian Government
Moscow, Russia

Mrs. Maria D. Vishnevskaia
Committee for State Property Management
Moscow, Russia

Univ.Doz.Dr. A. Wörgötter
Head, Department of Economics
Institute for Advanced Studies
Vienna, Austria

Dr. Iliana Zloch
Department of Economics
Harvard University
Cambridge, MA, USA
also:
Auhofstrasse 164/1/4
Vienna, Austria

IIASA Participants

Dr. Petr O. Aven
Economic Transition and Integration (ETI) Project

Dr. Vít Bárta
Economic Transition and Integration (ETI) Project

Professor Samuel E. Bodily
Core Research *and:*
Darden Graduate School of Business Administration
University of Virginia
Charlottesville, VA, USA

Mr. Kirill Cheremkhin
YSSP
Economic Transition and Integration (ETI) Project

Dr. Peter E. de Jánosi
Director

Dr. János Gács
Deputy Project Leader
Economic Transition and Integration (ETI) Project

Ms. Shari Jandl
Administrative Assistant
Economic Transition and Integration (ETI) Project

Dr. Il'dar Karimov
Economic Transition and Integration (ETI) Project

Professor Arkadii Maltsev
Secretary to IIASA

Professor Merton J. Peck
Project Leader
Economic Transition and Integration (ETI) Project

Professor Martin Rein
Economic Transition and Integration (ETI) Project

Dr. Christoph M. Schneider
Economic Transition and Integration (ETI) Project

Professor Tibor Vaško
Economic Transition and Integration (ETI) Project

Professor H. Peyton Young
Core Research