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Russian Privatization: A Comparative Perspective

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By the end of 1992 privatization had moved to the forefront of the Russian reform process. Indeed, while the Russian budget deficit was getting out of control, privatization was beginning to spread across the vast territory covering many activities and involving masses of people. It was pushed forward by the energetic minister in charge, Anatoly Chubais,[1] and was spearheaded by the first systematic privatization program of the International Finance Corporation (IFC) of the World Bank in Nizhni Novgorod in March 1993. The distribution of vouchers, each worth 10,000 rubles, which began on October 1, 1992 and which the citizens could use for acquiring a variety of assets, was an astute political move which created a pro-privatization fervor.

While privatization continued to be a positive feature of the Russian economic scene, its extension to large factories and the defense sector raised special problems. The loss of state ownership implied a surrender of decision-making control which the bureaucrats in the ministerial branches and party bosses in the regions were not ready to relinquish. Russian privatization was thus embroiled in ideological battles from the start.

Economic considerations too influenced the program and its pace. Potential buyers could readily be attracted to bid for a shop or a salon in auction or acquire shares in a medium-sized local food processing unit. By contrast, an integrated machine building plant was a costly and complicated prospect--more so as the branch ministries and enterprise managers resisted diversification of stock ownership in big factories. Russian corporatization[2] of large factories

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1 Chubais, who was privatization minister since November 1991 (until his appointment in November 1994 as First Deputy Prime Minister), was also head of the State Property Committee. The committee was set up in the summer at the initiative of RSFSR Prime Minister Ivan Silyayev and was headed initially by Mikhail Malei. Sergei Belyayev took charge as head of the committee in February 1995.

2 The distinction between privatization and corporatization is spelled out later. The process of privatization in transition economies involved the sale (for cash or via auction) of service sector and trading outlets, the corporatization of large and medium-sized enterprises via their formal conversion into joint stock companies with diversified stock ownership, and ultimately their commercialization and restructuring. Budgetary support was expected to cease in the final phase.

The term "privatization" is used in the text to denote this process which covers a variety of activities. Restructuring implies the organizational, financial and technological overhaul of an enterprise. If a factory such as a machine-building plant is vertically therefore was sought to be railroaded via a threefold program of centrally-mandated schemes and voucher participation by the public in successive waves for the purpose.

Privatizing apartment housing in the cities had to overcome the resistance of current occupants to convert de facto ownership of a heavily subsidized apartment into legal ownership involving payment. Local bureaucrats in the city housing administration had to be persuaded to seek out and transfer ownership documents to residents who were ready to strike a deal.

The agricultural sector faced formidable problems arising from the resistance of farm managers and the rural bureaucracy to privatize collective farms, the risks of mechanized farming of the large privatized farms, the lack of suitable machines and farm infrastructure, and volatile prices of inputs.

As the power struggle between President Yeltsin and the Supreme Soviet (Russia's legislature, elected under the Soviet Communist regime in 1990) intensified in Moscow culminating in October 1993 in its bloody dissolution and the elections which followed in December, the future of the program was cast in doubt as a result of the negative vote against rapid economic reform in the elections. Although Chubais continued as Deputy Prime Minister in charge of privatization, the agenda of speedy privatization of the large factories in defense and heavy industry was threatened with dilution.

The process was thus embroiled throughout 1993 in parliamentary resistance and presidential decrees aimed at overturning its legislation, and faced a slow pace after the December elections.

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integrated, it may be reorganized under a single management by closing the unviable and renovating the remaining sections. On the other hand, a horizontally integrated company involving organizational control of geographically dispersed plants in the same activity may be restructured by separating the viable plants into independent units and closing the rest. In either case, restructuring calls for worker layoff, technological retooling and additional investment. Financial restructuring requires settlement of old debts which may have to be written off, or converted into equity, or credit instruments which are bought and sold depending on the potential prospects of the enterprise.

Restructuring takes place routinely in market economies under the provision of bankruptcy regulations. By contrast, the process required nonmarket procedures and state intervention in all reforming economies.

However, its record by mid-1994 marked the successful completion of its first phase. Small outlets in the trade and service sector were sold or auctioned or leased; most medium and large factories were corporatized with diversified stock ownership; a substantial number of urban apartments were sold; most collective and state farms were converted into joint stock companies and a few private farms were created.

The next phase called for farm and factory restructuring, worker layoffs and adoption of new technologies, debt settlements and financial discipline--in fact, a massive overhaul of Russia's economy. It also involved cash (instead of voucher) payments by Russian and foreign investors for company stock.

As the program's new challenges began, its old accomplishments call for a critical evaluation. In particular, its objectives and methods need to be assessed in light of what privatization ought to imply, why it is necessary, what its goals should be, and how it might be undertaken. The Russian program can then be judged in terms of such normative guidelines. Again, Russian accomplishments and the privatization experience of Poland, Hungary and the Czech Republic[3] present illuminating contrasts which are discussed in the essay. The conversion to private ownership of enterprises in former East Germany under the direction of Treuhandanstalt (hereafter Treuhand), the German privatization agency, also conveys important lessons in this regard.

The question at the outset is whether diversified asset ownership in Russia's medium and large enterprises implies genuine privatization.

WHAT IS PRIVATIZATION?

Privatization implies the transfer of a variety of assets from state and cooperative ownership to private hands. Such divestment becomes effective when a truck or a shop or a factory is sold or auctioned off to groups or private individuals who not only acquire ownership of the outputs and

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3 Reference to the Czech Republic or former Czechoslovakia depends on the context in the text.

services of the assets--the so-called usufruct--but the assets themselves. They, in turn, can sell these assets (including enterprise stock) and shift to more profitable investments should they choose to do so. The inability to sell an asset because of incomplete information about alternative opportunities or absence of intermediaries which facilitate the transaction implies that privatization is less than complete.

This was particularly so with regard to large and medium-sized Russian factories which were converted into joint stock companies with diversified ownership by the state, the worker collectives, managers and the public. Moving in and out of equity ownership was rare: a secondary market supported by an active stock exchange, electronic transactions, and dependable brokers was not fully in place toward the end of 1994.

But that was not all. Very few of the corporatized factories started functioning like private businesses in market economies when they ceased to be fully state owned. Formal transfer of ownership did not produce the operational changes which characterize market economy private sector.

These two caveats of the inability of shareholders to shift their holdings in large companies and the continuing operation of these factories under soft budget constraints set them apart from private businesses in market economies.

Again, all assets were not put on the privatization block. Privatization programs retained critical activities in the economy (depending on the judgment of the lawmakers) in state ownership. (Details follow later.)

At the other end of the spectrum, small units such as retail trading and services, catering establishments, trucks and taxis began to be sold, or auctioned, or transferred to private owners at minimum charge. Occasionally, state housing was included in the definition of "small" privatization.

In reality, the process of small privatization had to cross a series of hurdles. When municipalities were put in charge of its design and implementation as in Russia, they had to be assigned the initial rights of ownership--by no means a swift and simple decision. Quite often, an overly restrictive definition of "small" resulted in a narrow coverage of establishments. For example, in Hungary, units employing a maximum of 10 persons (15 in the case of restaurants) could be privatized through public auctions, thus seriously reducing the number that could be actually included in the transactions. In former East Germany, Poland and Hungary, small activities could only be leased because municipalities were unwilling to give up ownership of land on which they were located. The Poles were happy with leasing arrangements but the Hungarians would settle for full ownership only. In former Czechoslovakia, new owners could not emerge unless the restitution claims of former owners (who were dispossessed by the communists) were settled. (United Nations, Economic Commission for Europe, Economic Survey of Europe in 1992-1993 (Geneva: June 1993), p. 200).

But these problems paled in comparison with those in big industry. Transferring the ownership of large factories in industry and the defense sector to private hands was hobbled by political resistance and economic problems.

Factory managers--often the party old guard--and workers who were ready to allow petty privatization were generally unwilling to let go their hold of large state units which legally did not belong to them but for which they could claim "accrual rights" arising from long association. If the enterprise had performed well over the years, they took it for granted that the resulting gains must accrue to them. Even if the factory was performing poorly, the managers could claim "implicit " property rights of its assets especially if the instructions from the planners in the past with regard to its management were not explicit and were relaxed over time (as it happened in Hungary). On the other hand, if the planners had entrusted the worker councils with decision making in the enterprise (as in Poland), the workers too developed "vested" rights bordering on its ownership.[4] Reforming privatizers had to satisfy these claims of insiders in large factories in their programs.

[4] For a discussion of "accrued," "implicit," and "vested" property rights, see United Nations, Economic Commission for Europe, Economic Survey of Europe in 1991-1992 (Geneva, June 1992), pp. 201-202.

Even without these conflicting claims, big factories were difficult to sell. Individuals and groups who could raise the cash for an outright purchase of a large enterprise were hard to come by. The emerging bourgeoisie must accumulate savings in trading, services and small scale manufacturing before it could command a financial stake in big items. Foreign investors who might be allowed to participate could raise the capital but might choose to hold back because of legal uncertainties, unpredictable tax policies and poor infrastructure. (The implications of voucher use for acquiring state assets are discussed later.)

Big industry privatization implying a switch from state ownership to private ownership therefore continued to be the major challenge to reformers in the former communist countries. Several intermediate steps, short of such full divestment, were therefore employed to start and sustain the process.

First, the enterprise ownership was legally retained with the state (as initially in Hungary and Poland) but the enterprise was converted into a separate joint stock or limited liability company (to insulate it from "ad hoc bureaucratic interference") and put under new management. The insulation would not create immediate productivity gains but it was an important step in breaking "the traditional state structures of the old-style planned economy" which would not disappear on their own (Hare and Grosfeld, 1991, p. 5).

Such corporatization, in which ownership and management were targeted for separation, was inspired by the example of big industry in market economies: it is organized differently from a corner grocery store which is owned and managed by the same person. In the Soviet command economy too the state owned all assets, and the ministries operated them through managerial cadres which were bound by the targets and the performance criteria set for them by the planners. By contrast, capitalist corporations are organized as joint stock companies in which shareholder owners leave the corporate managers alone so long as they turn out profits.

Russian reformers therefore deliberately chose to emulate the corporate format, delink enterprise operation from state ownership, and promote its efficient management via such reorganization. The old managers might survive the change but it was hoped that they would learn to play by the new rules of the market. The first step of the formation of joint stock companies was calculated to promote their substantive restructuring later.

Such corporatization did not imply that the enterprise stock at the start was legally held by the state alone (as was the case at the start of the process in Hungary and Poland). Two alternative arrangements of stock distribution appeared over time. In the first case, the legal ownership of an enterprise was diversified by allocation of stocks to state agencies, and to financial institutions, workers, managers and citizens in exchange for vouchers. In a different arrangement, investment or management funds acquired vouchers from the public, invested them in the stock of a number of enterprises, and promised to pay a return to the voucherholders depending on the performance of the fund portfolio.

These three cases in which the enterprise stock was legally owned by the state (but its management was separated from state control), or was acquired by a group of insiders and outsiders (including the state), or was pooled together for several enterprises by management funds have often been interpreted as genuine privatization because such corporatization evidently contributes to "the rapid enhancement of efficiency in the use of existing capital assets by taking the state out of the decision making about the allocation of the service streams obtainable from these assets." (United Nations, Economic Commission for Europe, Economic Survey of Europe in 1991-1992 (Geneva: June 1992), p. 207).[5]

However, the emergence of productivity gains in corporatized units not only requires that the state be taken out of the decision making but, more importantly, that the market be introduced via commercialization. They must be managed by an independent group of managers according to

[5] The Survey goes on to state: "There are of course different ways in which the state can be so relieved. Divestment is one such way. But there are others. Some of these approaches will be best suited because outright divestment is either simply not yet possible or not the best way of changing the decision-making arena for the allocation of capital services. In this context, due attention must be paid to the time element, given the path-dependency of the transition. That implies, for example, that although divestment may be possible in the long run, certainly in the case of sale but also when free distribution is being contemplated, in the interim the focus is best placed on taking the political bodies out of the microeconomic spheres." (ibid).

market economy incentives. Ideally, state subsidies ought to be denied to them and commercial bank financing should be increasingly brought in. Managers who fail to generate profits should be replaced by a new team at the initiative of the board of directors. Shareholders should be able to switch their stock from losing companies to profitable ones--a difficult choice in Russia because, two years after the start of the process in 1992, the line between viable and unviable units was blurred, stock market activity was limited and unregulated, and brokers were not always to be trusted. It was difficult to undertake restructuring according to market economy rules in Russia's big factories because market discipline was weak and institutional infrastructure was not in place.

Even before the appearance of enterprise corporatization, worker collectives and managers under communism were allowed to lease factory assets via contractual arrangements which offered them considerable autonomy and allowed them the use of their outputs in payment for a rental to the state. In fact, lease arrangements in farming, manufacturing, construction and services became widespread in the former Soviet Union in the final year of Prime Minister Nikolai Ryzhkov's regime (1986-1990).[6]

As an intermediate arrangement leading to full divestment, leasing offered the leaseholders valuable experience of managing a unit and an attractive opportunity of accumulating cash. Problems arose when leaseholders violated the contract or stripped the asset for immediate gain (Economic Survey of Europe in 1991-1992, p. 206). In the post-1992 arrangements, such asset stripping was sought to be prevented by contractual commitments which allowed leaseholders its eventual purchase financed from their savings and bank loans.

Finally, privatization involved the emergence of new, privately-owned units in industry, trading and services. Privatization of state-owned factories turned out to be a slow and complex process but new units in the tertiary sector emerged rapidly in all reforming economies. Almost a

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[6] Thus, "leasing is highly popular in the construction industry, where its share of all contracting activity rose from 7 percent in 1990 to 17 percent in 1992. It is increasingly popular in other industries, too; some 3,485 industrial enterprises (15 percent of the total) were already operating on this basis in 1992, and they contributed 11 percent of total output." Details are in Richard W. Judy, "Russia at Risk," Hudson Country Report, No. 3, May 1993, p. 10.

million new private businesses in this sector were operating in Russia by mid-July, 1994 despite financial risks and legal uncertainties.

WHY PRIVATIZATION?

It is hardly a matter of dispute that people like and want to own things. Proudhon's declaration that "property is theft" is to be viewed more as an indictment of the capitalist arrangements that allow a few to own property evidently at the expense of the many rather than of the individual instinct to be a property owner. Since the desire for property is as natural as that for freedom, the right to property, in the view of some, should be enshrined in the constitution. This demand surfaced occasionally during the constitutional debates over the drafting of the Russian constitution in 1993.

Not only is the philosophical basis for private property generally accepted; there is also widespread agreement with regard to the arrangements which offer opportunities to people to be property owners. Since the socialist system under which the state owned almost everything turned out to be too much bureaucracy, too little incentives and too few choices, the current view has shifted in favor of political pluralism and free markets which have the potential for creating widespread property ownership through individual decisions about which occupation to select, how best to spend one's income, and where to invest one's savings. Such choices are promoted by market-economy institutions which provide the necessary information and services, financial support, and the like.

Market economies also promote efficient asset choices because when individuals own assets, they use them in the most productive manner. They maintain them carefully, employ them in the most gainful use, and dispose them off when they cease to be profitable. At the very least, therefore, people should be free to buy and sell assets in order to realize these gains. Moreover, there should be a stable price system enabling owners to predict gains and losses, active financial intermediaries which facilitate sale and purchase transactions, and legal institutions which protect and enforce property rights.

In short, democratic pluralism, free markets and their institutions nurture human desire to own assets and channel their use in productive activities.

STEERING THE PRIVATIZATION PROCESS

The privatizing reformers had to resolve four issues in order to implement this seemingly self-evident agenda in the former socialist lands.

Private ownership, competitive pressures and restructuring create economic efficiency in market economies by working together. Private property (as already noted) promotes such efficiency by assuring its productive use. Again, corporate companies continuously restructure themselves. Where monopolies prevail, pressures from outside via imports provide the necessary stimulus. Free market institutions such as financial intermediaries, and government regulations defining bankruptcy procedures, for example, contribute to this Darwinian process.

By contrast, the former socialist economies not only lacked privately-owned corporate enterprises but also market-economy discipline and institutions. Therefore, the question arose: should the privatization package weed out bankrupt farms and factories and restructure the potentially viable units before they were corporatized or actually sold to private owners? In other words, should corporatization (as in Russia) or sale of assets (as in former East Germany) precede or follow enterprise restructuring? Again, should the institutional infrastructure of free markets which promotes such restructuring be created first? Second, should the process aim at an equitable distribution of assets? Will a program which enables every citizen to acquire corporate stock and other assets in exchange for a voucher result eventually in fair asset distribution?

Third, should the state assets be sold in order to raise revenue for the treasury rather than be given away gratis or at a discount?

Finally, should destatization be used as an ideological weapon to dislodge party bureaucrats in the ministries and enterprises (and in the distant regions of Russia) and prevent them from cornering the assets? This goal will influence the specific features of the program and the procedures of implementing it.

Economic Efficiency and the Sequencing Decision

Reforming policymakers recognized fully the negative impact of state ownership of productive assets on economic efficiency. Such ownership implied that planners took output and pricing decisions, managers implemented them in factories, consumers put up with shoddy products and shortages, and deposited the leftover income in savings bank accounts. The variety and abundance of consumer goods and of assets were missing. Producers lacked the incentives and the pressures to innovate and improve product quality.

While the reformers firmly believed in the role of private ownership in creating the incentives of the market economy, its implementation was fraught with formidable problems especially in Russia.

Property rights in large enterprises had to be sorted out among competing claimants across the state hierarchy before they could be put up for privatization. Their historical valuation was outdated; even so the financial resources required for the swift sale to private owners of the large viable units were immense. The breakup of large monopolies in machine building and the energy sector, in the view of some, threatened their technological and competitive potential vis-a-vis multinational corporations. (By contrast, there was general agreement that small units in trading and services could be sold or leased quickly.)

Again, the political consequences of restructuring large factories implying enforcement of bankruptcy procedures and worker layoffs overshadowed the economic arguments.[7] Such

[7] The crafting and implementation of bankruptcy laws were totally different in the reforming economies (considered here) from their market economy practices.

Market economy bankruptcy legislation seeks to strike a balance between the interests of an insolvent company (owned by an individual or a group which cannot pay its debt) and the creditors who have claims on its assets. The debtor is shielded from unduly harsh legal proceedings by its creditors who, in turn, are granted an equitable distribution of the debtor's assets. The debtor may fold its business or reorganize it de novo.

There were formidable problems of applying this model of bankruptcy legislation to enterprises in the former communist revamping was hobbled by the heavy indebtedness of corporatized units to each other and to commercial banks. If bankruptcies were to be carried out, a large chunk of industry and farming, evidently with limited resources for debt settlement and poor prospects for attracting investors, would simply disappear creating massive unemployment.

Nor were the necessary institutions and government regulations firmly in place for implementing speedy overhaul of factories. The shortages of arbiters, accountants and judges, of banks and financial intermediaries who could size up the investment potential of companies, and of brokers who could channel small savings in credible portfolios persisted everywhere. Government regulations were nonexistent or sporadically enforced.

The privatizing reformers had therefore to adopt sequencing decisions based on practical considerations and political expediency. In Russia and the Czech Republic, the process was marked by speedy sales of small units and a deliberate, corporatize-first-and-restructure-later policy with

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countries.

First, the state was generally the insolvent owner and the "unpaid creditor." If there were identifiable assets, they should therefore revert to the state. By contrast, in Polish liquidation of insolvent factories which was initiated by the state (under the provision of the Law on State Enterprises of 1981), the assets were acquired by the insiders (via auctions or outright purchases). This would correspond to the assets of the Chrysler Corporation being acquired by its workers and managers (instead of its creditors) if it were to be liquidated. Therefore, transition economy liquidations were different from bankruptcy closures in market economies.

Second, the state-owned enterprises were heavily indebted to the state bank or to one another and "continue to be solvent only by rescheduling the bad debts and carrying them as assets on their books. In a familiar Eastern European syndrome, a creditor-induced bankruptcy would threaten nearly the entire state sector, and is therefore `unthinkable.'... Not surprisingly, these liquidations do not involve the very large state enterprises, where the resulting social problems would be more difficult for the state to handle, but are limited to smaller firms, usually those with fewer than 200 employees." Details are in Roman Frydman, Andrzej Rapaczynski, John S. Earle et al (hereafter Frydman et al), The Privatization Process in Central Europe (Budapest: Central European University Press, 1993), p. 169.
As a result, bankruptcy procedures gave deliberate incentives to managers (far in excess of market economy measures) to reorganize large factories rather than fold them.

Third, there was a shortage of judges, liquidators and trustees for implementing bankruptcy procedures. "In the Budapest court there were only eight judges in mid-1992 handling about 4,000 cases." (The World Bank, Policy Research Department, Transition and Macro-Adjustment Division, Transition: The Newsletter about Reforming Economies, June 1993, p. 3).

Given these problems, the scope for restructuring and dissolving big industrial units via standard bankruptcy legislation was limited.

respect to the large and medium factories. In former East Germany, such factories were sold to private parties who promised to carry out Treuhand-approved restructuring plans. By contrast, Hungarian and Polish programs were devoid of the decisive Russian sequencing nor could they manage Treuhand-style simultaneous sale-cum-restructuring packages. (Detailed analysis of country programs follows later.) The Russian State Property Committee, in particular, proceeded headlong with the corporatization of medium and large units postponing the substantive issues of infrastructure buildup and enterprise restructuring. Free market institutions and their legal apparatus, the stock market and the bankruptcy procedures, for instance, cannot be created overnight anyway.[8] The urgent business of the day was to first diversify asset ownership in factories and leave the promotion of economic efficiency via restructuring to future battles. (It is argued later that this strategic decision gave the Russian and the Czech process a forward momentum which the Hungarian and Polish programs lacked.)

Equitable Asset Distribution

Market economy asset distribution results from free choices. People choose to spend their income on a variety of items and invest their savings in different assets. Among property owners, a small fraction owns corporate stocks; a sizeable majority owns housing and savings accounts. Such voluntary choice of consumer goods and assets contributes to efficient resource allocation which characterizes competitive markets.

However, the asset ownership cannot be argued to be fair. Many people do not own housing

[8] It was only on November 7, 1994 (more than two years after privatization began) that a presidential decree laid down the legal framework for regulating Russia's chaotic securities market. It required that financial institutions and commercial banks which operated in securities permitted by law (such as government bonds, registered shares of joint stock companies and banks, and housing certificates) must be licensed by the government "in concert with" the Russian central bank. The decree also ordered the formation of a federal commission for securities and the stock market.

The decree was not only calculated to prevent fraudulant activities by investment funds but also to promote guaranteed registering of shares by independent registrars rather than by corporatized factories themselves which could tamper with shareholdings. For reports of such share tampering by Russian factory directors, see The Financial Times, November 16, 1994, p. 1.

or a savings account. Even if ideal asset distribution can be defined, it is difficult to achieve it in practice. The best that can be championed under democratic pluralism is job opportunity and upward mobility. Equitable asset distribution is hardly a policy agenda of market economy legislators.

Not so with the reforming privatizers in the former communist countries. The issue of fairness was at the front of the decision making everywhere although the administrative procedures and the privatization schemes for implementing the goal, as will be discussed later, varied from country to country. In Russia, in particular, the program of factory corporatization had two egalitarian features: first, it was tilted decisively in favor of diversifying asset ownership via a distribution of vouchers to citizens. Neither the former managers who might be best qualified in terms of their experience and networking to convert a factory into a profitable venture nor the workers who a la Marx created the productive wealth in the first place were to be allowed to own it to the exclusion of the people. Second, the formal ownership of stock in the large and medium-sized factories was diversified via a choice of one among the three alternatives (these are stated later) which were mandated by the State Property Committee. Spontaneous corporatization choices by insiders were ruled out.

Asset diversification (via vouchers and state direction of the process) was also the goal of privatizers in Hungary, Poland and the former Czechoslovakia. Vouchers played a role (They never appeared in former East Germany and came somewhat later in specially tailored versions in Hungary and Poland); but the successive waves of corporatization offerings turned out to be slower than in Russia although the Russian scale was enormous. Again, in Hungary, Poland and the Czech Republic, state privatization agencies steered the program halting the earlier phase of spontaneous privatization by factory insiders.

Clearly, the purpose of Russian voucher privatization was to quicken factory corporatization and diversify stock ownership. But could diversified ownership in large and medium Russian factories (in which citizens exchanged vouchers for shares) ultimately lead to fair distribution of industrial assets? The voucher entitled everyone to an even chance of acquiring an asset but the turmoil of industrial restructuring would in the end throw up the lucky winners from an estimated 40 million shareholders. At the end of the market shakedown, enterprise shares acquired by Russian citizens in some large factories might turn out to be nonpaying nominal assets if not worthless lottery tickets. Stock ownership even in the best of circumstances is a risky business. Only 7 percent of the population in the United States owns corporate stocks.

The limitations of vouchers as instruments of creating equitable corporate stock ownership in Russia arose from four perspectives.

First, the unscrupulous activities of some Russian investment funds which acquired vouchers from the public in return for promises of "mountains of gold" dimmed the prospects of creating equitable ownership of factory assets via voucher corporatization. None of the funds--"black boxes" in fact--gave documents about their origin or financial activity to the voucherholders (Izvestiya, July 1, 1993, p.1.)[9]

Second, voucher corporatization was stretched over a period of almost two years starting in late 1992. Many citizens placed their vouchers too early and missed the more lucrative offerings which came later. For example, shares of Gazprom, the world's largest gas company and potentially one of the most lucrative, were offered late in October 1994 for which only 4 million vouchers were exchanged.

Third, citizens could hand over their vouchers to investment funds (which invested them at a time and in an outlet of their choice) or place them in voucher-based auctions in their

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[9] Take the bizarre case of the MMM investment company which had 5 million investors and 67 offices and had witnessed its share values climb by more than 40 times between February 1994 and July when they collapsed. Sergei Mavrodi, its director, not only ruined the company shareholders but got elected to the Duma evidently to escape charges of tax evasion on the basis of political immunity for legislators. Nor was MMM the only big investment fund to conceal its financial activities, suspend interest payments, and defraud shareholders. For a list of more such companies, see The Economist, November 5, 1994, p. 77.

Following the outright deletion by the management of the Krasnoyarsk Aluminum Plant of the stock of Trans-World Group, a British company that owned shares worth $800 million in the plant, the Federal Commission on Securities announced plans to tighten audit and enforcement of penalties on companies which indulged in such criminal activity. The measures were prompted not only by concern for protecting shareholders' rights but for safeguarding foreign investment. Details are in Sevodnya, Decemebr 9, 1994, p. 2.

neighborhood. They acted on the basis of limited information: how could a resident of the far eastern city of Nakhodka learn about the prospects of the Bolshevik Biscuit Factory in Moscow and bid for its shares? Since electronic transactions were not available to all citizens,[10] voucherholders in industrial towns and big cities had more choices.

Indeed, local citizens protested the appearance of "outsiders" who came with bagful of vouchers to corner shares in the coveted defense sector offerings in Chelyabinsk. Even when voucher-based auctions were carried out simultaneously, inequities developed. Thus, Gazprom shares with a face value of 10 rubles each were offered in the summer of 1994 in 60 regions of Russia all at once. One voucher on average captured 1500 shares but in Perm oblast with a heavy concentration of gas networks, a voucher exchanged for 6000 shares. (This implied that the market price of the voucher with a nominal value of 10,000 rubles had jumped to 60,000 rubles a piece at the time of the auction in Perm in contrast to its average price of 15000 rubles in Russia as a whole.) Supply and demand could not be equalized through electronic placements.

Fourth, several profitable ventures in consumer goods started issuing new shares for cash in the late summer of 1994. The Kirov Confectionary and Macaroni Combine which was corporatized toward the end of 1992 with partial voucher subscription by the public decided to float new stock in late 1994 in several installments. Newcomers could buy the highly appreciated shares of the company for cash whereas oldtimers were already ahead with infinite gains on their lucky winnings from cost-free vouchers.

The full story of the turmoil of voucher privatization, of the fates of the losers and the fortunes of the winners must await the complete shakedown of Russian factories endowed with uneven prospects. Incomplete information, unscrupulous fund managers, absence of regulations and the rough-and-ready, sequential mode of conducting the voucher-based offerings contributed to potentially unequal outcomes for the voucherholders.

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10 A country-wide, Nasdaq screen-based network in which brokers could trade the shares of the corporatized companies was expected to be in place by the beginning of 1995. Details are in The Financial Times, November 8, 1994, p. 3.

On the other hand, the privatization program deliberately avoided the free giveaway of tangible assets such as housing to the most vulnerable groups, among them pensioners and low income families, who had occupied it all their adult life. A free distribution of land, up to a certain limit, to farm families which wanted to quit a collective farm was however permitted. In practice, it was difficult to acquire a coveted piece of land (beyond the legal limit) even via recourse in a law court. A worthless plot was the more likely outcome. By contrast, the well-to-do urban residents took ample advantage of the offers of free plots of land to build dachas and cultivate gardens outside city limits. The line between the city haves and havenots was drawn by who commuted by car to the weekend dachas.

Raising Revenue from Asset Sale

Can sale of state-owned assets contribute to macroeconomic stabilization by generating revenue? If such cash flows materialize, they will be a single-shot gain for the federal treasury.

The size of the net revenue flows to the central budget for macroeconomic management of the reforming economies depended on three factors.

First, the property rights of the various state levels had to be clearly assigned for establishing their claims to the multiplicity of assets and to the cash from their sale. In Russia, the municipalities could claim revenues from the sale of small items in the trade and service sector, the regions were assigned property rights in the large and medium-sized units, and the federal agency owned the largest factories. In practice, the program's implementation turned out to be complicated. (These details appear later.)

Second, how substantial could the one-time gain of net revenues accruing to the central treasury from the sale of federally-owned assets be? The 1994 net balance in the Russian budget as these assets began to be sold for cash could not have been positive because corporatized industrial and defense factories received budgetary support which exceeded the trickle of sales receipts.[11] The

[11] By midyear, loans in the amount of 1.4 trillion rubles were granted from the federal budget to various factories among them, the Rostov

1995 prospects for earning net cash depended on the firmness with which the bankruptcy procedures could be implemented. If the soft-budget pressures were to be successfully resisted, net cash inflows from sale of state claims (in the corporatized factories) could help the budgetmakers contain inflation.

Finally, the revenue flows from sales of federally-owned assets depended on how they were priced. Toward the end of 1994, Russia continued to be regarded by outside investors as a risky market in relation to Hungary, Poland and the Czech Republic. At the same time, the capitalization values which emerged from corporatized industry sources and the State Property Committee were either laughably low or astronomically high and had little relation to the potential riskiness of investment.

Thus, Russia's proven oil reserves were valued at 10-15 cents to a barrel compared with $7 in the United States (The Financial Times, November 28, 1994, p. 15.) On the other hand, the sale of the central government's share of Gazprom stock to foreigners, in the words of former privatization minister Chubais, could bring in $20 billion which at the rate of $1 exchanging for 3,000 rubles amounted to half of the 1994 federal revenue projections!

In the long run, governments must rely on tax revenues to finance budget outlays. Federal budgets receive taxes from corporations and individuals, and local governments raise revenue from property and sales taxes. These prospects (for Russia, in particular) depended on the taxes that were devised at the various levels of government and the effectiveness with which they were collected. The chores of collecting taxes from independent taxpayers, individuals and companies located in territorial hieararchies, turned out to be more challenging than the earlier Soviet arrangements in which payments were automatically transferred to the central treasury by state-owned enterprises

Farm Machinery Plant, the Kama Automobile Plant, and the Altai Diesel Plant. The presidential decree of early August sanctioned an appropriation (not covered in the budget) of 3.5 trillion rubles for defense industry conversion: 2.9 trillion rubles were to be issued at an interest rate of 37 percent which was one-fourth of the Russian central bank's discount rate.

If the loans could be recovered from the factories, then the interest differential alone was the budgetary "loss" which needed to be set off against the "gains" from sale of government-owned stock in corporatized companies. However, few factories and farms repaid state loans.

and agencies.[12]

The Ideological Objective

Should privatization be used as an ideological weapon to subdue the party old guard which believed in continuing state ownership of property in order to retain its hold on the economy and society? If nationalization could be carried out to banish the bourgeoisie, why couldn't destatization be undertaken to emasculate the communist ideologues?

This issue was at the center of Russian privatization from day one. Communists elsewhere were retired into inactivity or converted into market economy supporters before privatization began. In Russia, the timing, speed, design and implementation of the program was in large measure dictated by the objective of launching a frontal attack on the Soviet command economy characterized by state ownership of property as its principal pillar, the apparatchiks as the supreme wielders of economic power, and the citizens as passive employees of the state. Privatization was strategically aimed at removing the party bosses from their central role in the economy, creating incentives of decision making in farms and factories and providing occupational choices to the workforce.

First, with regard to its timing. By the middle of 1992, as macroeconomic stabilization failed to take hold, a second front was opened in the reform battle with the decision to push privatization. Having realized that the Supreme Soviet was determined to force the central bank to print currency for subsidizing industry and farming, the Gaidar government could have resigned. Instead, it made a tactical retreat and opened up the privatization front (Moskovskii komsomolets,

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[12] 1994 federal revenues were unlikely to exceed 70 trillion rubles (in contrast to the targetted 124 trillion rubles). The continuing decline in industrial output shrank the tax base. (It was expected to fall sharply by 25 percent in 1994 compared to 16 percent each in 1992 and 1993, and 11 percent in 1991.) Again, consumer subsidies were abolished at the center but they persisted in the regions. As a result, the net revenues transferred to the federal government from VAT (Value Added Taxes) collected by the local administrations became more unpredictable as the subsidy claimants in some localities increased. With increasing regional decentralization and enterprise autonomy, the voluntary transfer required transparent and stable tax rules, commitment to fiscal contracts, and fear of revenue authorities. None of this was fully in place in Russia.

~~May 12, 1993, p. 1~~). The date of issue of vouchers which could be used to diversify asset ownership and prevent nomenklatura asset grabbing was brought forward from early 1993 to October 1, 1992. The populist appeal of owning property, free of charge, undoubtedly contributed to the pro-reform vote in the April 1993 referendum and the reigning in, for a while, of the conservative forces in the Supreme Soviet.

Next, with regard to the speed of the program. Russian privatization involving sale of small units and corporatization of factories represented the speediest destatization program in history. The speed ensured that the process was irreversible. The citadels of communism were captured. Not only were the timing and speed critical but secrecy was occasionally invoked to fortify the onward march.

Finally, the design and implementation of the program (Details follow later). In contrast to the process in Poland, Hungary and former Czechoslovakia which was also increasingly state directed, Russian corporatization was less flexible in design and more centralized in implementation from the start. Nothing, it would seem, was left to chance. Barring the largest units, all factories were required to choose from three mandatory schemes as the State Property Committee managed the successive rounds of factory corporatization with a firm hand. It was as though private property was being commandeered into Russia by market reformers in an authoritarian mode. The speed and timing, the occasional secrecy and the "dizzy with success" fervor earned them the title of "neo-Bolsheviks" from the conservatives.

Russian privatization, in short, was a remarkable political-ideological accomplishment. It buried once and for all the idea of state ownership of productive assets in the economy.[13] With regard to economic efficiency however it was no more than a first step awaiting formidable restructuring problems in the large factories in heavy industry, the defense sector and the collective

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13 The idea surfaced briefly when the new privatization minister Vladimir Polevanov (who replaced Chubais in the cabinet changes of fall 1994) declared in December that key industries in the energy and metal sectors might revert to state ownership. The hasty declaration cost him his job.

farms. Nor did the program guarantee an egalitarian outcome of asset ownership despite its emphasis on widespread asset distribution via vouchers in the corporatized factories. On the other hand, the efficiency and fairness gains (via employment creation, for example) arose from the sale of small businesses in trade and services, and were noteworthy. But the major task of the economy's overhaul which would release the efficiency gains of competitive markets and provide an equitable division of the expanding economic pie to the citizens was only begun in the first round.

In Poland, Hungary, former Czechoslovakia and East Germany, by contrast, the process was concerned more with balancing the goals of economic efficiency and fair asset distribution and with devising effective strategies for the purpose rather than waging ideological battles against old adversaries. [14]

PRIVATIZATION GOALS AND PAST HISTORY: THE INTERACTION

These objectives, which influenced privatization decisions and programs in the former communist countries, were in turn shaped by the burdens of the past.

A major problem affecting privatization efforts in all countries was the prevalence of large units in industry and the defense sector although the scale was massive in Russia. (The specific features of big industry in each country are discussed below.) Centralized management, outdated technologies, excessive labor, declining demand, massive inventories, and disruptions in material supplies (especially in Russia) marked big industry everywhere. Many factories and banks were heavily in debt. The absence of competitive pressures during the planned economy days had rendered them economically unviable.

While large industry privatization was a major headache in all countries, the economic and

[14] The paradox of the conflicting goals of privatization policies in a democratic environment was brought out by the results of a Polish opinion poll in September 1990 (Hare and Grosfeld, p. 28): 74.1 percent considered privatization as necessary but only 30 percent voted in favor of efficiency as the objective whereas about two-thirds voted for some form of social justice such as "not harming anyone, [and] avoiding the creation of new privileged groups."

political liberalization which had already taken place in Hungary and Poland under communist rule set them apart from Russia, the former East Germany and Czechoslovakia which were largely untouched by such liberalizing tendencies when they embarked on privatization. How did such early liberalization in Poland and Hungary influence the subsequent privatization process? Did it confer specific advantages to the Hungarian and Polish reformers in contrast to privatizers in the countries which were deprived of similar decision making freedoms?

The liberalization forays under communist rule in Poland and Hungary might have prepared them for big industry privatization from two directions.

Economic Liberalization under Communist Rule and Privatization

Consider first the impact of the economic liberaliztion: did the chances of enterprise asset divestment and restructuring improve with the gradual economic freedoms granted to managers by the communist planners with respect to their decisions of production, prices, investment and choice of technology ?

The persistent restructuring problems of big industry in Hungary and Poland with a past record of economic loosening and of Russia, the former Czechoslovakia and East Germany without such liberalization suggested that it was difficult to establish a positive connection between limited, market-socialism reforms under communism and the subsequent prospects for speedy industrial overhaul. One might think that the market-socialism reforms initiated in Hungary in 1968 and implemented in Poland in the 1980s had prepared Hungarian and Polish enterprise managers for a rapid revamping of enterprises under their management and that the pervasive bureaucratic control of Russian, Czechoslovak and East German enterprises during communist rule had blighted their prospects for economic restructuring. In fact, big industry in Hungary and Poland had missed the pressures of market economy competition and were in no better shape to face the rigors of restructuring than their counterparts in Russia, former Czechoslovakia and East Germany. They were all in the same boat. (However, the liberalization experience of Hungary in which the managers undertook decision making and of Poland in which the workers' councils had an important role influenced the privatization features which will be discussed below.)

Political Liberation from the Soviet Empire and Privatization

While economic liberation of the market socialism variety did not confer special advantages to Hungary and Poland in their subsequent efforts of privatizing and restructuring heavy industry, the political liberation from Soviet domination led all countries in the former Soviet Bloc to a rejection of state ownership of property which served as the foundation of a tyrannical ideology. Communists who enforced the ideology were discredited too. In Russia, however, the reforming privatizers had to battle ideological opposition to the process from communist members of the Supreme Soviet who in turn were supported by old faithfuls in factories, the ministries and the regions.

By contrast, take the following forthright statement arguing a case for private property in former Czechoslovakia:

> "If there is an undisputable argument in support of privatisation, it is of political nature. It is politically unacceptable to preserve the existing dominance of the state ownership as its direct consequence is the state monopoly of employment. It is then too easy for the revival of totalitarianism to occur in a country where government has this most efficient tool of controlling private lives of its citizens. ...Privatisation is, in our view, the only safe way to achieve the democratic organisation of a society. The economic prosperity, efficiency and growth is then a natural consequence of democracy.

This is why we want to privatise fast. This is the reason why the privatisation and restitution laws have played such a prominent role within our recent legislative development. (Jan Triska, "Why and How to Privatise in Post-Communist Countries: The Case of Czechoslovakia" (unpublished), 1991, p. 1).

The fact that communism was an alien imposition in East-Central Europe also contributed to a rejection of the principle of state ownership and of communists as a legitimate force. Few argued in favor of continuing the alien arrangements of state ownership, bureaucratic management and administered prices.

This is not to suggest that the task of implementing the program of private ownership especially of large factories in these countries was swift or simple. But unlike in Russia, the nomenklatura was not engaged in subverting its goals and distorting its features. The ideological confrontation was absent. Rather the programs had to balance the claims of various groups on state property, among them the managers, the employees, the expropriated bourgeoisie (in former Czechoslovakia), and the public, and ensure fairness.

Perhaps as a result of the absence of such ideological pressures, the process outside Russia was devoid of the singleminded committment of the band of privatizers in the Russian State Property Committee who mounted an assault on state ownership from several directions. They were seized with the manifold tasks of classifying all state-owned assets and assigning them to the various levels of state authority; of fixing deadlines of each phase beginning with the distribution of vouchers and ending with their exchange by the public for shares of corporatized factories via public auctions; of outwitting the the Supreme Soviet and providing the president with details of decrees to counter its legislation. It was an unprecedented race and by mid-July of 1994, the privatizers had beat the clock. As noted earlier, most large and medium factories were corporatized, the small items had been sold or leased, and most of the vouchers had been disposed off (with the remainder to be used by the owners by September.)

However, note that while ideological pressures were absent outside Russia, political considerations dominated the process everywhere (including in Russia). None of the governments were prepared to hand over privatization decisions to the factories or localities. In Poland, Hungary and former Czechoslovakia, the shortlived phase of factory initiatives was soon overtaken by programs monitored by state privatization agencies. (The shift arose out of the demands to ensure a fair distribution of state-owned assets.) The programs also avoided wholesale restructuring of big industry for fear of massive industrial decline and worker layoff. Indeed, the bankruptcy laws were diluted everywhere to forestall factory closures.

However, in Poland and Hungary, the lack of decisive progress on privatization coincided by late 1993 with establishment of left-of-center governments whose major concern was workforce welfare and big industry salvaging. By contrast, in Russia and the Czech Republic, a clear strategy coupled with its determined implementation under the leadership of Chubais and Vaclav Klaus kept the process forward despite political roadblocks (especially in Russia).

These programs are discussed below from the perspective of the policymakers' efforts to undertake big industry privatization.

FOUR PRIVATIZATIONS:
DIFFERENT PROGRAMS AND CONTRASTING PERFORMANCES[15]

Czech Privatization: Pragmatic Approach

Czech privatization was bold in its coverage of activities to be privatized, pragmatic in its decision to devise a workable mix of state supervision, enterprise initiative and public participation via vouchers, and resilient in its response of solving problems as they arose.

The Problems

The task consisted in privatizing 5,400 state enterprises of which 430 were industrial factories employing on average 2,586 employees.

Some large enterprises had 8 to 9 plants which manufactured similar items and were run by a hierarchy of managerial cadres. In such cases of horizontal integration, privatization required the closure of unviable plants, the transfer of the ownership of the viable units in private hands, and their management by independent decision-makers.

On the other hand, there were large, vertically integrated companies in the energy sector,

15 Some details in this section are drawn from United Nations, Economic Commission for Europe, Economic Survey of Europe in 1993-1994 (Geneva: 1994), (hereafter Survey).

telecommunications and airlines which involved top-to-bottom integration of production and distribution activities and of management.

The privatization mandate of the Act on Large-Scale Privatization adopted by the Parliament in February 1991 was to remove all assets from state ownership except the railways and the postal service and retain some apartments in communal ownership. The purpose of the program was to halt the spontaneous, 1990 buyout of individual plants of an enterprise by employees (EBO) or by managers (MBO), to prevent insiders from buying small units as well, and to ensure citizen participation via vouchers in the privatization of large factories and via public auctions of the small units in the tertiary sector. The big factories were required to submit privatization plans prepared by "any juridical or physical person,"--management or outsiders. These plans were to be screened by the State Privatization Agency. Unlike in Russia, however, the process displayed a flexible give-and-take between privatization initiators (inside or outside the factories), founding ministries and the privatization agency.

The financial implications of the program were brought out by the disparity between the worth of state-owned assets at 1,500 billion Czech koruna and public savings valued at less than one quarter of the bill.

The program

Small units in trading and services, and restaurants were auctioned off; some were handed over to previous owners from whom they were seized during the communist takeover.

Large and medium factories submitted privatization projects for part or all of the enterprise which were then forwarded to the founding ministry (for example, the Ministry of Industry and Trade) which, in turn, passed them on to the Ministry of Privatization after an initial screening.[16] Finally, the Fund of National Property implemented the plan approved by the Privatization

[16] The free-for-all invitation resulted in four competitive proposals, on average, per company. One enterprise invoked 128 competitive projects. The first wave, which did not include voucher participation by the public, generated 11,555 submissions of which 1,594 were approved by September 1992. Details are in Survey, p. 166.

Ministry.[17]

As a result, most of the large companies were corporatized and their stocks were acquired by the state, the worker collectives and managers, and the public via management funds. At first, the decision making and selection criteria were neither explicitly defined nor revealed to the public. The final contours of privatization therefore varied across enterprises depending on the initial proposals and the Privatization Ministry's choice.[18] Over time, the procedures were simplified, more information was released to the public, and personnel was changed often to minimize corruption.[19]

The pioneering feature of Czech privatization of big industry was acquisition of company stock directly, or indirectly through Investment Privatization Funds (IPFs) by the public which exchanged vouchers for the purpose.[20]

The Results

Toward the end of 1993, the number of industrial enterprises had risen to 3,084 (from 430 in 1989) and the average workforce had declined to 458 employees per enterprise (from 2,586 in

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17 The exception arose when a company proposed a direct sale to an interested buyer in which case government approval was necessary.

18 "The number of competing projects multiplied rapidly in the last weeks and days before the January 20, 1992 deadline. Some enterprises had as many as twenty or thirty competing projects (the highest number was 126 for the milk processing factory Lacrum Brno). In all, there were 2,884 basic or obligatory projects and 8,065 competing projects submitted to the Czech Ministry of Privatization, the latter forming 73.7 percent of the total. Among the basic projects, conversion to joint stock form (leading to share sales, meaning mostly voucher privatization) predominated; among the competing projects, direct sales predominated." (Survey, p. 81).

19 The latest casualty was Jaroslav Lizner, Chief of the Center for Coupon Privatization and Director of the Central Securities Registry who was arrested in early November, 1994 for taking a bribe in order to manipulate a stock tender. Prime Minister Vaclav Klaus in a display of robust pragmatism reacted to the "bolt from the blue" by saying that "speed was more important than accuracy" and that the voucher privatization program would remain on schedule. Details are in The Financial Times, November 3, 1994, p. 2.

20 According to the scheme, every citizen, eighteen years and above, bought a voucher book for a small price of $35. A voucher carrying "investment points" could be used for acquiring stocks of enterprises which were converted into joint stock companies and were put up for public subscription in successive rounds of two waves in 1992 and 1994. The voucherholders could directly exchange their investment points for corporate stock or hand them over, in part or fully, to IPFs which acted on their behalf.

The first wave which put up 988 joint stock companies for public offering was completed in 1993. The second wave which was expected to be completed in 1994 offered shares of 861 companies.

1989). By that time, the industry concentration, in terms of the relative contribution to output by enterprise size, was close to the pattern in Austria: the four largest producers contributed in 1992 more than 50 percent of the output in oil refining and tobacco (100 percent in each), in business machines and transport equipment (including automobiles), and metalworking. There was a sharp decline in such concentration in consumer goods such as textiles and leather industry, wood processing and furniture making, and optical and medical instruments. The structure of industry was evidently approaching market economy norms.

At the same time, the number of private proprietorships exceeded half a million by the end of 1992. Banks were reformed on the basis of the (February 1991) law on commercial banks, the Prague Stock Exchange was set up in April 1993, a secondary market of voucher-based securities was expanding and brokers were proliferating. Toward the end of 1994, 80 percent of Czech citizens had become shareholders in 1,849 companies. 80 percent of state assets were corporatized; a few of these were sold to foreign and domestic buyers (The Wall Street Journal, November 20, 1994, p. A14).

The Continuing Problems

Problems however persisted in large factories which were still state owned and in several others which were corporatized.

The first step in restructuring enterprises including commercial banks was to straighten out their financial accounts. Most of the enterprise debts was converted from short-term to medium-term obligations with a low interest rate (in the hope that they could be recovered) and were taken over by the Consolidation Bank which was set up in February 1991. Interenterprise debts were settled on the basis of voluntary participation by debtors evidently with limited success. The Consolidation Bank also took over at a discount the weak portfolios of commercial banks. At the same time, the Fund of National Property (which approved privatization projects and collected revenues from the sale of assets) repaid some of the obligations of banks and factories to the Consolidation Bank. The process was slow raising serious doubts about the recoverability of most of the debts.

Clearly, the approach of the Privatizing Ministry was to delay the implementation of bankruptcy procedures and protect the large factories with financial support from the National Property Fund and let the smaller units go under.

Indeed, the least coercive and concrete bankruptcy legislation obtained in the Czech Republic. "A debtor is defined as bankrupt if `he has several creditors and has been unable to repay his obligations, which are due, over a long period of time.' ...Also, neither the Bankruptcy Law nor other regulations force the debtor or the creditors to file a bankruptcy petition." (Frydman et al, p. 63). The various schemes of netting out inter-factory debts, of swapping debts for equity, of writing off the non-performing assets of enterprises, and the sale of enterprise debt at discount were calculated to forestall bankruptcies which, in principle, could take place following the bankruptcy law of April 1993. The go-slow strategy resulted from the fear that bankruptcies would lead to the closure of a large number of factories, create substantial unemployment and disrupt material supplies.

The problems of settling the debts of factories and banks as well as of finding investors, domestic and foreign, who could restructure the large units continued into 1995. With the completion of the second wave of voucher privatization in 1994 (which raised little capital), companies sought cash to finance fixed investment. At the same time, foreign investors considered the Czech Republic attractive because it showed a strong and improving external financial position, the most promising among transition economies: its current account surplus increased in 1994; rising foreign investment contributed to capital imports (although the inflows declined in the first half of 1994); foreign currency reserves rose to $8 billion in August 1994; net foreign debt was reduced substantially and the country's credit rating improved among foreign investors. (United Nations, Economic Commission for Europe, Economic Bulletin for Europe, 1994, (Geneva, 1994), pp. 95, 106, 118, 120).

However, the prospects for augmenting foreign investment depended on the speed with which the the finances of corporatized companies could be tidied up and stocks of energy and telecommunication enterprises (which foreign investors coveted) could be offered for cash. The selective and cautious approach of the Czech government with regard to foreign participation also restrained foreign investment flows.

Clearly, Czech reformers pushed privatization forward in a benign financial environment of low budget deficits and external debt.[21] However, the strategy of corporatization (with or without restructuring) with enterprise initiative and public participation gave the process a decisive clarity and kept it on track.

By contrast, Hungarian privatization was marked by confusion. Factory privatization started with managerial initiative but it was halted as the problems of selling big factories to potential buyers, domestic and foreign, turned out to be complex; the State Privatization Agency stepped in to reverse and regulate the process.

Hungarian Privatization: Wrong Sequencing and Missed Opportunities

The Problems

There were 10,811 economic enterprises in Hungary in 1988 of which 22 percent were state enterprises, 63 percent were cooperatives, 9 percent were corporations (including joint stock and limited liability companies) leaving 6 percent as unclassified units. The large, state-owned organizations in Hungarian industry (which belonged to this group of economic enterprises) posed continuing privatization challenges to Hungarian reformers.

As in the Czech Republic, Hungarian industry was characterized by firms employing a large number of workers and exercising market power in their products: state- owned enterprises (SOEs),

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[21] High budget deficits and external debts (in relation to GDP) in Hungary, Poland and Russia, by contrast, called for austerity measures implying cutbacks in budgetray support to factories (threatening unemployment) and to consumers (adding to their hardships). A swift restructuring of privatized factories required by such austerity measures could be politically destabilizing. When budget deficits and foreign debt are low, the pressures to balance the economic gains from closing unviable factories (under private ownership) and the political costs of enforcing such closures are less demanding.

employing more than 1000 workers, were 45 percent of all industrial units in 1980; the leading manufacturers controlled more than half of the market in two thirds of 458 product categories.

Three features marked these enterprises on the eve of privatization: first, the individual plants were geographically dispersed with diverse technologies and varying economic prospects; next, they received investment funding and subsidies from the state budget--especially if they were geared to exports; and finally, self-governing councils, dominated by managers, decided whether plants under their control should merge or split or form joint ventures.

The Program

The privatization program covered three phases.

The First Phase-1988-1989: Plants and factories were spontaneously organized into holding companies at the initiative of management -dominated self-governing councils. The large shareholders in these holding companies were state-owned enterprises and banks, and occasionally, a foreign investor. Company shares were not offered in exchange for cash via public subscription. Thus, the companies continued to be state owned but the decisions to buy and sell assets, bring in a new partner or let a plant become independent lay with the management councils and not with the founding ministry, or a state privatization agency (which was to appear later).

Thus, the management of holding companies (which was none other than the self-governing councils) actively began house cleaning: they wrote off some debts, invited new cash and began buying and selling stocks. A few factories spun off from the parent company and became organizationally and financially independent. These changes were supported by the communist government which was increasingly strapped for funds with which to bail out factories.

If this process was allowed to continue, it was clear that the state would gradually lose control over the disposal of its assets which could eventually be cornered by a group of enterprising managers. There was "public outcry over questionable transactions in late 1989 and early 1990." (Frydman et al, p. 126). Therefore, one of the last acts of the communist government in March 1990 was to set up the State Property Agency (SPA) to regulate transactions in state assets.

The Second Phase-1990-1991: This phase was marked by a leap in the dark aimed at selling state companies without prior restructuring or settlement of their debts.

The activity of the SPA which directed the process covered four groups.

Companies below a specified value required SPA approval for restructuring including sale of property but the permission was readily given. Next, the SPA initiated and successfully completed privatization via asset sales of 366 state-owned companies (which were divided for the purpose into 10,000 units) in retail trade, public catering and restaurants. Again, it allowed breakup of medium-sized SOEs into smaller SOEs in agricultural machinery, textiles, and construction industry. Finally, it put up a few, large SOEs for outright sale in the hope that the buyers would restructure them. However, no buyers came forward.

As a result of the SPA monitoring, the management-directed, spontaneous privatization of the earlier phase which involved enterprise splitting into separate units (with independent control and improved financial viability) was halted. At the same time, except for the transfer of SOEs in the service and trading sector to private buyers, the sale of large industrial assets remained in limbo. Indeed, their economic situation was alarming: 40 percent of the companies were making losses, company towns with total dependence on a single smoke-stack industry such as iron and steel were collapsing, and the unemployment rate in some counties at 15 to 20 percent was above the national average in 1992. It was time to change the privatization strategy.

The Third Phase-1992-1993: The third phase simulated the procedural and restructuring efforts of the first phase of spontaneous privatization with the major difference that the process was now centrally directed. Its novel feature was the introduction of "credit notes" with which citizens could acquire company shares.

A State Holding Company (SHC) was created in 1992 to manage large SOEs in energy, telecommunication and pharmaceutical industries which could not be sold right away. The enterprise management councils were allowed to sell the remaining units; they could be split up so that citizens might buy them with preferential loans or lease them. Those that could not be sold by the end of 1993 reverted to the full ownership of the SPA. They were however converted into joint stock companies with managerial initiative and with participation by the Hungarian middle class which was encouraged to acquire company shares via "credit notes" and push corporatization forward.[22]

The corporatization and asset diversification of the SPA-controlled companies thus proceeded (unlike in Russia) along the Czech route with grass-roots initiative. "The predominant pattern has remained the treatment of each transaction on its own terms rather than adoption of a set of strict rules applied to all of them." (Frydman et al, p.130). The corporatization "laws describe possibilities without placing many rigid constraints on outcomes, which depend more importantly on the circumstances and the relative bargaining power of the actors in particular cases." (ibid, p. 131).

Finally, a bankruptcy law was enacted to resolve the financial crisis of companies irrespective of whether they were fully or partially state owned. The law which went into effect on January 1, 1992 was strict on paper having an automatic trigger mechanism which forced the debtor "to file for bankruptcy if it is more than ninety days behind in the payment of its debts, and managers who fail to take this step are made personally liable for the losses originating from the delay."(Frydman et al, p. 115).[23] The start of bankruptcy procedures implied that a factory could reorganize itself or go bust. In practice, creditors and debtors had the option to work out an agreement during the bankruptcy or liquidation proceedings. The debts could be cancelled or rescheduled or exchanged for equity. These rescue clauses were calculated to preempt wholesale industrial collapse.

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22 A citizen could get, without collateral, credit notes up to Ft100,000 for acquiring company shares. The companies would eventually repay the credits out of their incomes.

23 However, the law "envisages bankruptcy (as opposed to liquidation), somewhat analogously with Chapter 11 proceedings in the United States, as a process temporarily shielding the debtor from his creditors, and allowing him an opportunity for restructuring and reorganization." (ibid). The debtor's management was allowed sixty days to prepare a reorganization plan which must be unanimously approved by the creditors or it faced liquidation.

The Results

There was a phenomenal growth in the number of small and limited liability companies resulting from the breakup of large SOEs and the appearance of new units. The share, in the total, of companies with less than 20 workers rose from 18 percent in 1988 to 80 percent in 1993. However, 1.6 percent of the industrial firms which employed more than 1,000 workers each accounted for nearly half the employed workforce.

The Continuing Problems

The problems of converting the large SOEs (under the ownership and management of the State Holding Company) and the not-so-large companies (owned by the State Privatization Agency) into independent private companies and of shoring up their finances continued into 1995. As already noted, the bankruptcy law was applied to reorganize companies rather than liquidate them.[24]

The reorganization of large S0Es continued at two levels.

In some cases, loss making companies (coal mines, for example) were merged with profitable units (thermal power plants which used coal) in a single organization involving transfer prices and supplier-client relations. Occasionally, such large units were preserved because foreign investors preferred large size and the accompanying market share. On the other hand, some large S0Es were split into independent units, their assets were partly sold, and the funds were used to pay up the debts and revive the bankrupt units of the parent company. The policy of combining economically weak and strong units and of baling out the unviable units by penalizing the viable ones kept foreign investors from investing in Hungarian industry.

SPA-approved mergers and splits occurred also in the corporatized units with diversified ownership (under SPA control). Once again, the state eased the financial stress by a variety of

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[24] Toward the end of August 1993, 5,000 bankruptcy and over 15,000 liquidation petitions were filed. Only 4,000 cases in each category could be handled because of shortage of judges and arbiters. About one quarter of the bankruptcy petitions under consideration were resolved via agreements with creditors in the private sector, and banks, customs and tax authorities in the state sector. Thus, private business and the government contributed to the rescue operation.

measures: debts were written off, rescheduled or exchanged for equity; new loans were granted, old liabilities of taxes and customs duties were cancelled. The state lost revenues and postponed burdens into the future but the preferential treatment was expected to consolidate the deserving companies. Over time, the definition of deserving units was stretched to include private business, farms and some regions.

The government however was under enormous pressure to boost revenues by selling state-owned stock of companies[25] and earn foreign exchange by attracting foreign investment. The former was necessary to keep the budget deficit at the projected 5.5 percent of GDP for 1995, and the latter to offset the current account trade deficit (which was 9.4 percent of GDP in 1994) and to service the foreign debt (which reached $28 billion by the end of 1994, the highest per capita debt burden among East-Central European reforming economies).

The privatization program approved by the cabinet in November 1994 (and awaiting legislative confirmation) proposed to meet the challenge by inviting strategic investment in oil, gas and non-nuclear energy followed by public offerings of shares. The telecommunication and pharmaceutical sectors were evidently to be next in line. The State Holding Company and the State Privatization Agency were to be merged.

But the Socialist-Liberal coalition government (elected in the summer of 1994) of the Socialist Prime Minister Gyula Horn was marked by internal dissensions, dismissals of reformist members followed by resignations of hardliners and a total disarray in implementing the privatization program.[26] In February 1995, Standard and Poor's Rating Group "revised its

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25 At the start of 1995, the government owned 850 companies with assets valued at $14 billion. Details are in The Wall Street Journal, March 14, 1995, p. A10.

26 In January 1995, the Prime Minister upset investor confidence by cancelling the high-profile, $57.5 million deal to sell the state-owned hotel chain Hungar Hotels just days before a contract was to have been concluded. He said it was "foolhardy" to sell a profitable hotel chain at such a low price to foreigners. He then sacked the reformist privatization chief Ferenc Bartha who had negotiated the contract. Soon after, the Finance Minister Laszlo Bekesi resigned rather than surrender the control of the finance ministry on privatization decisions. In March, the new finance minister Lajos Bokros and the central bank governor Gyorgy Suranyi, both reformers, proposed radical spending cuts and a devaluation of the Hungarian forint by 9 percent--measures which prompted the socialist ministers of welfare and national security affairs to resign. In mid-March, the Zurich bank Credit Suisse backed out of plans to buy Hungary's top commercial bank, Budapest Bank.

Hungarian rating outlook to negative from stable, citing the budget deficit and privatization problems." (The Wall Street Journal, March 14, 1995, p. A10).

The problems of Hungarian privatization, in short, were twofold: it failed to attract broad popular support (which the Russian and Czech programs managed by corporatizing companies with massive voucher-based participation by the public in the first step); nor did it attract the hoped-for foreign investment in the early phase of management-directed initiatives which were reversed in favor of monitoring by a state agency.

Polish privatization, like the Hungarian process, began with a miscalculation. The reformers thought that the sale via liquidation of small factory assets in which workers played an active role could be extended to cover big industry but public offerings of such factory shares found few takers. As in Hungary, the scheme of diversified corporatization with participation by the public appeared later and, as will be argued below, on a limited scale.

Polish Privatization and Worker Participation

The Problems

Polish industry, like its counterpart in the Czech Republic and Hungary, consisted of large, horizontally-integrated enterprises which had grown during the planned economy days with extensive state support. In 1980, there were 8,000 large and medium-sized companies with heavy concentration of employment in the large units. Thus, SOEs employing more than 1,000 workers represented 21 percent of the firms and employed 71 percent of the industrial workforce[27]

But unlike in Hungary and the Czech Republic, the workers' councils had an influential role in the privatization process. The emergence of factory labor as a solid force in Polish industry after

These events, following in quick succession, raised doubts about the parliament's ability to jump-start the privatization process by approving the November package and about the coalition government's readiness to implement it in the coming months.

[27] However, the share of the large SOEs in the number of firms and industrial employment had dropped respectively to 17 percent and 65 percent by 1989.

a decade-long struggle under the banner of Solidarity complicated the process of privatizing large enterprises under successive governments.[28]

Thus, according to the 1990 Law on Privatization, workers could express their views through the councils, or through general assemblies of workers, or through delegates in the case of large SOEs. Liquidation was to be undertaken with consultation and participation of these bodies. Workers councils could appeal against liquidations initiated by the founding ministry; they were allowed to participate in the decisions to choose investors in the new companies and nominate a third of the board of directors. Article 9 of the Privatization Law gave them the right to become employees of the new companies.

As a result, the presence in the parliament of any party which represented the interests of the workers be it Solidarity at the start of the transition in 1990 or the Communist Party after the fall 1993 elections politicized the privatization process in favor of safeguarding worker benefits and employment.

The Program

Deputy Prime Minister Leszek Balcerowicz, who initiated the shock therapy in January 1990[29] with a firm emphasis on macroeconomic stabilization, expected that the restructuring of Polish industry would take place with the direct participation of foreign investors. The program anticipated that half and as many as 85 percent of all SOEs would be sold and become private by 1994 and 1996 respectively.

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28 "The most characteristic feature of the Polish enterprise governance system is the dominant role of the workers. The historical background of this state of affairs goes back to September 1981, when the Polish government agreed to a Solidarity demand for legal guarantees of worker participation in the management of state enterprises. Despite the subsequent imposition of martial law and a temporary reassertion of state power through the military, the repeated attempts at a decentralizing economic reform in the 1980s marked a further shift of power from the state administration to the employees. In the characteristic Eastern European confusion of managerial and ownership rights, the demise of communism and the dismantling of the economic planning apparatus has further reduced the state's control over the enterprises, leaving workers' councils and general workers' assemblies as the dominant stakeholders and supervisors of enterprise activities." (Frydman et al, pp. 159-160).

29 For a definition of shock therapy and its consequences in Russia, see the author's "Aftershock in Russia's Economy," Current History, October 1994, pp. 320-323; and "Beyond Shock Therapy," Journal of Democracy, April 1995, pp. 101-112.

In order to meet this challenge, the Polish parliament enacted the Privatization Law for State-Owned Enterprises in July 1990 and set up the Ministry of Privatization in August 1990.

According to the Privatization Law, the worker's councils and management could convert the SOE into a joint stock or limited liability company or liquidate it with the approval of the Privatization Ministry. In the former case, the shares of the company (which initially belonged to the treasury) had to be disposed off within two years through public offerings, auctions or tenders or a combination of the three methods.[30] As for liquidation, the founding ministry of an enterprise could initiate liquidation in consultation with the workers' council provided "the Minister of Finance does not object to the liquidation within two weeks." (Frydman et al, p. 169).[31] If the company was liquidated, its assets could be sold or used to form a new company or leased for a fixed period.

In practice, privatization through liquidation emerged as the most popular method in the case of small and medium-sized units. Workers' councils and managers initiated the liquidation proceedings, acquired stock in the new (joint stock or limited liability) companies and attracted outside investors. Leasing the assets of the liquidated enterprises with or without the right to eventual purchase was also widespread.[32]

By contrast, five large SOEs were put up for sale by the Privatization Ministry via public offers of shares on November 30, 1990. The companies were bought but the process took time and money costing about 17 percent of the asset values.

The next phase therefore involved rapid privatization of a large number of financially viable

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30 The Department for Property Rights Supervision of the Privatization Ministry was responsible for more than 500 treasury-owned SOEs in 1990.

31 Liquidation could begin if the independent, viable status of the enterprise was blurred for a number of reasons: if it had failed to pay the asset tax on the capital contributed by the state, or more than half its assets had been leased away, or operated for other businesses.

32 The assets of the liquidated state-owned companies--75 percent of the 845 units--were leased by workers who could then become owners on fulfilling their financial commitments. (Survey, p.209).

companies by converting them into joint stock companies and placing their shares into national investment funds (NIFs).

The Mass Privatization Program (MPP), which was approved by the parliament in April 1993 after prolonged debates, provided that 20 national investment funds each managing up to 30 state- owned companies be set up with authority to arrange management contracts or invite investment (in the funds or the companies) from foreign or domestic sources. These wide-ranging powers of the funds were however constrained by the requirement that the shares of each company be held uniformly by four groups: 33 percent by a lead NIF, 27 percent by the remaining NIFs (in equal amounts), 25 percent by the state and 15 percent by the employees. (By contrast, the Russian program offered a choice of <u>three</u> equity ownership plans to each company.)

<u>The Results</u>

The noteworthy results were the sale of state-owned outlets in trade and services and the creation of new businesses in construction, small manufacturing and trade. "The spontaneous growth of the private sector through new start-up companies, green field investments and the purchase of assets from state-owned factories rather than formal privatisation ... pushed the private sector's share of GDP to more than 50 per cent." (<u>The Financial Times</u>, March 28, 1995, p. VI). The number of private businesses rose from 16,600 in March 1990 to 64,700 in September 1993. There was a phenomenal growth in the number of firms employing less than 5 people, from 814,000 in December 1989 to 1,683 million in June 1993. (<u>Survey</u>, p. 205).

By contrast, the sale of companies by public share offerings on the Warsaw stock exchange and to foreign investors initiated in 1990 were miniscule: by July 1994, 20 companies were sold via public subscription and 60 were bought by foreign investors. 1000 medium-sized companies were liquidated and were sold or leased to employees. (Note that the companies to be privatized numbered 8,000.)

<u>The Continuing Problems</u>

Problems persisted in the large units.

The Mass Privatization Program, which was aimed at privatizing them, limped along amidst governmental delays and political infighting. The Solidarity government, which lost the September 1993 elections, had selected 350 companies and 19 management groups for inclusion in the program (The Financial Times, September 22, 1994, p. 2). A year elapsed before 100 additional companies were added to the list. Prime Minister Waldemar Pawlak, who headed the new coalition government, argued that the plan gave "too great a role for foreign managers" and included "too many plants in key sectors." (The Financial Times, October 20, 1994, p. 3).

The real problems, however, were elsewhere. The program was bureaucratized and centralized: it gave a dominant role to government officials (rather than company managers) in selecting companies and supervisory boards of NIFs which in turn signed contracts with groups of managers, foreign and domestic. The situation was rife for collusion and conflict of interest. (Cf. Lucja Swiatkowski Cannon, "Poland's Privatization in a Mess"' The Financial Times, September 9, 1994, p. 13.) Again, citizens were to be offered shares for a fee (equal to a month's average wage) in a limited tranche of 460 companies. (Insiders, however, were guaranteed 15 percent of the stock). Contrast this miniscule offering to 27 million Poles with the massive voucher-based privatizations in the Czech Republic and Russia!

In the meantime, the government's attempts at shoring up finances of state-owned companies showed similar vacillation. The New Law on Financial Restructuring of Enterprises and Banks of 1993 gave commercial banks (instead of government bureaucrats) the authority to initiate reorganization in large, state-owned enterprises in a "conciliatory" fashion by hammering out debt cancellation or rescheduling, or debt-equity swaps. If, as a result, the firm improved its financial wellbeing, it could escape liquidation.

Evidently, bankruptcy laws were not applied vigorously in the Czech Republic, Hungary, and Poland (as well as in Russia) to liquidate large factories. How then might one regard Czech (and Russian) privatization ahead of the Hungarian and Polish programs despite this similarity in the halfhearted implementation of bankruptcy laws in all the countries?

The Hungarian and Polish privatizers lost valuable time, at least two years, in their failed attempts to sell big factories. The large number of companies in both countries which could not be sold (or liquidated in Poland) continued to be state owned with deteriorating finances. Toward the end of 1993, political decision making had passed in both countries into the hands of socialist-dominated coalitions which could not be expected to ignore high unemployment rates (ranging from 10 to 15 percent of the workforce in the two economies) and the emerging income inequalities. Privatized factories, it was feared, would lay off more workers, reduce output (by streamlining production activity), and result in further income disparities. The election results reflected these concerns, rekindled a preference among the socialist partners in the governments for state and domestic (as against foreign) ownership in key industries and in turn affected the speed of factory overhaul. The high hopes of rapid sales to foreign investors of early 1990 when reforming privatizors were in charge in both countries could not be reignited in the changed political and economic circumstances four years later.

By contrast, the Czech process benefitted from the continuing leadership of the ardently reformist Vaclav Klaus and the low unemployment rates and income inequality as the transition unfolded.[33] As a result, the prospects of restructuring the large factories (which were corporatized) were ahead of those in the Hungarian and Polish units (which remained essentially state-owned).

Russian privatization of large factories, as in Hungary and Poland, had to be managed in the

33 The Czech Republic maneuvered the transition displaying strong economic indicators among them low inflation and unemployment rates, and a positive current account balance (resulting in a stable currency). Thus, in 1994 the Czech economy had a real GDP growth rate of 3 percent, an inflation rate of 9.7 percent, an unemployment rate of 3.2 percent (by year end), and a positive current account balance of $657 million (in January-September). By contrast, Hungary had a GDP growth rate of 3 percent but its inflation rate was 18 percent, its unemployment rate was a high 10.4 percent (by year-end), and its current account balance was in the red with a deficit of $3.4 billion (in January-November, almost 9.4 percent of GDP). Poland's real GDP grew at a hefty 5 percent in 1994 but its inflation rate was 32.2 percent, its unemployment rate was at a record 16 percent (by year end), and its current account balance showed a deficit of $944 million. Data are from Deutsche Bank Research, Focus: Eastern Europe, No. 126, February 28, 1995.

Thus, the three economies had rebounded to positive economic growth (from the output declines of the previous years); but Poland and Hungary had high inflation and unemployment rates which contributed to political divisions, and negative current account balances which (coupled with massive foreign debts) damaged foreign investors' confidence.

midst of production decline, rising unemployment and unequal income distribution besides being embroiled in ideological battles. But its sequencing of corporatization first (with voucher participation by the public) and restructuring later gave the process a forward momentum under the determined leadership of the State Property Committee which directed it from the beginning.

A totally different agenda of privatizing large and medium factories was in place in former East Germany. It was unique because proposals submitted by the factories involved their sale and restructuring. The state agency Treuhand balanced efficiency and fairness by screening every scheme suggested by enterprises and by ensuring that potential buyers fulfilled investment and employment targets. The program was unique not only because the agency invited proposals for simultaneous buyout and restructuring of factories but also because it was supported by substantial resource transfer from west German taxpayers; these funds financed a massive infrastructure upgrading, generous unemployment benefits and worker retraining.

Treuhand Privatization in former East Germany: A Unique Agenda

Treuhand, which was set up by former East Germany's last communist government in March 1990, received its mandate of privatizing state-owned enterprises from the democratically elected government in June 1990.

The Problems

A basic feature of state-owned industry in the eastern Lander of Germany was heavy concentration in giant companies. A little over three-fourths of the industrial labor was employed in 25 percent of the firms each employing over 1,000 workers. Another 23 percent worked in 58 per cent medium-sized companies (collectively known as the Mittelstand) each hiring between 100 to 1000 workers. Barely 1 per cent of labor worked in the remaining 17 percent units with less than 100 workers per unit (United Nations, Economic Commission for Europe, Economic Survey of Europe in 1991-1992 (Geneva: June 1992), p. 209).

As the world's largest holding company, Treuhand started with "13,781 industrial enterprises on its books, plus 10,652 small shops and other businesses. It employed about 4m people, 3.5m of them industrial workers." (The Financial Times, December 30, 1994, p. 12).

The program

Treuhand's mandate was threefold: it selected viable enterprises, split them into saleable units, and offered them to buyers who would transform them via labor cutback and appropriate investment. (Such repackaging was possible with multi-product or multi-plant firms in which the unprofitable product lines or plants could be closed.) The remaining units were to be folded, or continued in operation for a time with subsidies financed by the German taxpayers. Thus, transfer of factories to private ownership via sale went hand in hand with plans for their restructuring (with temporary financial support). There was no place in the Treuhand program for voucher-based corporatization.

The administrative setup of Treuhand to carry out its program was a workable mixture of bureaucratic centralization of the agency and efficient decision making in the large units.

It was a monolith with a supervisory board at the top which watched the activities of nine high-ranking managers who, in turn, oversaw a staff of 3,000. The central office, located in Berlin, controlled the decisions of regional branches which might otherwise give in to local pressures of saving factories from liquidation in the interest of keeping local jobs.

At the same time, large enterprises employing more than 500 workers had supervisory boards with authority to fire their managers and responsibility to suggest restructuring plans for them. These boards, whose members were drawn from west German industry and banks, pulled the factories in the world of western technology, accounting norms and marketing practices. In the final phase, Treuhand put up a factory for sale in return for the prospective buyer's commitment to bring in cash and to guarantee jobs. It avoided open-ended acquisitions by foot-loose entrepreneurs via competitive bidding in auctions or outright purchases. If the buyer failed to meet his contractual commitment, he was penalized.

Take the precise details of a contract involving the sale of a foundry:

> "The purchaser will by the end of 1993 have invested at least DM20m in [a new foundry], in particular for the procurement and installation of a large new moulding plant, and by the end of 1995 a further DM20m. If, by the end of 1993, there are not binding orders for the investment of DM20m, then the purchaser must pay the Treuhand the difference between the value of such orders and DM20m." (Carlin and Mayer).

In other words, if the investor fulfilled the first round commitment of investing DM20m by say DM15m (by placing orders for the necessary equipment), he must pay Treuhand the shortfall (in investment) of DM5m.

The selective interventionist approach in which the restructuring decisions for large factories were worked out by a state agency rather than left to the free play of market forces[34] embroiled Treuhand in several controversies.

The first charge was that the agency was employing an industrial policy to salvage ailing factories which should be allowed to buckle under free market signals so that labor, after adequate training, could move to new factories. At the same time, the agency was under fire for closing too many factories, creating massive unemployment (approaching 15.4 per cent of the workforce by 1993) and imposing heavy burden of financial support to the unemployed on the (West) German taxpayers. Ultimately, the choice between handing over some factories to private investors and closing others was governed by the social and political costs of massive liquidations in the midst of the appearance of the neo-Nazi movement in former East Germany.[35]

The second charge against Treuhand was that it concentrated on big industry privatization and neglected the Mittelstand which could stimulate economic growth and job creation. A related complaint was that Treuhand kept out west German business from acquiring east German

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34 Take this emphatic statement from Treuhand Director, Birgit Breuel with regard to the suggestion that companies should be sold via competitive bidding: "It makes no sense to give a company to the Western investor who pays the highest price and then just closes it down." (The Wall Street Journal, September 25, 1992, p. A6).

35 If strict economic criteria were to be applied, Treuhand would have had to fold most of east German industry: the monetary union between the two Germanys on the basis of one-to-one exchange of the two currencies had rendered much of east German output uncompetitive because of low labor productivity and high wages. Wages were raised disproportionately to prevent massive labor migration to west Germany.

Mittelstand which was sold to local managers who lagged behind in technical and managerial expertise. (The Economist, June 20, 1992, pp. 65-66). Treuhand bureaucracy was evidently so keen to sell these units to its current managers that it ignored inquiries from west German businessmen and avoided time-consuming negotiations with them. Once again, the problem was balancing the demands of efficient entrepreneurs from the western part to acquire small and medium factories against the claims of experienced managers in the east who had risen to the top in their factories after years of waiting.

Take the case of Michael Zack, a manager of Technische Gummiwaren, a former division of an east German rubber conglomerate, which illustrated this conflict between efficiency and fairness. After a search of several months, Treuhand was not "able to find any bidders for the maker of technical and medical rubber parts. The only thing that interested potential investors was the factory's valuable real estate--just 15 minutes from Alexanderplatz, the heart of Eastern Berlin. At that point, the Treuhand and the company's board wanted to close down the 106-year-old concern, once East Germany's technological leader in medical rubber processing." (The Wall Street Journal, August 17, 1992, p. B4A). But Mr. Zack persisted: "He cut the work force to 50 from 300, consolidated production in one-third of its former space so the remaining land can be sold, and found new customers in the West to keep the business afloat." (ibid). He turned out to be a good example of the kind of "dynamic and capable manager the Treuhand wants to help establish." In the final arrangements, Mr. Zack was allowed to buy the plant and equipment at a fair price through a low-interest loan (designed to support east German entrepreneurs) and lease the factory site with an option to buy it several years later. Treuhand acquired the rest of the land for sale to a potential buyer from west Germany.

In general, Treuhand decisions to hand over small and medium units to current managers and sell the big units to outside investors was informed by a judicious balance of market efficiency and fairness. The approach was administratively centralized but interventionist on a case-by-case basis. (It was also fast-paced.) Ultimately, everyone had to swim or sink in a competitive environment after the initial support of low-interest loans was phased out.

The Results

Of the industrial enterprises, 3,527 were closed. Almost all the rest were sold: 2,679 to management buyouts, 855 to foreign investors and the rest to west German investors. (The Financial Times, December 30, 1994, p. 12). Treuhand's financial record was mixed: it attracted investment commitments of about DM206 ($82) billion, earned DM64.9 ($26) billion from sales and left a debt of at least DM275 ($110) billion for the federal treasury (ibid). By the end of 1993, however, private investment in the amount of DM140 ($56) billion was placed to modernize east german factories and improve their distribution. 1993 per capita investment in the east exceeded that in the west (ibid). West German industrial labor productivity, however, far exceeded that in the east.

Could the Treuhand model be duplicated elsewhere? Unlike in Hungary, Poland and the Czech Republic, the industrial sector under Treuhand mandate was not merely corporatized, but put on a commercial footing (with temporary state support) and, essentially sold to current managers or outside buyers.

Its speedy, down-to-earth approach was supported by resource transfer from (west) German taxpayers on a scale which was not feasible for other privatizing countries. About 20 per cent of the annual west German output was being transferred to the east during the agency's operation (The Financial Times, August 11, 1992, p. 2). This amount, estimated at roughly DM180 ($73) billion in 1993 alone, financed interest payment on the accumulated debt of the agency (estimated at $165 billion by the end of 1993; The Financial Times, November 12, 1992, p. 19), the DM60 ($24) billion cost of upgrading East German telecommunication system, the payments to unemployed workers, and the support programs to the revamped factories. Even the 10 year bonds floated by the agency had a Triple-A rating thanks to the government guarantees.

Treuhand privatization therefore was exceptional in combining the generous financial support of the "rich-uncle" next door, the energetic, no-nonsense approach of its director, the ready acceptance by German industry of market-type solutions via speedy restructuring and swift liquidations, and the tolerance of labor, despite occasional protests, in accepting heavy unemployment. The combination of fairness and efficiency created viable prospects for east German industry of ultimately competing with west German and foreign manufacturers.

In conclusion, Hungarian and Polish programs lacked a coherent strategy and a decisive drive, and were embroiled in political dissensions; by contrast, Czech privatization maintained a continuing, problem-solving momentum; east German privatization involved Treuhand screening, west German financial support and transfer of assets to investors who promised factory restructuring.

Every problem which the privatizing decisionmakers faced in the Czech Republic, Hungary, Poland, and former East Germany was magnified in the case of Russia. The political and economic burdens of the planned era weighed heavily on the Russian reformers in devising and implementing an effective program.

RUSSIAN PRIVATIZATION

All productive assets in the economy were centrally owned and directed in the command economy days. Economic decisions in the factories, farms, the trading and distribution networks were bureaucratized and devoid of incentives: workers and managers responded to the production targets and performance norms of the planners rather than the sales and profits criteria of the market place.

The workplaces were also mini-welfare states with provisions for subsidized housing, health care benefits, and school, hospital and day care services. (The factories carried the costs of these items on their accounts.) Workers were therefore tied to their jobs for most of their working lives. Labor immobility was further encouraged by managers, who having risen to the top of decision making after decades of service, regarded the workers as their family and were reluctant to remove them from the factory payroll (when the bankruptcy laws appeared).

Then there were structural problems. Often, a Russian factory combined manufacturing from start to finish (as in machine building), and controlled a large share of the market. In other instances, a number of plants making similar items were combined under a single management and financial control. In either case, the enterprises were generally marked by outdated technology, shaky finances and redundant labor.

The defense sector dominated Russia's economy. During its heyday, it commanded the best resources of men and materials and turned out products without concern for their cost effectiveness. Its conversion to new products and technologies was complicated by the defense lobby's argument that the capital sunk in machines and skilled manpower should not be sacrificed in the process. In other words, cost benefit criteria were not applied in the past so they should be ignored in the future.

Finally, there were collective and state farms which were huge, heavily indebted, and mostly denuded of young workers. Were they to be rapidly broken up, they would still remain big (because of low population density) and require a complete overhaul of the existing stock of machines. The ideological preference of the farms and of the farm lobby for the continuation of the old order stood equally in the way of speedy restructuring.

Among the challenges faced by the reformers therefore were large, economically unviable factories and farms, excessive defense orientation, and bureaucratic control of the economy.

Take the privatization problems in Russian industry.

The Problems

The Industrial Sector: Russian factories were large and specialized in the production of a single category of items. In general, the products tended to be material intensive and lacked variety. The Shatalin Plan reported that 2000 manufactured items in the former Soviet Union were produced by a single factory (Merton J. Peck and Thomas J. Richardson (Editors), What Is To Be Done?: Proposals for the Soviet Transition to the Market (New Haven: Yale University Press), 1991, p. 63). Large plants which produced an item dominated industry: a single producer supplied 96 percent of all diesel locomotives, 100 per cent of all air conditioners, 100 per cent of all deep water pumps and 66 per cent of all batteries in the former Soviet Union (ibid).

Russia thus inherited a production structure that was heavily concentrated in a single or a few large units.

Russian factories also tended to be highly integrated: materials got in at one end and finished products emerged at the other with little subcontracting of components.

Kamaz, the truck manufacturer in Tatarstan, arguably "the world's most self-contained company," took in steel, glass, rubber and other materials at one end and churned out trucks at the other. "Not content with making its own machines, it even makes its own machine-repairing machines." (The Economist, March 5, 1994, p. 79.)

Take again the massive steelworks in Magnitogorsk city in Chelyabinsk province in the heartland of Russia.

> "Forty-three kilometers around, the Magnitogorsk Works, a dense mass of smokestacks, pipes, cranes, and railroad track that dominates city life in every way, consists of 130 shops, many of which are as large as whole factories. "Steel plant" would be an inadequate description of the complex formed by an ore-crushing and ore-enriching plant, a coke and chemical by-products plant, 10 gigantic blast furnaces, 34 open-hearth ovens, and dozens of rolling and finishing mills. The Magnitogorsk Works produces as much steel each year--16 million tons--as Canada or Czechoslovakia do, and almost as much as Great Britain does. This industrial colossus is just one such enterprise, albeit one of the largest, in an economy comprised of thousands of large factories located in hundreds of similar towns that have arisen in the Soviet period." (Stephen Kotkin, "Perestroika in the Soviet Rustbelt," The Harriman Institute FORUM, February 1991, p. 1).

Most large factories like the Magnitogorsk Steelworks not only undertook production from start to finish but, as noted earlier, also provided housing and social services to their employees. They owned and maintained apartment complexes, hospitals, schools, child care and cultural centers and transport services for their workers. This vast non-production paraphernalia had to be shaken off from enterprise budgets and passed on to local administrations or forced to exist on its own before the factories could be restructured. But note that the existence of this vast social infrastructure dictated that the factory could not be closed:

> "...the [Magnitogorsk] factory remains tied to its location by the substantial housing stock it has built up. Such commodities do not come cheaply in the Soviet Union. Moreover, a government predicated on notions of social justice could not very well throw the more than sixty-thousand people at the plant--not to mention those employed in town--out of work." (ibid, p. 2).

These large Russian factories employed too many workers and used outdated technologies.

> "To produce 16 million tons of steel, the Magnitogorsk Works employed more than sixty thousand workers. By comparison, the USX plant in Gary, Indiana, the most modern large integrated American mill, produced eight million tons with 7,000 workers." (ibid).

The factories hoarded labor in order to ensure production of spare parts and materials on factory site (requiring additional manpower), to "cope with the strains of outmoded and overtaxed equipment," and to undertake "storming" toward the end of a plan period in fulfillment of "draconian" plan targets (ibid). They had to trim the excess labor in order to streamline production activity and raise efficiency.

Again, obsolete equipment characterized big factories. "More than one-half of all fundamental equipment [in Magnitogorsk] has been in use for over thirty years." (ibid). In the planned economy days, planners sought to promote new technologies via command by prescribing targets for technological innovation in products and processes. Factory managers lacked the what's-in-it-for-me motivation of a competitive environment and preferred to stretch the working life of current equipment rather than risk the search for a better machine or a superior process. As a result, the upgrading of industrial technology to international levels during the transition required massive resources and complex restructuring decisions.

Production concentration, bureaucratic management, collective mentality and backward technologies in large enterprises combined to reinforce their traditional dependence on government bailouts from the budget. When prices were set free on January 2, 1992 for a variety of products, and financial support to factories was abolished in the first quarter of 1992, factories failed to adjust their production and employment to the new set of relative prices; instead, they accumulated inventories, unpaid bills and massive debts to one another. Throughout 1992 and 1993, the support to factories and the settlement of their debts via financial provision from the federal budget led to currency emissions for the purpose and high inflation rates. The support slowed in 1994 but the resolution of the problem of transforming large factories and putting them on rigorous financial discipline was not in sight.

The problem defied solution in the defense sector, especially in those plants which struggled to convert to civilian production.

The Defense Sector: The Russian military industrial sector which belonged in large measure to the Machine Building and Metal Working (MBMW) branch was massive and concealed from public scrutiny. As a result, its size was difficult to pinpoint.

Thus, the number of industrial enterprises belonging to Russia's defense sector "ranged from 731 to 4,000 for industrial enterprises and 714 to more than 1,125 for research and development and design facilities." (James H. Noren, "The Russian Military-Industrial Sector and Conversion," Post-Soviet Geography (hereafter Noren), November 1994, p. 498). A "reasonable" estimate of industrial enterprises in the Russian defense industry was 1,500 to 2,000 (ibid). It employed 6 to 7 million workers, almost a quarter of the workforce in industry, which represented an overwhelming share in contrast to employment in the U.S. defense sector.[36]

There were however no doubts about the heavy concentration of defense manufacturing in a few enterprises in the MBMW branch and their location in select cities. Thus, 317 MBMW enterprises, representing only 7 percent of the total in MBMW, turned out 34 percent of the branch production. The ten largest MBMW factories produced 20 percent of the branch output (Noren, p. 500). Most of them were located in Moscow, St. Petersburg and cities in the Urals.

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[36] It is difficult to measure the share of the defense output in the MBMW branch because of pricing problems and of the wellknown practice of subsidizing defense items (which were procured by the government) at the expense of civilian production (which was bought by industry). According to one estimate of the MBMW structural breakdown for Russia in 1990, however, "equipment for investment accounted for 54 percent of final output in domestic prices and 35 percent in world prices, military equipment for 29 percent (domestic) and 60 percent (world), and consumer durables at 17 percent (domestic) and 5 percent (world) prices." (Noren, p. 499).

A striking example of such a huge defense factory which produced titanium ballbearings of various sizes for use in fighter planes, missiles and rockets was the aerospace ballbearing enterprise in Nizhni Novgorod. The situation of this highly specialized factory, the only one of its kind, turned grim when the demand for its ballbearings from the Russian defense industry plummeted; nor could it compete with the low cost aluminum ballbearings for use in motor cycles, bicycles and wheelchairs produced by a number of developing countries. The factory, which was corporatized in 1993, battled problems of product diversification (with foreign collaboration) and labor layoff.

But not all defense plants in the MBMW sector were completely specialized. They produced civilian machinery and consumer durables in amounts ranging from 75 to 100 percent (Noren, p. 500). It was hoped that as government military procurement declined, the switch to civilian production would accelerate.

The response of the defense factories to this challenge evolved in three overlapping phases. The procurement cutback by the government of a variety of defense items[37] forced defense manufacturers to slash production, but soon enough the need to revive exports (implying a restoration of production) gained ground; meanwhile, the promotion of R & D and production potential of the core military sector with foreign participation in the conversion activity (for example, in nuclear fusion and outer space) emerged as a decisive objective.

These choices in market economies also called for government involvement and pressure group politics. In Russia's case, the process was complicated not merely by the sheer size of the defense sector which embodied the best technologies and skills but by the traditional preference of policymakers for ad hoc and institutional rather than market-oriented solutions.

The size factor dominated conversion activity in various ways. It would be cost effective to

[37] Thus, as early as "December 1988, Gorbachev announced a reduction in the armed forces that gathered momentum over the following three years. The defense industry accepted its assigned tasks reluctantly, and the government struggled to come to grips with what "conversion" entailed." (Noren, p. 501).

demolish these plants rather than convert them for making civilian items which could be made with less cost in new factories. However, this would imply abandoning a few townships in Siberia. Skilled engineers and technicians in military plants which serviced nuclear warheads and made rockets, missiles, cannons, tanks, and ships in the company towns of Arzamas, Chelyabinsk, and Krasnoyarsk had nowhere to go if they were laid off. (Izvestiya, September 16, 1993, p. 4). The decision to salvage defense capacities was also influenced by the fact that the best material and human resources were poured in creating them. The defense lobby would not accept the notion that these could turn obsolete overnight.

As a result, the conversion was haphazard.

To begin with, the big bang decision to cut back government procurement of armaments by 67-68 percent in early 1992 was imposed without an orderly, long-term procurement schedule and contributed to a sharp output decline. (The production of military goods was reported to have slumped, as a result, by 38 to 50 percent in 1992 alone. Noren, p. 507.).

The policy reaction in 1992 was to provide financial support to defense factories and in 1993 to supplement such support with ad hoc measures. Occasionally, factories received state orders (plus budgetary support) in preference to a potential foreign supplier for manufacturing items which could be turned out with the technology in place. Thus, the Sevmashpredpriyatiye which manufactured multipurpose nuclear-powered submarines in the northern city of Severodvinsk was assigned the state order for offshore gas-and-oil drilling platforms for Rosshelf which planned to drill for gas on the Barents sea shelf. (Izvestiya, July 13, 1993, p. 4). However, before this order actually materialized, the factory started making barges and hulls for tugboats so that its workforce could remain employed.

In other instances, defense enterprises sold low quality, high cost consumer goods in domestic markets with excess demand. The submarine factory in Nizhni Novgorod emerged as a dominant producer and seller of irons, kettles and home-heating systems in a sheltered market. Occasionally, robust sales of consumer goods supported the overhead costs and surplus capacity in a partially converted factory.

The market, however, was generally in chaos: the price decontrol of January 1992 which coincided with the continuing disruption in supply and distribution networks catapulted farms, factories and households into financial disarray. The extreme inflations of 1992 (at 2,600 percent) and of 1993 (at 900 percent) resulting from the currency emission to bail out enterprises contributed to the uncertainties. Inventories accumulated as orders languished because of inability to pay. The extensive decline in the demand for civilian machines and consumer durables adversely affected conversion in defense factories.[38] Export outlets were equally difficult. More so because the efforts of defense factories to switch to outside markets were caught up in organizational confusion: a government decree of May 6, 1994 allowed them to export military items (in excess of state orders), but a government agency was established in August to supervise such sales. (Russia's exports of military hardware were $2.15 billion in 1993, down from $10 billion in 1990 and $7.8 billion in 1991 for the Soviet Union. Noren, pp. 513 and 514).

While managers in the defense enterprises battled problems of converting plant capacities and exploring export markets (in the face of declining demand for consumer durables and civilian machinery at home and for military items from abroad), a paramount concern of policymakers was the promotion of the production and R & D potential in the core military sector consisting of 300 enterprises. Large scale conglomerates, in their view, were necessary for generating R&D, raising finances, competing with market economy corporations, providing state-of-the-art weapons for Russia's defense, restoring its mobilization capability, and serving as "locomotives to propel the dynamic development of the entire Russian economy." (Noren, p. 516). A presidential decree of December 1993 allowed corporatized enterprises (including those in the defense sector) to pool their stocks and form financial-industrial groups (FIGs).

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[38] Demand for civilian machinery declined because of plummeting investment financed from the state budget. The reduced demand for consumer goods was attributed to widening income differences and the preference of the well-off income earners for imported goods. Details are in Noren, p. 508.

Needless to say, the privatizers in the State Property Committee viewed the arguments in support of this institutional revival (resembling the technological-industrial associations of the Soviet days) with suspicion. By contrast, the committee sought to divide formal ownership of industrial and defense monopolies not only for creating competition but also for destroying the hold of the apparatchiks in the ministries and in the regions in which the plants were located.[39] With equal vigor, the oldtimers in the military-industrial-bureaucratic complex resisted these attempts to cut the size of an enterprise and curtail their authority. They succeeded in influencing the contours of privatization by successfully excluding some enterprises in the defense sector from the mandate and by retaining a large chunk of the stock of the largest corporatized units for the state.[40]

The Farm Sector: The farm sector consisted of 12,000 collective farms (each averaging 6,600 hectares) and an equal number of state farms (averaging 9,000 hectares per farm), agricultural enterprises such as seed and pedigree farms, and the Russian Grain Agency, Roskhleboprodukt, which consisted of 3,500 mixed feed plants, grain elevators, and procurement agencies.

The farms were bound by traditional farming practices which failed to provide incentives to the managers and households. They planted the same crops from year to year; however, as output and procurement quotas were relaxed in the late 1980s, they increasingly chose to sell grain in the cooperative market (rather than to the state grain agency), to hoard it, or convert it into livestock feed. The choices, however, were limited by poor infrastructure (among them roads and grain elevators), inadequate marketing, and technological knowhow (of converting grain into a balanced livestock feed, for example). The farms which were large and mechanized were also vulnerable to rising costs of machines, spare parts, and oil. The unfavorable terms of trade with industrial purchases hit them hard in 1992: the prices of producer goods supplied by industry to the farm

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39 Note that in the State Property Committee's view, the gas industry's various sectors ought to be corporatized as separate joint stock companies rather than combined as a giant joint stock company (which was what Gazprom ultimately turned out to be).

40 Note that foreign investors preferred to invest in monopoly industries because of the economic advantages arising from large size. Also, large units were retained elsewhere (for example, in the energy sector in Hungary) by the privatizing agency.

sector were on average 17 to 20 times as high in 1992 as in 1991 whereas the prices received by farms from the state rose by a factor of 10.

As for the farm households, they followed the routine of supplementing their wage earnings with income from the household plots which averaged at 0.2 to 0.5 hectares. The desire to strike out on one's own was missing.

The Program

Russian privatization consisted of a threefold agenda of the program design, the crafting and the adoption of the necessary legislation, and its implementation. The progression from the program's conception to its adoption was by no means smooth and was often threatened with derailment by opposition from the Supreme Soviet, industry and defense lobbies, and regional and local bosses.

The design of the agenda: Anatoly Chubais believed in the ability of the free market system to generate economic efficiency and in the merits of private property to provide the necessary incentives for the purpose; more to the point, he combined this belief with a problem-solving approach and a single-minded commitment to implement it. In his view, it was not only necessary to free Russia's productive assets from state ownership and from extensive bureaucratic control but also to ensure that they did not fall in the hands of apparatchiks and communist-era managers as the process unfolded. The program, as argued earlier, was a political-ideological battle with a populist thrust to diversify asset ownership via vouchers. It contained top-to-bottom guidelines of asset classification and time-bound targets for their release from state ownership; it laid down specific breakdown of stock ownership by the various claimants in the corporatized companies.

The first order of the day in devising the privatization program was to retain specific assets under state ownership and to assign property rights in the remaining assets to the federal, province and city levels so that the privatization procedures could be implemented. If assets were legally handed over to appropriate property funds, asset grabbing, it was hoped, could be effectively forestalled.

Classification of Assets and Assignment of Property Rights: A certain fraction of state property, 30 percent, was to be left in state ownership. (Izvestiya, May 20, 1993, p. 4). Forests, monuments, roads, the central bank, universities, and broadcasting stations could not be privatized.[41] (The 1992 privatization program prohibited privatization of commercial banks, foreign trade companies, publishing houses and health resorts without government approval.)

The State Property Committee classified the remaining state assets as largest, large, medium, and small on the basis of simple rules of thumb. [42]

Next, among the assets to be privatized, the largest belonging to the defense sector, the energy complex and transport could only be privatized in consultation with the relevant ministry and on an individual basis. However, the large enterprises in these sectors, next in size, were required to choose from the three corporatization options laid down by the State Property Committee. The assets in these two categories, 31 percent of the total, belonged to the Federal Property Fund.

Small privatization involving shops, restaurants, trading and service outlets and city transport, another 17 percent, could be handled at the local level. These assets were assigned to the City Property Funds. Note that by this criterion, the Moscow city subway, the famous GUM (state

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41 Tensions developed over time on the issue of the branch of the government, the executive or the legislative, which should control TV stations and whether they should be privatized.

42 Among the largest enterprises were those with fixed assets worth at least 150 million rubles and a workforce of at least 10,000. The State Property Committee could privatize these enterprises on a case-by-case basis in consultation with the branch ministries or departments. These firms were exempt from the threefold privatization options. Most defense enterprises, public utilities, nuclear power plants, transport and telecommunication companies (which met the above criteria) belonged to this group.

Large enterprises were those with a workforce of between 1,000 and 10,000 and fixed assets of between 50 million and 150 million rubles.

Medium-sized factories in the program had a workforce of between 200 and 1,000 and fixed assets ranging from 1 million to 50 million rubles.

The small assets had less than 200 workers and a fixed asset valuation of less than 1 million rubles.

Asset values were defined as of January 1, 1992.

department store), the hotels and restaurants, the gas and water supplies, and sports facilities belonged to the Moscow City Property Fund which also claimed ownership of city land which it planned to lease on a long-term basis (Izvestiya, December 30, 1992, p.2).

A little over 20 percent in the middle could be privatized by regional authorities but required the authorization of the State Property Committee. (ibid). These middle level assets were transferred to the ownership of the Regional Property Funds.

The various property funds thus owned the assets and acquired cash when their share was sold to the public. (Note that share offerings for cash began toward the end of 1994 after the first stage of corporatization was completed.) On the other hand, the branches of the State Property Committee implemented the program according to the Committee's guidelines which were approved by the Supreme Soviet. Altogether, there were over 100 branches of the State Property Committee and property funds in 1992. The essence of the arrangements was that, having assigned property rights at various levels, the State Property Committee would aggressively push the program forward.

While the property rights were defined on paper, the actual claims and the division of the proceeds from the sales became matters of dispute on several occasions. Members of the Federal Property Fund were drawn largely from the branch ministries (Sevodnya, July 23, 1993, p. 3; Sevodnya, August 13, 1993, p.2) and disagreed with the aggressive mandate and practices of the State Property Committee. There were also occasional frictions with the regional property funds. The small items with local claims could be disposed of at local initiative but tensions intensified as the process moved to large enterprises, the oil and gas industries and the defense factories.

The Three Options of Stock Ownership: The immediate focus of the Chubais mandate was to diversify asset ownership in the large and medium factories which were converted into joint stock companies for the purpose.

This was necessary in view of the declared intention of managers and the workers to be majority owners of factories in which they worked: the former were supported in their claims by the

Russian League of Industrialists and Entrepreneurs headed by Arkady Volsky and the latter by the enterprise trade unions. They also supported the formation of closed joint stock companies, a step which would exclude share ownership by outsiders except with the consent of the majority shareholders (Seija Lainela and Pekka Sutela, "Russian Privatization Policies," in Pekka Sutela (Editor), The Russian Economy in Crisis and Transition, (Helsinki: Bank of Finland, 1993), p. 90). The situation was thus ripe for asset grabbing by worker collectives and managers.[43]

Therefore, it was essential for the process to be completely transparent with publicly announced formations of joint stock companies. Moreover, in Chubais's view, individual vouchers rather than collective financial resources such as enterprise incentive funds (which would give undue advantage to worker collectives) should finance asset acquisition by small investors, inside and outside the enterprise.

In the first step, worker collectives and managers of the medium and large enterprises selected one of three options for converting the unit into a joint stock company. The factories were put up for subscription to the shares by the public after the factory insiders had acquired their prescribed share in a closed operation.

The three options offered special terms to the insiders with offsetting features to balance the concessions: for example, workers could acquire a small fraction of company stock free of charge but without the right to vote; in such cases, the shares were in the preferred category allowing the owners a first claim to dividends. Alternatively, they could acquire ordinary shares at a discount or at full price with voting rights. Again, the worker collective (including the managers) could acquire a 51 percent ordinary stake but at a higher than the nominal share price. They could thus control the company but at a higher cost of acquiring the majority share. Finally, workers could get a certain fraction of the stock free of cost but they had to fulfill restructuring plans. (This option was offered for small companies.) These features figured in the three corporatization choices such that insiders

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[43] Note that the Privatization Law of June 1991 enacted by the Supreme Soviet before the dissolution of the Soviet Union recognized the need for diversifying asset ownership but the law had no enforcement mechanism.

were sufficiently induced to corporatize without excluding outsiders. At the same time, the property funds retained claims to a fraction of the shares which they could sell for cash after the corporatization process was completed.

The first scheme allowed workers 25 percent of equity gratis without voting rights plus the option to buy 10 percent more stock at 70 percent of book value. Managers could buy 5 percent stake at its full value. The remaining shares were to be sold at closed-bid public auctions, 35 percent for vouchers, the rest (belonging to the property fund) for cash.

In the second option, the worker collective could acquire 51 percent equity ownership by purchasing company shares at their nominal price plus a surcharge of 70 percent. The decision required 2/3 majority vote by the collective. A further 10 percent shares were to be auctioned in closed-bids in exchange for vouchers leaving 39 percent with the relevant property fund (to be eventually sold for cash).

The final alternative was limited to companies with less than 200 workers and asset value between 1 million and 50 million rubles. Workers were given the incentive to restructure the unit and improve its financial position by being allowed to buy 20 percent of equity at 70 percent of nominal price. They could acquire an additional 20 percent stake at 70 percent nominal price on completing their assignment.

The second option with majority ownership for the worker collectives turned out to be the preferred choice for large and medium corporatized companies. The regional property committees had put up 5,631 factories in this group for corporatization in 1992. 63.7 percent of the worker collectives chose this option assigning them majority ownership. (Izvestiya, January 27, 1993, p. 2).

The program specifying details of asset classification, the assignment of property rights in the various state hierarchies, the three corporatization options, and the role of the State Property Committee and its various branches in the privatization process was adopted by the Supreme Soviet in June 1992. This was indeed a major victory for its architects because, by that time, the legislators had opposed the shock therapy measures launched in January by Acting Prime Minister Yegor Gaidar.

As far as privatization was concerned, the conservative opposition began to crystallize around three issues.

The use of vouchers to diversify asset ownership was, in its view, calculated to weaken the traditional bond between the worker collectives (including managers) and the ministry bureaucrats, and ultimately deprive the branch ministries of industrial control and management. Voucher privatization must therefore be opposed via legislation at the center and sabotage in the regions.

The mandate of the State Property Committee, in the view of the conservative legislators, was too centralized and must be diluted by inviting greater participation from the regional and local administrations.

Tension also arose over the State Property Committee's intention to break up monopolies, Roskhleboprodykt, for example, and corporatize the individual units separately. That idea not only threatened centralized control by managerial groups of the corporatized assets but also the opportunity to make big money if assets in the oil, gas and communications industries were to be put up for sale in small and separate parcels. Some critics opposed the Chubais idea on the ground that it would weaken the R & D and technological viability of critical industries.

The battlelines were therefore drawn around these three features of the program. Indeed, tensions over these issues continued beyond the demise of the Supreme Soviet in October 1993 and the election of the Duma which started operating in January 1994.

Parliamentary Opposition and Voucher Corporatization:The role of the Supreme Soviet: Throughout 1993, the State Property Committee's privatization mandate was threatened by the Supreme Soviet and had to be rescued by presidential decrees. This procedure was repeated in the summer of 1994 when the Duma acted to weaken the committee's agenda further.

As 1993 advanced, the legislators' attitude to voucher privatization (allowing voucher holders to claim factory shares) hardened. Indeed, the presidential decree of May 8, "On State

Guarantees of the Right of Russian Citizens to Participate in Privatization" stipulated that each corporatization auction must allow at least 29 percent of the proposed stock for participation by the public.

In retaliation, the Supreme Soviet adopted three resolutions during July 20-22 striking a blow at the entire voucher-based privatization program.

First, it transferred the functions of the State Property Committee to the Russian government which could, as a result, delegate the committee's powers of managing federal assets to ministries and regional executive bodies. In other words, the Supreme Soviet nullified its December 1991 resolution granting exclusive rights of management and disposal of state assets to the State Property Committee.

Second, the lawmakers declared that the presidential decree, which specified that a minimum number of stocks in a proposed auction must be put up for voucher participation by the public, was unconstitutional; they sent it to the Constitutional Court for review.

Finally, they proposed that the vouchers be placed by citizens in accounts with banks. This explosive device was calculated to throw vouchers and the investment funds (which had acquired vouchers from citizens) out of business: the funds would not be allowed to exchange these vouchers for shares of the newly created joint-stock companies on behalf of the citizens for three years. The public would be divided into two camps of the 12 million who had already exchanged their vouchers for shares and the laggards who had procrastinated. (Sevodnya, July 23, 1993, p. 3).

Indeed, in early August, Vice-President Rutskoi demanded Chubais's resignation and called upon Bryansk machine builders to prevent "outsiders" from staking a claim on "their" shares via vouchers. The Yeltsin decree of August 10 "On Protecting the Right of Russian Federation Citizens to Participate in Privatization" (Izvestiya, August 12, 1993, p. 1) was intended to counter such violations of the existing law which allowed voucherholders a free choice in acquiring enterprise shares. The decree instructed the Council of Ministers to give every Russian citizen equal access to acquire property and to speed up privatization (so that such opportunities were created), and laid down measures to counter violations in the implementation of voucher-based privatization. (ibid).

Parliamentary Opposition and Asset Sales for Cash:The Role of the Duma:The confrontation between the Duma and the State Property Committee surfaced in the late summer of 1994 when the Chubais proposals for the post-corporatization phase came up for the lawmakers' approval. A key provision of the plan was to allow corporatized factories to offer large blocks of shares (in excess of 51 percent of their authorizsed capital) to strategic investors (Sevodnya, April 13, 1994, p. 2). Recall that the labor collectives and managers of 80 percent of the corporatized enterprises had by that time chosen the option to own 51 percent of their stock at nominal prices thus acquiring control over the enterprises's furture direction. The intention of the new provision was to break the status quo mentality of insiders and speed factory restructuring by attracting investment. The program also called for the development of an urban land market by allowing factories to buy rather than lease the factory site (from the local administrations).

The Duma turned down the proposals and sought to revise the privatization agenda by demanding that the future privatization contours of the largest federal assets be decided by the legislators rather than by the State Property Committee in consultation with the government. This raised the possibility that the largest assets in heavy industry, the defense sector and energy, for example, could revert to state ownership at the Duma's decision.

President Yeltsin countered by passing a decree which restored the State Privatization Committee's mandate to push forward the post-corporatization asset sale but conceded the Duma's prerogative to legislate tax provisions with regard to the corporatized factories. Also, the issue of factory land sale was to be deferred till the enactment of the Land Code by the Duma.

Confrontation between the legislators (in the old Supreme Soviet and the new Duma) and the State Property Committee also arose over the issue of the overcentralized and aggressive mandate of the committee vis-a-vis the regional and local administrations.

The Supreme Soviet in Support of Decentralized Decision Making: In a calculated move to halt the process, the defiant legislators in the Supreme Soviet also backed the effort of the regional authorities to sabotage the decisions of the State Property Committee. (Sevodnya, April 13, 1993, p. 2). Battles erupted when the regional property committees (which were in essence controlled by the local administrations) opposed the program of the Chubais central committee by claiming to protect local interests. In Chelyabinsk and Novosibirsk provinces, the local Soviets temporarily banned voucher-based auctions because outsiders--representatives of Moscow and Kazan investment funds-- carrying bagful of vouchers threatened to buy up properties and deny local citizens legitimate access to "their" property. There were more vouchers than property for sale. Anatoly Chubais offered to hold more auctions of enterprises and generate widespread opportunities for placing vouchers in other regions of these provinces.

Ultimately, the authority of the State Property Committee to regulate regional privatization activity came to an end when the Duma passed legislation allowing regional and local authorities to determine the speed and the price at which they could sell assets under their control in the post-corporatization phase and decide payments from the sales revenues into their respective budgets (Kommersant-Daily, January 25, 1995, p. 2).

The continuing confrontation between Anatoly Chubais and Yuri Luzhkov, the Mayor of Moscow reflected basic disagreement on the privatization process between a committed decisionmaker at the center and a popular boss of a city with several prized assets. It was ultimately settled by a presidential decree in favor of the mayor.

Chubais versus Luzhkov: In the committee's program, part of the factory shares, as already noted, were to be exchanged for vouchers; next, company stock was to be offered in the subsequent phase for cash at "reasonable" prices in order to attract investment; more to the point, potential investors were to be given ownership of the factory land (which they could buy from the relevant property fund) and a significant share of the new stock issue.

The mayor opposed the committee's mandate on all points: in his view, the city property was not be exchanged (even partially) for vouchers; nor was it to be sold "dirt cheap" to investors;

factory land could only be leased not sold.

The presidential decree "On the Next Phase of Moscow City Privatization" of February 1995 resolved the issue. (Kommersant-Daily, February 8, 1995, p. 2). According to the decree, parcels of factory land were to be leased and not bought by factories (including outside investors);[44] the city property fund was left free to set its own asset price in order to generate local revenue; part of the revenue raised from the sale of a factory stock was to be used for the financial support of other factories in the city. Needless to say, these provisions dampened the attractiveness to domestic and foreign investors of acquiring Moscow's big-ticket assets.

The final contentious issue related to the breakup of monopolies and their corporatization as separate units.

Anti-monopoly Corporatization versus Economies of Scale: The conservative lawmakers, industry barons and a handful of economists put up a combined opposition against the Chubais view of breaking up the largest units in defense, energy and transport for corporatization. Sergei Glazyev, a one time Gaidar protege and Deputy Minister of Foreign Economic Relations, subsequently leader of the Democratic Party of Russia in the Duma and Chairman of its Committee on Economic Policy, opposed the idea and supported the development of large financial-industrial-technological groups which could, via targetted investment, serve as catalysts for export and industrial growth. (Sevodnya, May 12, 1993, p. 3). This view, however, put him in the camp of branch ministry bosses who not only wanted to preserve the conglomerates but also desired controlling blocks of shares so that they could manage industrial enterprises in the defense, heavy industry and the energy sector. While Glazyev argued for an industrial policy, the ministry oldtimers wanted control of the economy's strategic sectors. By contrast, Anatoly Chubais wanted to break up the monopolies and corporatize the pieces of property by inviting public participation via vouchers.

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[44] By contrast, the St. Petersburg city administration encouraged factories to buy land on which they were located. But the high land prices and the large plots, on average two hectares, prevented factories from taking up the offers of the municipality which was keen to raise instant cash. Details are in Kommersant-Daily, February 18, 1995, p. 2.

This problem surfaced with regard to the corporatization of the Russian oil and gas industries and the defense sector. Note that the enterprises here, the largest in the economy, were exempt from the three corporatization options imposed on the large and medium units. They were also to be corporatized in consultation with the ministries and the government. Chairman Chubais, in fact, was fighting a losing battle. Barring 300 core units in the defense industry, these were corporatized as monopolies or semi-monopolies with diversified stock ownership but the government retained control by acquiring a large ownership stake and the right to appoint the chairmen and the board of directors.

Take the oil industry. The presidential decree of November 1992 allowed the formation of three joint stock companies in which the federal government controlled up to 45 percent of the stock. (Izvestiya, June 23, 1993, p. 1). Their corporatization with voucher participation by the public followed in rapid succession when Lukoil was corporatized as a giant company in April 1993 with 38 percent of the stock for the state (i.e the Federal Property Fund), 25 percent of the preferred stock for the workers, and 5 percent for management. Foreign investors could own up to 15 percent of the company. The rest was offered for voucher subscription by the public. (Izvestiya, April 20, 1993, p. 1).

The corporatization of Roskhleboprodykt, the grain agency, followed the same route: the agency retained its monopoly and government decision making but distributed stock to the food industry and the public (Sevodnya, November 23, 1993, p. 2).

Gazprom, the world's largest gas industry, acquired similar corporatization features with a controlling share for the Federal Property Fund and a 15 percent potential participation by foreign investors.

The mandate of the State Property Committee also wore thin in the largest units in the defense sector which were left out of its decision-making reach.

On the other hand, it had a better record of rescuing medium-sized companies from buckling under the bureaucratic pressure of the parent enterprise: thus the state-owned Metrostroi enterprise which controlled Moscow subway construction impeded the privatization of the small collective of Moscow subway builders (which started as a leasing collective in 1989) under the pretext of preserving the production and technological advantages of a larger umbrella enterprise. Anatoly Chubais had to step in to defend the privatization claims of the collective. (Izvestiya, April 23, 1993, p. 4).

The Results

The State Property Committee reported that 103,796 units from the federal to the regional and municipal levels had been privatized under its mandate by July 1, 1994. Russian citizens had placed 144.5 million vouchers (out of 148 million) in enterprises and investment funds of their choice.

The achievements were momentous in the sphere of "petty" privatization: over 67,000 enterprises in retail and wholesale trade, public catering and restaurants, and consumer services were sold, or leased with prospects for future purchase.

Next, nearly 30,000 large and medium enterprises had started the process of conversion into joint stock companies beginning with approval of plans and ending with actual registration (of 21,000 units).

10 million apartments, 30 percent of all urban apartments set aside for privatization, had been transferred to private ownership by September 1994.

By contrast, the progress of land privatization was lukewarm.

At the start of 1993, Russian collective and state farms, and agricultural enterprises (such as seed and pedigree farms), were offered a choice to convert to joint stock or cooperative units or keep their current status and thereby risk losing state support in the future. By March 1993, 22,200 farms, nearly 87 per cent of the total, were reregistered. Only one-third of them retained their former status while the remaining units switched to other forms with a distinct preference for the joint stock company option. (Izvestiya, January 20, 1993, p. 2; Izvestiya, May 22, 1993, p. 4). As a result, the legal claim of each household to land, livestock, and equipment was put down on paper.

The Nizhni Novgorod pilot project sponsored by the World Bank's International Finance Corporation to restructure Russian farms provided a new wrinkle in the process by encouraging farm households to auction their land ownership certificates.[45] On March 10, 1994, Prime Minister Chernomyrdin declared during a visit to a farm auction in Nizhni Novgorod province that the scheme would be applied in the country. However, the pressure of the agrarian lobby prevented a legislative adoption of the program. Even in Nizhni Novgorod, only seven farms had adopted the model. (Nezavisimaya gazeta, February 8, 1995, p. 3). Farm restructuring in Russia was left to the traditional method of voluntary cooperation among farm members. By July 1, 1994, 277,000 private farms, averaging 43 hectares each, represented 5 to 6 percent of the arable land. At the same time, 20,000 private farms went out of business in Russia during the year. (Sevodnya, December 8, 1994, p. 3.)

All in all, the quantitative results were impressive (except in agriculture), but the policy agenda of the State Property Committee was diluted with regard to the corporatization features of the largest enterprises (which were included in the program). The government retained control by owning a large chunk of these assets which were also preserved as monopolies or semi-monopolies. Again, the Duma wrested from the committee the decision making with regard to the sales--pricing and scheduling--of regional and local properties and passed it on to the relevant administrations. These limitations notwithstanding, the quick corporatization of a large number of factories and the speedy sale of small assets in the trade and service sector to private owners was a momentous achievement. It created opportunities for enterprising managers to embark on restructuring factories in their charge and become Russia's capitalist owners.[1]

These managers led the charge in retooling their companies, shedding the workforce, trimming the social infrastructure, adopting new marketing and financial strategies, and seeking foreign investment. Still exceptions to the general breed of Russian managerial cadres, they nevertheless served as catalysts in the overhaul of key Russian enterprises. It provided hope to millions of citizens at making a small fortune of their own as they awaited the return on their

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45 In the first step, the farm households were encouraged to trade, sell and pool together certificates which gave them land and property claims. These voluntary transactions were calculated to give purchasing power (in terms of the certificates) to households who could then bid for plots of land and farm property in auctions. The farms were divided into lots (to be put up for auctions) on the basis of their existing subdivisions. Property and land deeds were issued to the new owners after the auction.

46 Among this small and growing group of young managers who were bent on turning around the companies in their charge, were: Lev Khasis, a 28-year-old banker with a degree in aviation engineering, who struggled to streamline Aviacor in the city of Samara, one of Rissia's biggest aircraft manufacturers; Vagit Alekperov, the president of Lukoil, who sought foreign institutional investors in the oil company; Victor Korovin, who managed a profitable turnaround of Uralmash, "the factory of Russian factories," located in Yekaterinburg in the Urals; Ilya Klebanov, the general director of Leningrad Optical Mechanical Organization, who modernized LOMO; Alexander Vladislyavlev, the flamboyant manager of ZIL (which produced limos, trucks and buses from the days of Stalin), who used "Soviet-era connections, partial grasp of current management practice and inside

voucher investment in Russian industry.

The Continuing Problems

The next phase of the program involved the daunting task of restructuring the viable enterprises and liquidating the bankrupt units: while a few small and medium-sized companies had increased production efficiency, shed labor and diversified product mix, the big enterprises responded tardily to market forces and accumulated massive payment arrears. The sale of stock (owned by the property funds in the corporatized companies) and new issues of stock for cash which could generate the needed capital for the companies from foreign investors[47] and domestic subscribers also lay ahead. This required the regulation of the chaotic securities market so that shares which were safely registered could be bought and sold thus reflecting market valuation of companies.[48] Inflation control was equally imperative in order to boost investor confidence.

By the start of 1995, industrial restructuring policy hobbled along from a total disregard of the bankruptcy legislation by the managers in the early years to imposition of deliberate measures by the Chernomyrdin government and the State Property Committee from the top. A substantial bureaucracy was created to screen factories with a view to support their reorganization rather than enforce their liquidation. The objective of the carrot and stick approach (discussed below) was to provide sufficient incentives to the managers to turn around factories without explicit subsidization from the budget.

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government horse trading" (The Financial Times, July 25, 1994, p. 8) to rescue the aging behemoth under his command.

47 Toward the end of 1994, foreign direct investment amounted to $2.7 billion in the Czech Republic (by September), to $6.9 billion in Hungary (by November), to $4.4 billion in Poland, and to a mere $2.9 billion in Russia (by October). Data are from Deutsche Bank Research, Focus: Eastern Europe, No. 126, February 28, 1995. "Per capita investment was only $24 in Russia, the same as in Albania but topping Ukraine's $10, while trailing far behind Hungary's $631 and the Czech Republic's $271." (The Wall Street Journal, December 6, 1994, p. A24.).

48 Occasionally, the variation in share prices was enormous because company managers deliberately refused to authenticate shares owned by clients by opening up their registries. Shares could not be bought and sold because ownership was not validated. A scandal broke out in late March, 1995 when managers of Gazprom, valued at $300 billion, the darling of Russia's equity market, demanded $5 a share for which Russian voucherholders had paid one cent to 20 cents, and Russian brokers were willing to pay 30 cents to 50 cents. "The message they got back from the offering was, `You've got to be crazy." (The Wall Street Journal, April 3, 1995, p. A10). In this instance, potential investors were ahead of the foolhardy managers but investors generally preferred to hold back till the security chaos was regulated.

Bankruptcy Legislation and Implementation

The Law on the Bankruptcy of Enterprises (Izvestiya, February 4, 1993, p. 2), which went into effect on March 1, allowed a court of arbitration to consider an appeal from an insolvent enterprise or its creditor or a prosecutor to start proceedings for its liquidation or reorganization. If reorganization failed, the factory could continue operating for two and half years before it could be closed. A special fund was created to support insolvent enterprises in key industries.

The legislation clearly balked at the idea of factory closures; its potential implementation was hampered by the absence of qualified judges, independent auditing and systematic revaluation of assets to account for inflation. More to the point, the prices which could serve as signals in bankruptcy decision making were out of line with their market economy norms. Toward the end of 1993, Russia's oil prices were 30 per cent of world prices but the prices of grain and some machinery were close to international levels. The disruption of supplies of materials and machines from the former republics had again an uneven impact on factories.

In view of the disruptions in deliveries of machines and materials and of unpredictable prices, the profit and loss indicators in industry did not provide firm guidelines for starting bankruptcy proceedings. Take, for example, the case of the thriving Tula ferrous metallurgy joint stock conglomerate with 140 plants which produced everything from cast iron, steel and building materials to waterheaters, vacuum cleaners, footwear and sausages. It turned out sumptuous profits and distributed 1000 per cent annual interest to shareholders in mid-1993. (Izvestiya, May 21, 1993, p. 4). Evidently, product diversification helped boost its performance. But how would this ferrous metallurgy plant perform if the price of oil were to be raised to world levels?

If legal guidelines and economic reality mitigated against the implementation of bankruptcies, the triage route of selecting a few factories for "instructive bankruptcies" was also missing. It was rumored in mid-March, 1993 that a four page list of such bankrupt factories existed but it was never published. (Izvestiya, March 20, 1993, p. 2)

The State Property Committee however pushed the process forward by setting up a network of administrative units for screening unprofitable factories. The committee's Federal Bankruptcy Agency started functioning by September 1993 and bankruptcy agencies were in place in 82 regions of Russia by September 1994. The Bankruptcy Resolution of the government of May 20, 1994 laid down the procedures: it granted a moratorium on enterprise debts for 18 months during which the enterprise was required to pay off arrears by selling property and finding new investors. State subsidization was ruled out. Private auditors hired by the Federal Bankruptcy Agency screened enterprise balance sheets. By early August, 100 factories were put on the insolvency list and the number was increasing daily by several dozen. (Izvestiya, August 25, 1994, p. 1).

The Prospects

The principle feature of the Russian restructuring approach allowing incentives to managers to redesign rather than close economically unviable factories resembled the policies of the other privatizing economies. Insolvency did not imply liquidation because the top-down, bureaucratized industrial policy facilitated factory conversion. The bureaucratic pyramid consisted of the Federal Bankruptcy Agency which influenced and monitored the decisions of the local bankruptcy agencies. First Deputy Prime Minister Oleg Soskovets personally oversaw the restructuring of large units in the defense, heavy industrial, and energy-producing sectors of the economy. Despite the presence of private auditors, decisions regarding the fate of most factories were hardly the work of independent experts applying objective economic policies.

Russian industry, top-heavy with huge and unwieldy units, and watched by a government legitimately concerned with the social consequences of enterprise failures or reorganizations, was thus geared for pell-mell change at the start of 1995. Direct support from the budget to facilitate factory restructuring could not be ruled out: a portion of the planned 1995 budgetary outlays earmarked for "national economy" and "other" categories could be diverted for the purpose.

At the same time, the State Property Committee announced plans to offer cash auctions of state holdings in 7,200 enterprises to domestic and foreign investors. The list included the less profitable, medium-sized units in port facilities and heavy machinery and excluded the sought after companies in defense, communications and energy. The auction was calculated to raise $1.8 billion of which 55 percent would contribute to cover the planned budget deficit (of $16 billion) and the rest would be left at the disposal of the companies for investment. The committee was geared to mount an aggressive advertising campaign at home and abroad to attract cash(The Wall Street Journal, April 14, 1995, p. A6).

Could private capital inflow supplement domestic savings and push the restructuring in desirable directions?[49] The Duma was set in the spring of 1995 to enact the necessary legislation which would guarantee asset ownership and settle disputes involving foreign investors. Dmitri Vasiliev, executive head of the Federal Commission on Securities and Capital markets, announced plans in early March for developing secure and transparent capital markets and introducing independent registers of shares of the corporatized factories in order to facilitate share transactions.[50] The government under IMF pressure promised to bring monthly inflation down to a steady 1 percent by the end of 1995.

The overhaul of Russia's farms and factories into viable productive units would stretch into the foreseeable future. Their swift and systematic conversion into corporate entities in 1993 and 1994 marked the end of the first critical phase. Russia's policymakers were set to start the next phase of the economy's transformation in 1995 by promising to enforce internal budgetary discipline and by providing inducements to domestic and foreign investors. Factory sales could

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[49] The mid-April offer by a consortium of Russian banks of a loan (at less than market rates) of $1.8 billion to the Russian government in exchange for the government's handing over the management of its stake in many leading companies to the banks was evidently prompted by the consortium's desire to prevent "the buying up of the most attractive Russian enterprises by foreign investors for next to nothing." (The Wall Street Journal, April 13, 1995, p. A11). Sergei Belyayev, the new head of the State Property Committee and a Chubais appointee, supported the proposal.
As property sales proceeded in Russia, such schemes were bound to appear from time to time. The consortium proposal was also calculated to preempt the flow of short-term portfolio investments from abroad and channel foreign investors into providing long-term investments and the much-needed technologies.

[50] The share registration service, to function as an independent company, was planned to be created by two Russian financial institutions, Oneximbank and Nikoil, and the Bank of New York with well known expertise in the field. Lukoil, which planned to sell 15 percent of its share to foreign investors, became the first company to use its service. Details are in The Financial Times, February 15, 1995, p. 2).

begin in the midst of an improving macroeconomic environment backed by an orderly securities market and foreign investment flows. 1995 promised progress on that front.