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**« PRIVATIZATION IN RUSSIA »**

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***Privatization in Russia***<sup>\*\*</sup>

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## **Abstract**

This paper surveys Russia's experience with privatization during the 1990s. First, we set out the basic facts about Russian privatization since 1991. Then we consider some of the barriers to change in Russia, focusing on the banks, financial markets more generally, and the labour market. Further barriers associated with the maintenance of traditional networks, the use of barter and similar payment mechanisms, and the linkages between enterprises and the state are examined later. This discussion helps to explain why restructuring has been relatively slow in Russia thus far. Changing tack a little, the paper then addresses the particular issue of the public utilities in Russia and how they are being or are likely to be privatized. Bringing all this together, the paper acknowledges that Russia has achieved a truly impressive rate of privatization in the past decade. However, the resulting insider-dominated ownership structures leave the country with a huge legacy of restructuring still to be carried out. In time, a more competitive economic environment supported by a sounder institutional structure, will improve the incentives for this restructuring to occur.

**JEL Classification:** L33, P31

**Keywords:** privatization, insider-ownership, public utilities, institutional structure, restructuring.

## Introduction

In all countries privatization programmes are pursued to fulfil a range of state and/or social objectives. The methods adopted are commonly influenced by the priority ranking of these objectives, and this can change over time for either political or economic reasons. In any case, the outcome of a privatization programme is a set of privatized firms whose subsequent economic behaviour and performance will depend not only upon their new private sector status, but upon many other features of the economic environment that have little or nothing to do with privatization per se. This, of course, is why privatization in the transition economies, where much of the institutional environment for a market-type economy is still under construction (see Hare, 2001), sometimes turns out to be disappointing in its impact on the economy, as compared to privatization in a long established market-type economy such as the UK. Russia is a case in point.

Overall economic performance, even in an economy like Russia's that was predominantly state-owned for decades under the communist system, depends both on how the former state-owned firms function post-privatization and on the activities of wholly new firms. At the start of transition, the importance of the latter factor was seriously underestimated, with the result that external advice as well as official policies paid rather more attention to organizing privatization and implementing it speedily than now appears justified. Later, attention shifted to new firm formation and the policies and institutions needed to support that aspect of building a private sector. Growth in the economy is then generated as a result of a dynamic process that includes the following elements:

- (a) entry of new firms (hopefully of relatively high productivity);
- (b) growth, restructuring and transformation of existing businesses (both state-owned enterprises (SOEs), former SOEs, and new entrants); and
- (c) the orderly closure of failing businesses (and one hopes that these are overwhelmingly low productivity businesses).

The balance between these elements can vary a good deal between countries and over time. For instance, if too many firms close at a time when few new ones are being established, the result will be rapidly rising unemployment rates and withdrawals from the labour market, with costly implications for public expenditure. There could also be political unrest if such change is perceived to be too rapid. On the other hand, if there is little new entry and there are few closures, the economy is not likely to be growing very successfully. This is closer to the Russian pattern over the 1990s, at least up to the end of the decade.

In what follows, we proceed as follows. First, we set out the basic facts about Russian privatization since 1991. Then we consider some of the barriers to change in Russia, focusing on the banks, financial markets more generally, and the labour market. Further barriers associated with the maintenance of traditional networks, the use of barter and similar payment mechanisms, and the linkages between enterprises and the state are examined later. This discussion helps to explain why restructuring has been relatively slow in Russia thus far. Changing tack a little, the paper then addresses the particular issue of the public utilities in Russia and how they are being or are likely to be privatized. Finally, we conclude by outlining some practical policy proposals through which Russia could yet develop a thriving private sector.

## The Process of Privatization in Russia

“Voucher privatization ... was a large-scale programme largely of a socio-political rather than an economic character. It was a fundamental means to create the socio-political preconditions for

solving economic problems.” (Anatoly Chubais, Head of the State Committee for the Management of State Property, 1994)

According to the conventional wisdom of transition economics, it was necessary first to achieve macroeconomic stabilization, then (or in parallel) to liberalize domestic prices and foreign trade, moving on finally to privatization and enterprise restructuring (e.g. see Portes, 1991 and, for a more critical view of early transition mistakes, Portes, 1994). Throughout the whole process, a great deal of institutional change would also be going on to enable the emerging market economy to function well (see Hare, 2001). In practice, many countries, including Russia, liberalized first and then found that the ensuing burst of inflation, together with losses of tax revenue, required even more stringent stabilization efforts than initially anticipated. Thus the Gaidar reforms initiated in January 1992 substantially - though far from completely - liberalized prices and trade, and the ensuing burst of inflation was not quickly brought under control (see OECD, 1995 and 2000; and EBRD, various years). Hence, when Russia embarked upon its programme of mass privatization, in the period 1992-1994, it did so in an economy that was still experiencing high inflation and substantial government deficits, and in which financial discipline at the enterprise level was practically non-existent (see Leijonhufvud and Craver, 2001).

The task of privatizing the Russian economy was of an enormous scale. As described in Blasi et al. (1997), the Russian economy in the late 1980s was dominated by large and medium-sized industrial enterprises that had more than 200 employees. These firms employed about 95 percent of the industrial workforce and produced 95 per cent of production. Large firms with more than 1000 employees accounted for 75 per cent of employment and production. At the beginning of 1991 the Russian Federation had approximately 24,000 medium-sized and large industrial enterprises and about 170,000 smaller ones – astonishingly few businesses for such a large and diverse economy. Moreover, virtually all these businesses were in the state’s hands.

As OECD (1995) explains, measures taken towards the end of the communist period in Russia had allowed a variety of co-operatives and leasehold enterprises to be established, often using the assets and labour force of existing SOEs to set up these new, quasi-private businesses. These measures gave rise to a wave of spontaneous or *nomenklatura* privatization. This spontaneous privatization took a variety of forms: from *nomenklatura*-bureaucratic privatisation to managerial privatization and employee lease-buyouts (see Radygin, 1995 for an account of spontaneous privatization). The last scheme was especially widespread – the USSR law on leasing enacted in 1989 provided employees (worker collectives) with the opportunity to lease state enterprises with the right of buy-out; the enterprises were then re-established as 100% insider-owned closed corporations. Formally, the lease-buyout privatization was stopped in mid-1991 when the law on privatization was passed; however, it *de facto* continued through 1991 and even 1992. The incidence of the lease-buyout scheme was particularly large in the retail trade and consumer services sectors, in light industry and some others. By February 1992, 9451 state enterprises accounting for 8 percent of total employment were leased by their workers and managers (Blasi et al., 1997).

Partly in order to regain control over this process, the Russian government launched its main privatization programme in mid-1992 (see Sutela, 1998). The programme classified enterprises into three categories: (a) small enterprises, to be sold by competitive bidding or lease buy-out; (b) large enterprises, to be converted to joint stock companies first (corporatization), then privatized through the mass privatization programme; and (c) medium enterprises, which could use either method. Some enterprises, such as most public utilities and firms in the defence sector, were exempted from this round of privatization. However, firms in retailing and consumer services, which had already been transferred to municipal ownership in 1991, were required to take part in the small privatization (i.e. category (a), above), and mass privatization was required for about 5000 large enterprises and over 15,000 medium-sized ones. In what follows, we mostly deal with the privatization, restructuring and performance of medium-sized and large firms.

## Mass Privatization

The process referred to as mass privatization in Russia implied, de facto, a combination of two main techniques – management-employee buyouts and the mass privatization itself. Surprisingly, the main role in the process turned out to involve the former rather than the latter technique. Besides, some elements of the competitive sale of enterprise shares for cash – through cash auctions and investment tenders – were also incorporated in this stage of privatization.

Associated with the mass privatization, the Russian government distributed to the population, for a nominal fee of 25 Roubles per voucher, around 150 million vouchers, each with a face value of 10,000 Roubles. Since vouchers were freely circulating securities, people could use them as a means of payment when purchasing shares of enterprises at voucher auctions, could sell them or invest them in specially created voucher investment funds. The management-employee buyout component stemmed from the substantial privileges given by the state to managers and employees of the enterprises offered for privatization. The programme granted these groups the opportunity to receive a significant fraction of shares either for free or with substantial discounts.

Privatization of each enterprise started with a development of a privatization plan which determined the procedures for the sale of shares as well as the proportions offered to various groups of potential investors, most importantly, employees and managers within the limits allowed in the privatization regulations. The plan was to be approved by the State Committee for the Management of State Property (GKI) – the main Russian privatization agency – or its regional offices. The next step involved corporatization, which transformed state enterprises into open joint-stock companies wholly owned by the state. At this stage the charter capital of each firm was calculated as the book value of its assets other than land (and net of any outstanding debt), and the board of directors was appointed comprising the general manager with two votes, a representative of rank-and-file employees, and one representative each of the federal and local governments. Shares of newly created companies were transferred to the Federal Property Fund (FPF) and its regional branches, which acted as the sellers of enterprises.

Given the generous entitlements offered to managers and employees in the Russian privatization, these insiders were able to choose from among three options, or privatization methods, at a general meeting of their enterprise:

- Option 1: Workers and managers were to receive 25% of equity in the form of preference (non-voting) shares for free, plus the right to purchase a further 10% of ordinary (voting) shares using cash or vouchers (at 30% discount on the January 1992 book value). In addition, senior managers of enterprises could purchase an additional 5% of the stock in the form of ordinary shares.
- Option 2: Workers and managers could buy - for cash or vouchers - 51% of voting shares at 1.7 times the book value of the enterprise on January 1992.
- Option 3: A managing group (that could include existing management and workers, or any other physical or legal person) that took responsibility for the execution of the privatization plan and the prevention of enterprise bankruptcy could buy 30% of the voting shares; a further 20% could be purchased by management and workers (regardless of whether they were part of the managing group) at a 30% discount.

In addition, employee shareholdings could be increased through so-called Employee Privatization Funds (Fond Aktsionirovaniya Rabotnikov Predpriyatiya - FARP). Ordinary shares amounting to 10% of a firm's charter capital (if an enterprise followed the second option of privatization, the limit was 5%) could be assigned to these funds for subsequent sale to employees on preferential

terms. These funds could be created only if the application for privatization was submitted before 1 February 1994.

Option 1 was first proposed as the main approach, but it met with strong resistance from managers who, through regional leaders and through their representatives in the parliament<sup>1</sup>, were able to put sufficient pressure on the government to have Option 2 included in the programme (Åslund, 1995). Option 3 was also included due to pressure from the managerial lobby, but in practice the government banned its use at large enterprises and by imposing a “no bankruptcy” condition finally made it rather unattractive for the managers. In all three options, given the rapid inflation in Russia during the relevant period, the prices that insiders were asked to pay for enterprise shares were scarcely more than nominal. In this sense, the mass privatization really was a give-away operation.

As for the mass privatization component, the programme envisaged that not less than 29 percent of shares of each firm would be sold at a voucher auction, though in reality the figure was closer to 20 percent. How people disposed of their vouchers was interesting: about half were invested by employees (and, as a rule, their relatives) in their own enterprises, either through closed subscription or through voucher auctions. A quarter of the vouchers were sold, and the remaining quarter were invested in voucher investment funds. These were closed-end funds that issued their own shares in exchange for vouchers invested by people; they were not obliged to repurchase the issued shares. The number of voucher funds peaked in 1994, amounting to 662. About 25 million people – over 16 percent of citizens – became shareholders in these funds which acquired over 10 percent of the assets of the firms offered for privatization.

The last component of privatization – the competitive sale of shares at investment tenders or cash auctions – typically involved 10 to 20 percent of the shares of enterprises. In an investment tender, which was a competition between investors to buy a block of shares, bidders had to agree to provide the company with additional assistance in the form of capital investments or technology. Similarly, cash auctions also produced capital for enterprises.

What were the results of this privatization programme? Quantitatively, they were extremely impressive. Firstly, within two years the programme transferred the majority of state-owned firms to private ownership, representing an unprecedented privatization effort in the world. As a result, by September 1994 there were already 100,000 privatized firms in Russia (outside agriculture), accounting for over 80 per cent of the industrial workforce (OECD, 1995). Most small enterprises had been privatized, and of the 24,000 or so medium and large enterprises, most had been corporatized and over 15,000 privatized by the end of 1994. Privatization then lost momentum to some extent, and continued at a much slower rate in subsequent years. Nevertheless, the main goal of separating the business sector from the state to limit the scope for state interference into enterprise activity was formally achieved.

Secondly, the privatization programme resulted in substantial ownership by managers and employees. Over 70 per cent of the firms offered for privatization chose Option 2, just over 21 per cent chose Option 1 for their privatization, giving insiders - managers and workers taken together - an overwhelming degree of control at most enterprises (see also Earle and Estrin, 2001). It is worth noting, however, that the incidence of employee ownership was much smaller in large enterprises, which represented the jewels of the economy. While, for example, 61 per cent of all enterprises that were privatized through corporatization in 1994 chose Option 2, their share in the total charter capital of all privatized firms was only 19 per cent (IET, 2001). In other words, in large, capital-intensive enterprises, insiders were unable to accumulate enough funds to buy 51 per cent of shares under Option 2; as a result, these firms mostly followed Option 1 privatization.

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<sup>1</sup> We use the term, parliament here and later to avoid possible confusion. The institution has had different names at different times - such as Supreme Soviet under the communist system, Duma or State Duma more recently.

Thirdly, outsider control over firms was rare immediately after privatization. Outside ownership was typically spread among numerous investors so that none had enough votes to influence corporate decision-making processes significantly. In particular, the role of voucher investment funds, which were originally considered as a potentially important locus of outsider control and a vehicle of restructuring, was limited. The most visible manifestation of this was the sharp reduction in the number of funds, so by mid-1997, only 350 funds remained out of the 662 existing in 1994. More importantly, the funds only played a minor role in the governance of privatized firms, mostly because their shareholdings in individual companies were limited by privatization regulations. Even when they had enough shares, they often lacked the necessary expertise in managing industrial enterprises. Finally, the funds could not provide financial resources to enterprises as they often held relatively illiquid shares in poorly performing privatized firms which did not pay dividends. The Russian experience simply confirms many of the concerns regarding the role of voucher investment funds in privatization expressed in Ellerman (1998).

Foreign involvement in this stage of Russia's privatization was virtually negligible, and most of the FDI entering Russia - whether for wholly new undertakings, or related to privatization and restructuring - was heavily concentrated in just four areas: Moscow City, Moscow oblast', St Petersburg, and Leningrad oblast' (Broadman and Recanatini, 2001a). More recently, it is clear that FDI inflows remain highly differentiated by region, being concentrated in those areas already relatively developed and in receipt of most western technical assistance (Bradshaw, 2002).

### Other Steps towards a Private Sector Economy

During the same period, 1992-94, several million apartments in Russian cities were privatized - usually to their existing tenants - either for free or at highly subsidized prices. However, as Starodubrovskaya (2001) points out, the opportunity was not taken to make the new owners responsible for the maintenance of common areas and external structures of apartment blocks, nor were the prices paid by residents for their public utility services - water, electricity, heating, gas - raised to anywhere near their costs of supply. After a number of adjustments, the current position is that these prices are set to cover costs by 2008.

Little progress was achieved in the early 1990s in privatizing land. The right to hold land as private property first appeared in the RSFSR (Russian Soviet Federative Socialist Republic) Law on Property adopted in 1990. In 1993, private property in land appeared in the new constitution that was approved through a referendum. However, the detailed regulation of land sales and purchases and, more importantly, the mechanisms for registering and protecting individual property rights in land, have not been in place for almost a decade since then. The result has been a very modest turnover of land. Moreover, the fact that property rights in land were so poorly defined has meant that most transactions took the form of leasing.

One of the consequences of the deficient regulation in this area was that privatization of state enterprises was not accompanied by the privatization of the land on which the enterprises were located (the land was not counted as one of the enterprises' assets). Hence even now, most privatized firms in Russia do not own the land which they use, these being leased from municipalities or oblast' authorities (OECD, 1995, p.69). Though the privatization of these lots was permitted by a Presidential Decree as early as 1992, the process was rather slow. During 1995-1999, only 327 transactions were registered. As for the amount of land purchased, during the period 1994-1999 (the official statistics are only available from 1994-5) this only amounted to 366 square km (with 296.3 square km of this in 1995 alone) (see IET, 2001).

In agriculture, progress was limited by opposition from associations of kolkhoz and sovkhos managers, as well as by the parliament's reluctance to pass a comprehensive land law legalizing the

private ownership of land and establishing a functioning market (Åslund, 1995; see also Leonard and Serova, 2001). With the reorganization of collective farms (kolkhozy) into joint-stock companies at the beginning of the 1990s, most residents of the rural areas (primarily collective farmers or kolkhozniki) gained the right to a share in the arable land of their farms. The outcome of the process was that about 12 million people became owners of land. However, no mechanism for identifying and separating off the land belonging to particular individuals was created, so in effect they merely owned abstract shares of fields and these could not be bought and sold. Moreover, various laws contained contradictory provisions concerning the use of agricultural land. For example, the law on mortgage directly banned the use of this land as collateral, while the law on agricultural co-operation allowed such transactions.

It was only in the year 2000 that land reform really started to be discussed seriously. Then in 2001, the parliament adopted a Land Code regulating the market for non-agricultural land (in industrial areas, cities and settlements, accounting for about 2% of the land resources of the country). A principal condition of the new law was that the land on which immovable property is located is now automatically treated as part of the asset concerned. Hence such property can no longer be privatized without privatizing the associated land, unless some special restriction is imposed. With respect to agricultural land, the breakthrough occurred in 2002 with the adoption of a new law that envisaged clear procedures for separating off the plots of agricultural land already privatized to rural residents, as well as clear rules for buying and selling land.

Aside from creating a private economy through its privatization policies, Russia also experienced a considerable upsurge in new business formation. By late 1993, Goskomstat statistics showed that Russia had over 700,000 new private businesses (accounting for over 11 per cent of total employment). By 1999, however, there was only about one business entity per 55 people in Russia, scarcely one-fifth of what one would expect from the corresponding statistics for Central and Eastern European economies, or for typical, developed market economies. In Russia's case, entry of new businesses was almost certainly discouraged by bureaucratic obstacles and various forms of corruption and criminal behaviour, together with the factors discussed in the next two sections. Åslund (2001) suggests that mafia-type activities have been more predictable, and hence less damaging to new business formation, than the arbitrary interference of government agencies, which is an interesting observation. Further, the lack of adequate bankruptcy laws, and a great deal of official protection for firms deemed "too big to fail" ensured that the turnover in the enterprise sector remained low: there were too few "exits", and there was too little "entry". The result was continuing soft budget constraints, even for privatized firms (Kornai, 2001).

## Loans-for-Shares

1995 was a turning point in the Russian privatization programme. With the accomplishment of the mass privatization programme, the government announced a shift of priorities. The emphasis was placed on maximizing privatization revenues. The first manifestation of this change of direction was the loans-for-shares privatization, which was at best controversial, if not actually rigged. An excellent account of the loans-for-shares scheme is provided in Lieberman and Veimetra (1996), and a brief description follows below.

The idea of the scheme was advanced by a consortium of the largest Russian banks in March 1995. The scheme envisaged that the banks would lend funds to the government, taking blocks of shares in large and strategic enterprises as collateral. Blocks of shares would be auctioned separately to the banks, and the bank that offered the largest loan would be the winner. It was required to hold the shares until 1 September 1996 and within two years after that date could sell the shares and take one-third of the capital gains. While holding the shares, the banks had the right to vote at

shareholder meetings, except over certain issues such as reorganization, liquidation and the issue of new equity.

Two reasons are typically put forward to explain the use of the loans-for-shares scheme. On the one hand, the Russian government was desperate in 1995 to increase its revenues from privatization. But it was facing severe difficulties in achieving its budget targets for privatization revenues, given the increasing uncertainty due to approaching parliamentary elections, as well as a direct ban on privatizing enterprises in the oil industry, which had been imposed by the parliament. On the other hand, the banks wanted to gain control over some of the largest Russian companies as cheaply as possible.

The implementation of the loans-for-shares privatization was questionable, to say the least. The auctions were administered by the banks, which also could participate in them as both bidders and depositors for bids. The participation of foreigners was restricted and competing bids were often disqualified on technical grounds. For example, Oneximbank administered the auction for Norilsk Nickel and won it for USD 170.1 million, only USD 0.1 million above the starting price, by disqualifying a bid for USD 350 million on a technicality. The transactions frequently represented either buyouts of enterprises by their own managers supported by banks or – in most cases – direct, non-competitive sales of blocks of shares to the interested banks or Financial-Industrial Groups (FIGs) (see IET, 1997).

The initial plan was to apply the loans-for-shares scheme to 29 enterprises, but only 12 enterprises finally took part, of which half belonged to the oil sector. All the transactions were implemented within a two-month period, from 3 November to 28 December 1995. All but two blocks were sold by the banks in 1996-1998, mostly to the banks' affiliates<sup>2</sup>. The government raised over a billion US dollars, but the non-transparency of the auctions immediately caused a public uproar over privatization. In subsequent years, there were a number of attempts to revise the results of the loans-for-shares privatization, mostly on the part of the communist-influenced parliament. This contributed to the insecurity of property rights and delayed the restructuring of some of the companies concerned.

### Case-by-Case Privatization: 1996-2001

Since 1996, the policy of privatizing firms to maximize state revenues was continued, but privatization was increasingly implemented on a case-by-case basis. Typically, most revenues came from one or two major transactions in a given year, but their size varied dramatically from one year to the next. Most privatization transactions were prepared with a known buyer in mind, typically insiders since the presence of controlling shareholders in Russian companies reduced the interest of potential external buyers to purchase minority ownership stakes.

The echoes of the scandalous loans-for-shares scheme, presidential elections in 1996, and President Yeltsin's heart troubles resulted in no major transactions in 1996. Revenues from privatization were less than USD 300 million, which is the lowest figure for the entire period 1995-2001. In terms of privatization revenues, 1997 was the most successful year so far. The revenues exceeded USD 3 billion, of which USD 1.875 billion came from the sale of a 25% +1 share stake in Svyazinvest, the national telecommunications holding company. Little progress was achieved in 1998, except for the sale of 2.5% of Gazprom shares to Ruhrgas for USD 660 million. Revenues from privatization did

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<sup>2</sup> Two remaining shareholdings are 26,7% of voting shares in Novorossiysk Sea Shipping Company and 25,5% in North-Western River Shipping Company with loans of USD 22.5 mn and USD 6.05 mn respectively. In 2001 the government decided to repay the loans in order to regain these shareholdings. The loans are to be repaid from federal budget revenues in 2002.

not exceed USD 1 billion. The financial crisis resulted in the suspension of privatization tenders after 17 August. In 1999 the Federal Government conducted two major privatization transactions – the sale of 10% of the shares in Lukoil and 49.806% of the shares in the Tyumen Oil Company (TNK). Total revenues from privatization were less than USD 400 million. In 2000 the list of potential privatizations included 242 companies belonging to 24 sectors, as well as shares in about 1500 recently corporatized enterprises. However, most revenues again came from two transactions: the sale of 85% of the shares in the ONAKO oil company for USD 1.08 billion, and the sale of 0.5% of Lukoil shares for about USD 50 million. Overall, privatization activity in 2000 yielded revenues of somewhat more than USD 1.1 billion.

According to BOFIT (2002), Russian privatization in 2001 involved divesting stakes in 125 enterprises, mostly sold at auction. Most stakes were less than 25% of the companies involved, but the sales contributed about USD 350 million to the Federal budget in 2001. The largest deal was the sale of almost 80% of the coal company, Kuzbassugol, through two auctions, and the sale of the state insurance company, Rosgosstrakh. These two transactions accounted for revenues of over USD 200 million. For 2002, the privatization of shares in 426 corporations and about 150 unincorporated entities is expected to yield over USD 1 billion, with two large transactions - a 20% stake in the oil and gas producer, Slavneft, and a 6% stake in LUKoil - accounting for over 85% of the expected revenues.

### Performance of the Privatized Economy

There are two levels at which to think of Russia's economic performance, the macroeconomic and the microeconomic. The former (the macroeconomy) concerns overall activity levels, as reflected in aggregate growth trends, employment and unemployment levels, and similar indicators. Looking at such measures of performance, it is clear that until the past three years or so, Russia's economy has done very badly. This is not the place to go into detailed explanations for the economy's aggregate behaviour, but the general trends and some related analysis can be followed in EBRD (various years), and OECD (1995, 2002). Here it is enough simply to note that whatever beneficial effects privatization might have had in Russia, they are not yet particularly evident in the aggregate data. The situation is summed up in Table 14.1, below.

**Table 14.1 Indicators of Russia's Macroeconomic Performance, 1991-2001**

Item\Year	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
GDP growth (% p.a.)	-5.0	-14.5	-8.7	-12.7	-4.1	-3.5	0.9	-4.9	5.4	9.0	5.0
Inflation (% , Dec to Dec)	160.4	2509	839.9	215.1	131.3	21.8	11.0	84.4	36.5	20.2	18.6
Government balance (consolidated budget, % of GDP)	n.a.	n.a.	-4.7	-9.4	-5.7	-8.9	-8.8	-4.5	-1.0	2.8	2.9
Unemployment (% of labour force)	n.a.	5.2	5.9	8.1	9.5	10.4	11.8	13.2	12.6	9.8	8.9

Source: Goskomstat.

At the microeconomic level, what we are interested in is evidence of beneficial restructuring. Has privatization stimulated firms to undertake restructuring, or have privatized firms somehow managed to survive without much restructuring? Have persistently loss-making firms been

compelled by market pressures to retire capacity, and in extreme cases even to close? The evidence is rather mixed, but on balance quite negative. Numerous enterprise surveys, some of which are referred to in the next two sections, show that many firms have not experienced much pressure. They have survived despite being unprofitable and are most probably non-viable in the longer term. Interestingly, whether firms are still state-owned or already privatized seems to make rather little difference to the extent and nature of restructuring undertaken.

Various studies report that the post-privatization ownership structure with its dominant role for insiders, primarily employees, seriously inhibited restructuring efforts. It is no exaggeration to say that the Russian experience with employee ownership confirms many of the concerns expressed in the theoretical literature. Firstly, regarding such an important dimension as employment restructuring, employee-owned firms proved to be more inclined towards labour hoarding than outsider-owned firms. Secondly, employee-owned firms had much more limited opportunities to raise external funds. The core problem here is the risk facing potential investors that their funds would be used to sustain existing levels of labour inputs rather than to undertake modernising investment. No less important is the fact that employee ownership often results in little or no control over the managers, who may therefore pursue their own personal objectives, including personal enrichment (Frydman and Rapaczynski, 1994). Evidence for such adverse consequences of employee ownership in Russia can be found in Blasi (1996), Earle (1998).

Ownership by the second group of insiders, namely managers, in the transition economy of Russia has typically been considered beneficial in terms of its likely impact on enterprise performance and restructuring (Earle, 1998; Klepach et al., 1997). However, a serious caveat associated with managerial ownership in Russia is the possibility of entrenchment of old managers who are simply unable to run firms in a market economy.

Using a sample of firms from Sverdlovsk oblast', Perevalov et al. (2000) concluded that privatization "on average" produced decent improvements in operating profit margins and to a lesser extent, in labour productivity. At the same time they found that corporatization was no worse than privatization per se because the performance of companies wholly owned by the state scarcely differed from that of privatized firms with little or no residual state ownership. Thus, according to Perevalov et al. (2000), the transfer of ownership from the state to private owners is of secondary importance as compared to the initial step of separating enterprises from the state through corporatization, since this already starts to harden the budget constraints facing firms.

To extend the argument, imperfections in the internal mechanisms of governance emphasize the important role that must be played by external mechanisms, primarily bankruptcies and closures of badly performing enterprises and an active takeover market. The evidence on the role of these mechanisms, however, is rather mixed and often negative.

## **Barriers to Change 1: Banks, Financial Markets and the Labour Market**

From the previous section it is evident both that Russia privatized a large part of its economy at astonishing, indeed unprecedented speed; and that the outcome of the process has been disappointing, characterized by weak and often poorly directed restructuring efforts, and the survival of many enterprises that should have disappeared long ago. In this and the next section, we sketch out some of the factors that help to explain such lacklustre performance.

### **Banks and Financial Markets**

In a normally functioning market economy the banks - and the financial sector more generally - provide resources for enterprise-sector investment and, through the resulting financial discipline,

contribute to the imposition of hard budget constraints on all business entities. In Russia, this type of mechanism worked very badly during the 1990s for several reasons. First, before August 1998 the banks themselves could make more money from lending to the government or through their foreign transactions than from lending to business. Second, the demand for bank credit for investment remained low, with most firms either not investing at all or relying on own-resources such as retained profits, reserves, and so on. This was primarily due to the high interest rates that resulted from the state's aggressive borrowing. (In passing, however, it is worth remarking that the lack of business-sector borrowing is a reason why Russia's business sector was not greatly affected by the 1998 financial crisis). Third, even when banks did lend, they were inclined to lend to traditional customers and were sometimes amenable to government "requests" to go on lending to firms that were technically insolvent. Fourth, quite aside from government pressure, the banks' own incentives often encouraged them to hide bad debts by continuing to lend more to ailing enterprises, in the expectation that sooner or later they might well be bailed out by the government.

Since the 1998 financial crisis, the banking sector remains underdeveloped and consists of over 1000 banks, most of which are small and undercapitalized. Moreover, the crisis resulted in a loss of confidence in the banking sector on the part of depositors and a virtual monopoly of the state-controlled Sberbank or Savings bank which now has 72 percent of the retail market (RET, 2002). Overall, therefore, the Russian banking sector functioned extremely poorly for much of the past decade, and contributed to the endemic "soft budget constraint" culture (see, however, OECD (2000) which suggests that budget constraints are slowly getting harder).

Similarly to the banking sector, the Russian stock market has never played an important role in providing enterprises with financial resources. The number of listed equities is about 200 of which only a few dozen are regularly traded. Most equities are illiquid. For example, while the market capitalization of several individual companies amounts to billions of dollars, the average daily turnover in the Russian Trading System (RTS) – the largest over-the-counter market in Russia – has not exceeded USD 100 millions.

As Kogut and Spicer (2002) have emphasized, the Russian style of privatization that gave rise to substantial insider control and extremely dispersed share ownership outside the firm, with weak legal and institutional protection for minority shareholders, has itself seriously discouraged financial market development in Russia. Effective corporate governance of enterprises requires concentrated ownership of shares. Although some concentration has occurred since the privatization "rush" of 1992-94, insiders have often managed to inhibit such processes. "In the absence of institutional mechanisms of state regulation and trust," even those financial markets that came into existence in Russia often became "arenas for political contests and economic manipulation" (Kogut and Spicer, 2002, p.1).

## The Labour Market

The behaviour of the Russian labour market during the 1990s has been one of the big surprises of the country's transition. First, the general decline in output in virtually all sectors from the start of the 1990s, and continuing through the mid-1990s, was not accompanied by a parallel decline in employment, with the result that labour productivity declined sharply in much of the economy. The unemployment rate rose slowly during the 1990s and only reached the levels of 10-15 per cent of the labour force by 1997, in contrast to Central Europe where such levels came about far more rapidly.

Second, the Russian labour market was characterized by a high turnover of labour – higher than in other post-socialist countries – but surprisingly low rates of job destruction at the same time. In

other words, even in firms whose demand had collapsed severely, workers who left of their own accord were frequently replaced, and few workers were made compulsorily redundant.

Third, specific adaptation techniques were developed by Russian firms. For instance, instead of cutting employment, most Russian enterprises cut wages (in practice, by allowing money wages to rise more slowly than the general price level), delayed the payment of wages, or placed workers on various forms of leave, often unpaid or at reduced pay. The latter arrangements were not equivalent to dismissal, since the workers concerned remained on the enterprise payroll and they and their families retained their entitlement to whatever social benefits were supplied through the firm. In many cases, these benefits were substantial (on the start of this process, see Commander et al., 1995).

Fourth, the interregional mobility of labour remains low due to administrative barriers, the lack of reliable information about employment opportunities in other regions, the underdevelopment of the housing market, the low density of the transportation network, and the high costs of moving to other regions (Kapelyushnikov, 2001).

More recently, some of these trends have been investigated in detail in Broadman and Recanatini (2001b). By using data from around 70 enterprise case studies in eight Russian regions, and Goskomstat data on over 125,000 firms for the period 1996-99, the authors found that on average, firms had only downsized their employment by about 12 per cent by 1999. Since 1998 there has been some job creation in sectors benefiting from stronger export incentives, or sectors more able to compete with imports (import substitution). However, downsizing and other aspects of restructuring are still often constrained by the restrictive Labour Code<sup>3</sup>, by local political pressures and by poor incentives. Indeed, rates of job destruction have actually declined markedly in the last few years, suggesting that labour market barriers to restructuring are not diminishing.

## **Barriers to Change 2: Networks, Non-monetary Transactions and the Role of the State**

Continuing the analysis of the previous section, we next turn to outline those factors that can be regarded as holdovers from the socialist system, or revivals of socialist-era practices, and also touch on the role of the state in hindering or promoting enterprise restructuring.

### **Networks and Non-monetary Transactions**

How do firms survive in circumstances where demand collapses, and when what had been a rather stable economic environment suddenly becomes exceptionally turbulent? Several strategies can be envisaged, depending on many features of the economic landscape. Under competitive conditions with very hard budget constraints, firms would essentially have to “sink or swim”. Many would certainly fail, but a surprising number of Russian firms would probably have discovered that they could adapt to the new conditions, and some would even be prospering already.

A less risky approach would be to rely on the business networks established under socialism, both horizontally (across an industrial branch) and vertically (up and down the supply chain). Exploiting these networks, and sometimes building new ones, firms in trouble can then assist each other by agreeing to trade with each other, by accepting products in lieu of monetary payments, by granting each other credits, and so on. This process was facilitated in Russia by the willingness of the state to

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<sup>3</sup> The old Labour Code was replaced in 2002. The new Code appears to be less restrictive for employers, e.g. it envisages a broader range of reasons for dismissals and restricts the power of trade unions.

accept tax payments in the form of commodities, and by the toleration by the major public utilities either of non-payment or of payment in kind. These inter-related transactions were mutually reinforcing, and have contributed to the survival through the 1990s of many Russian enterprises. By the mid- to late 1990s, the share of inter-enterprise transactions in Russia that involved non-monetary payment rose to somewhat over two-thirds, though since the 1998 economic crisis and with the tougher approach to economic policy adopted by President Putin, the phenomenon has been steadily declining since then.

This is just as well, since in our view the combination of networks and non-monetary payment seriously restricted, and still does restrict, the development of competition in the economy. One aspect of this, even more damaging from the standpoint of longer term performance, is that new entry is strongly deterred, since many potential entrants will rapidly discover that there are no customers for their output, these being already committed to the existing trading and production networks.

## The Role of the State

How has the new Russian state operated during the 1990s, and how have its actions hindered or supported enterprise restructuring, both pre- and post-privatization? Right from the start of transition it was acknowledged that the state's all-pervasive role in the economy was a key factor explaining widespread inefficiency, slow responses to market pressures, lagging innovation, and the like. While privatization, as described above, was a major part of the response, this was commonly preceded by corporatization, the conversion of SOEs into joint-stock companies, still with 100% state ownership but with management/enterprise boards somewhat distanced from day-to-day political concerns. But separating the economy from the state in this way often did not turn out to produce much real change in business behaviour, for two reasons: (a) in Russia, as elsewhere, it was quickly discovered that business behaviour depends not only on formal ownership and management structures, but also on other aspects of the business environment, notably those to do with competition; and (b) it turned out that there remained in place many other channels of influence over enterprise behaviour through which government - at all levels - could operate, and these frequently served to undermine the initially stated goals of corporatization and privatization.

As regards competition, various laws and decrees governing competition policy in Russia were passed during the 1990s, but their effectiveness was weakened by their poor and inconsistent administration, the discretion remaining with government bodies (e.g. ministers) to determine whether a particular situation would be governed by the general policy or allowed to stand as an "exception", and the practice of forming networks noted above. Under pressure from sector lobbies, or from regional elites nervous of the political repercussions of high unemployment in their areas, government frequently allowed such exceptions. Further, local governments were also not slow to restrict trade in diverse ways in order to protect "their" enterprises. Such interventions seriously inhibited competition, enabling far too many existing SOEs (even after their privatization) to survive even while failing to undertake substantial restructuring. The counterpart to this is that new entry was also discouraged, a factor that tended to reinforce officials' desire to protect existing businesses.

While these remarks refer largely to Russia's domestic markets, and the problems facing new Russian entrants, much the same points also apply to many of the foreign companies seeking to enter the Russian market. Despite nominally low tariffs in most sectors, companies have faced a diverse plethora of non-tariff barriers that have served to protect many Russian firms, even poorly performing ones. Much of this informal/implicit protection will need to be removed as Russia completes its negotiations to join the World Trade Organization (WTO) (see Hare, 2002), and this might finally improve the all-important competitive environment in Russia.

The other channels of influence through which firms' behaviour could be affected were more indirect and selective. They included:

- Toleration by the government of non-payment of taxes and/or social security contributions;
- Toleration by government of non-payment of other obligations, principally utility bills;
- Selective provision of subsidies either directly via the state budget or indirectly via directed bank credits (or even more indirectly via toleration of the delayed or non-servicing of outstanding credits) Such subsidies could be paid directly to specific enterprises, or could take the form of import duties to protect domestic producers (these act as a subsidy by allowing the domestic prices to be higher than they otherwise would be).
- The complex and fluid relationships between the Federal Government and the 89 Federal "subjects" provided opportunities for intervention in the affairs of many enterprises not only from the centre, but often more importantly, through regional/oblast' authorities. The latter often introduced local trade restrictions to "protect" their enterprises, or offered tax reliefs or other favours, sometimes contrary to the rules already in place at Federal level. Since Putin became President, these inconsistencies between Federal and regional/ local policies are slowly being brought under more rational control.

### **The Public Utilities: Steps towards Privatization and Issues of Regulation**

"We work in the situation of strong monopolies and a weak state." (Andrey Sharonov, Deputy Minister for Economic Development, explaining the threat that the monopolies will block the reform, 2001)

Public utilities reform started in 1992, but is still far from complete. Different degrees of progress can be observed in different sectors. First, many of the natural monopolies have undergone corporatization and partial privatization (e.g., power utilities sector, tele-communications – fixed networks). Others still exist in the form of governmental agencies or state enterprises (e.g. railway transportation is undertaken by the Ministry of Railway Transportation, water supply is provided by local state-owned enterprises). It is important to note that the existing organisational forms were mostly created in the first half of the 1990s, and that since then the government has not taken major steps to corporatize or privatize public utilities.

Regardless of the organisational form and ownership, the government has failed to establish a sound system of monopoly regulation to date. For many sectors, the main problem is that the existing public utilities operate in both potentially competitive and monopolistic sub-sectors (like UES, the national electricity holding company, which owns both the grid (monopolistic sub-sector) and power-generating stations (potentially competitive). Thus, monopolistic businesses are not yet separated from the potentially competitive ones. As a result, it is difficult to estimate the costs of production of public utilities and to regulate their tariffs. It is also impossible to create competition in the potentially competitive sectors, as independent producers have no guaranteed access to the grid in the case of power utilities or to the pipelines in the case of the gas industry. This issue of the appropriate mode of restructuring public utility industries, and the extent of vertical integration that should be retained in post-privatization industry structures, is examined in Pittman (2001). In general, the best outcome depends on three factors: (a) capabilities of regulatory bodies; (b) effectiveness of the judicial system in enforcing regulatory orders; and (c) effectiveness of the country's information systems (which in turn depends on telecommunications and IT systems). For Russia, one would have to rate all three of these dimensions rather poorly, and the design of public utility structures should take this fully into account.

Besides such regulatory problems, the government often forces public utilities to take into account its social objectives, which are often unjustifiable from an economic viewpoint and can even be damaging in terms of their impact on the utilities themselves and the economy as a whole. For example, the government establishes and maintains low prices of electricity for households. The resulting losses are then expected to be covered through higher tariffs for industrial consumers, giving rise to a price structure for electricity exactly the opposite of what is normally found in developed market economies (where prices paid by households are generally far higher than those paid by industrial and commercial customers). The same sort of cross-subsidisation still exists in other sectors.

Other restrictions on public utilities include the requirement to continue supplying several categories of consumers even if they do not pay for the services. This restriction applies primarily to sectors regarded as strategic, such as national defence. Obviously, however, these sectors should be financed by the state in such a way that they are able to cover all their costs, including those associated with the consumption of public utility services. In practice, this has not always been the case in Russia (for an example of this in the higher education sector, see Hare and Lugachev, 1999). It is evident that tariff regulation is meaningless if some consumers are, in effect, permitted not to pay, since these entities will be able to treat the service in question as if it were a free good. In economic terms, this is an extremely inefficient practice.

After assuming power in 2000, the Putin government declared that public utility reform would be one of its priorities. But given the enormous difficulty of the task, few major practical steps have been taken so far. Limited progress has been achieved in the field of tariff regulation. Thus in 2000, the government established a special body to regulate tariffs in railway transportation, and quite recently a unified tariff body was created. But the major issue of how to separate potentially competitive sub-sectors from monopolistic ones remains unresolved. Without this the costs of production can hardly be controlled.

In some sectors, progress is more tangible. In particular, the government announced a number of measures to reform the power utilities and railway transportation sectors. On the other hand, there is much less clarity concerning other sectors, including the gas industry. The rest of this section therefore focuses on the major utilities that remain in federal state ownership, namely UES, the Ministry of Railway Transportation, and Svyazinvest - representing the power utilities, the railways, and the telecommunications sector, respectively. We also refer briefly to the gas industry, specifically the company Gazprom, although the state no longer holds a majority stake.

### Price regulation: 1992-2001

With price liberalization in 1992, the government determined the list of goods and services whose prices would continue to be regulated by the state and introduced maximum limits for their permissible price increases. Several services such as, telephone network services for business entities which were provided by natural monopolies, and which were not considered as socially important, however, were omitted from the list. Aside from introducing in 1992-1993 a variety of price ceilings and maximum limits for price increases, the government also established maximum profitability levels in some cases.

At that time most sectors were still regulated by the relevant sector ministries and regional authorities. Outside the ministries there existed only one system of regulatory bodies, namely the Federal Commission and Regional Commissions for Energy, which were created in 1992 to regulate prices in the electric power and heat-and-power sectors. However, even in this sector the legal basis for such regulation was not formally established until 1995.

Price regulation underwent substantial change in 1995. Firstly, natural monopolies were distinguished as special sectors which, due to their economic nature, required special regulation. Three governmental agencies were created to deal with price regulation in the energy sector, in transport and in telecommunications. In 1998 the responsibility for regulating the latter two sectors was transferred to the Ministry for Antimonopoly Policy.

Secondly, a division of authority and responsibilities was introduced between the federal centre and the regions on price regulation issues. The list of goods and services whose prices were to be regulated by regional authorities was announced – it included electricity and heating, natural gas for residential use, and charges for mail and telephone communications at the regional level. This created the conditions for tariffs to differ between regions. At the same time the reform weakened the coordinating role of the centre and this resulted in substantial tariff differences for the same services in neighbouring regions. The level of tariffs in a particular region depended on the ability of regional monopolies to justify their cost levels and required rate of return to their local government. The lack of any agreed methodology to assess the validity of costs, and the substantial uncertainty regarding external factors affecting costs (such as unpredictable inflation) ensured that an objective revision of the tariffs was virtually impossible.

The next major step in developing methods of price regulation was the 1997 government decision to reform monopolistic industries. The government had several objectives in mind: to separate off potentially competitive activities; to introduce common, non-discriminatory rules for using network infrastructure (electricity grid, pipelines, etc.); and to reduce the extent of inefficient cross-subsidization. However, the reform largely failed due to resistance from the sectoral lobbies, as well as the impact of the 1998 economic crisis.

The most recent attempt to reform the system of price regulation commenced in 2000 with the adoption of an ambitious governmental programme of reforms, known as Gref's programme (German Gref being the leading economic minister). According to this programme, establishing a system of price regulation should take place in parallel with reforming the monopolies. The latter, however, causes disputes both between the government and the monopolies and within the government itself. To date, almost the only visible outcomes of the new programme is the establishment of a unified body for tariff regulation, with responsibility for regulating tariffs in sectors such as oil, gas, energy, and transportation.<sup>4</sup>

## Power utilities

The sector was corporatized and partially privatized under a special scheme set up in accordance with a Presidential Decree issued in 1992. Under the scheme, the government distributed the grid and all non-nuclear electricity-generating stations among the 72 regional companies and Unified Energy System (UES), a national holding company operating in the sector. Typically, all enterprises operating in a particular region were included in large regional companies. The number of regional companies is, however, fewer than the number of subjects of the Federation (89). This is due to the fact that some regional companies operate across several regions; for example, Lenenergo supplies electricity to both the city of St. Petersburg and the Leningrad region, and these are two independent subjects of the Federation. The scheme also envisaged that controlling blocks of the regional companies would be held by the national holding company, UES. As a consequence, each regional company became a monopoly in a particular region in regard to distribution, and inherited most electricity-generating assets (except for nuclear stations, which remained state-owned).

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<sup>4</sup> Note, however, that the issue of Russia's domestic energy pricing is likely to be critical for WTO entry. See Hare (2002).

According to the recently announced governmental programme, reform in the sector will include the separation of electricity generation from electricity transmission and measures to induce competition among independent producers. Rather than keeping majority ownership in the national holding company, UES, the state will only control the company established to own the main power lines (i.e. the grid). Generating capacity, as well as the local distribution networks, will be transferred to private ownership. As with other monopolistic sectors, the reform will also deal with the price imbalances referred to above, by removing cross-subsidization and ensuring that the general level of electricity prices is economic.

## Gazprom

Gazprom is a single company which controls the major share of Russia's gas reserves; it operates both in gas extraction and in transportation, owning all the major pipelines. The main problems currently facing the gas industry are similar to those in other monopolistic sectors, namely the interweaving of competitive and monopolistic sub-sectors and extensive cross-subsidization (the domestic price for gas being several times lower than its export price). Hence, the proposed reform package is similar to those in other industries, involving non-discriminatory access by independent producers to the pipelines and greater competition among producers. But the case of Gazprom is different from other utility industries in one key respect: the state does not have a majority ownership stake, controlling less than 40 percent of the voting shares in the company. Therefore, reforming the gas industry is likely to be a difficult process since any major reorganization of the company will require the consent of minority shareholders.

## Railway transport

Currently the Ministry of Railway Transportation performs two functions: (a) it is the governmental body with responsibility for determining state policy in the rail sector; and (b) it is the business entity that actually operates the railway system in Russia. The conflict of interests is apparent. Therefore, the government plan for restructuring of the industry envisages several steps. The first step entails establishing a 100 percent state-owned joint-stock company to operate the railway transportation business. At this stage it is planned to transfer all the assets to the new joint-stock company. Second, it is planned to separate different types of business activity within the company; thus passenger transportation would be distinguished from freight transportation, and one benefit of this is that it would become possible - perhaps for the first time - to calculate their respective costs in a way that would facilitate major improvements in the tariff structure. The next stage envisages a sub-division of the company, with different businesses being transferred to a number of separate subsidiaries of the company. The company would thus be transformed into a state holding company, which would own the entire railway infrastructure (track, signals, stations and the like) together with shares in the various subsidiary companies. The latter may then be privatized, partially or fully.

The government also plans to abolish gradually the practice of cross-subsidising passenger transportation through higher tariffs on freight transportation. It is planned that by 2005 the budget will contain a separate item to compensate fully for passenger transportation losses. Such subsidies are not feasible now, as the real losses from passenger transportation are unknown due to the lack of transparency in the Ministry's operations and accounts.

## Telecommunications

Reform in the sector started with the establishment of 88 regional operators and the national operator, Rostelecom (which covers long-distance and international backbone traffic). In 1995,

controlling blocks of shares in regional operators were transferred to a specially established holding company, Sviazinvest, which became responsible for channeling investments into the sector. In 1997, as noted above, a 25 percent plus one share stake in Sviazinvest was sold to private investors. Repeated efforts by the government to sell a second 25 percent minus two shares stake met with apathy from potential investors and were finally abandoned. The 1998 economic crisis severely hit the sector as many operators held hard currency loans for their equipment purchases while collecting all of their revenues in roubles.

The effective tariffs, which were among the lowest in the world in dollar terms even before the crisis, were substantially reduced by devaluation. The tariffs charged to residential users for local calls have remained artificially low for political reasons. After the crisis, average local monthly fees, which represent the major source of operators' revenues (there is no per minute charge on local calls), were about two US dollars and tariff increases were postponed in view of the forthcoming elections. As in most sectors subject to anti-monopoly regulation, the telecommunications sector has been characterised by extensive cross-subsidization. Losses from the low tariffs on local calls continue to be offset by revenues from international and long-distance calls as well as from higher tariffs for business entities, which account for most revenues in the sector. This sharply contrasts with the situation in more developed markets where local calls are the major source of revenues in the sector.

Reform in the telecommunications sector appeared on the policy agenda in 2000, based on the idea of increasing growth through attracting more investments. The reform envisages mergers among the existing regional operators to form seven larger companies, with the main aim of raising their market capitalization and liquidity to increase their ability to attract additional funding for new investment (from both domestic sources, and foreign, through the issuance of American Depository Receipts). A further important component of the reform will be the introduction of per minute tariffs on local calls all over the country and the gradual abolition of cross-subsidization.

## **Conclusions: Building a Competitive Private Sector**

Competition is something that economists like and firms generally detest. In elementary accounts of the economists' conception of competition - for instance in the models of perfect competition or the Chamberlinian model of imperfect competition - competition is there in the background, forcing firms to organize their production in a way that keeps costs at a minimum, and giving rise to an efficient, static market equilibrium. More sophisticated accounts regard competition more as a process, giving rise to the entry, exit and incumbent restructuring, referred to in the introduction to this paper. In principle, the process should result in an evolving population of firms producing a changing mix of products with growing productivity. But as we saw above, especially when looking at the barriers to change, there are many reasons why such a benign<sup>5</sup> process might not function properly in a country such as Russia. Entry of new firms has been very sluggish compared to the more dynamic transition economies of Central Europe, and this in turn has made it easier for existing enterprises to apply political pressure to secure their protection through the various mechanisms noted above.

Related to this, some very interesting points are made in the recent survey paper by Megginson and Netter (2001). These authors find that privatization is usually beneficial, and that it is often associated with general improvements in governance at all levels in a society; but they do note that

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<sup>5</sup> It is benign, of course, only for those firms that prosper. For those that fail, it can be quite brutal. However, from a social point of view even failure is not so bad, since people and assets can be, and usually are, redeployed into other, more productive activities.

the position in the transition economies is extremely mixed at present. They suggest some areas for further research:

(a) Can reforms other than privatization serve as a precursor or substitute for privatization? Their discussion suggests that responsible governments will not wish to push forward a risky and difficult policy such as privatization without being sure that other supporting policies are in place. Concerning the Russian case, this raises questions about the possible need to have achieved stabilization, and to have implemented important legal and institutional reforms, prior to privatization. It also raises the question whether extensive pre-privatization restructuring should have taken place. In our view, Russian privatization was pursued in excessive haste, with poor results in terms of the subsequent enterprise behaviour and performance. However, the situation can be “rescued” to a large extent as the government implements and enforces measures to deal with the problems highlighted above.

As regards pre-privatization restructuring, this is a hotly debated issue in the privatization literature, but for Russia we seriously doubt the merits of such a policy. Why should we have expected the state which created Russia’s medium and large enterprises under conditions of central planning to suddenly develop a capability to restructure these entities into units that would be viable and competitive in the market? Instead, we prefer to see the emergence of conditions in which many enterprises will undertake post-privatization restructuring under new management, or at least in a new market environment.

(b) The second research area concerns the labour economics of privatization - does privatization lead to big layoffs, can the social costs of restructuring be handled through retraining, relocation, support for new businesses, etc.? In Russia, wages have fallen sharply and enforced layoffs have been surprisingly few. The social and political costs of restructuring have been perceived as unacceptably high in many instances, with the result that we noted above, namely slow and limited restructuring so far. However, these costs might have been perceived as far lower had positive policies to encourage and support new business been pursued earlier and more vigorously.

(c) The last area is more forward-looking, to do with the role that privatization can play in preparing an economy to meet new challenges, e.g. globalization, the increasing role of information-based industries, IT, and the like. It cannot be claimed that much of Russia’s privatization during the 1990s was motivated by such concerns, but perhaps the subsequent - and long delayed - restructuring of the economy will be.

In the light of these observations, we offer a few conclusions concerning the Russian privatization process.

First, the institutions and procedures to manage Russia’s privatization process were established quite early in the Russian transition. While they have evolved over time, and gradually eliminated or reduced the incidence of various abuses, the basic structures have achieved a virtually unprecedented volume of privatization transactions within an exceptionally short period. Much of the Russian economy is now privatized, across virtually all sectors.

Second, the principal exceptions are defence industry enterprises and much of the public utilities, involving firms mostly exempted from the first privatization “rush” of the mid-1990s. However, even here there have been significant moves towards privatization, and substantial efforts to strengthen economic regulation to constrain the abuse of monopoly power.

Thirdly, nevertheless, the huge volume of privatization activity in Russia has not yet been accompanied either by sufficient restructuring of production, or by dramatically improved economic performance as measured by a whole range of microeconomic indicators - profitability, productivity, export performance, and the like.

Fourth, the rush to implement mass privatization (which was motivated by political reasons) resulted in the emergence of firms substantially owned by their employees and managers – an ownership structure that has proved to be inefficient from the viewpoint of enterprise restructuring and performance. Though the incidence of employee ownership decreased in the years following the mass privatization, it still remains a significant obstacle to the revitalization of Russian firms.

Finally, we find that this weak performance is not only due to deficiencies within the privatization process per se (such as the resulting preponderance of insider/employee ownership), but also relates to a combination of institutional, political and economic policy shortcomings. These have to do with the political inability to tolerate high rates of unemployment, even temporarily, in many areas, the accompanying soft budget constraints that remained pervasive, and the very slow evolution of the necessary legal and regulatory institutional structure needed to support a well functioning market-type economy. Thus, the poor outcomes are also due to the lack of competition throughout the Russian economy.

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