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**Enterprise in transition: institutional framework, economic behavior and the implications for macroeconomic management. Retrospective look on Russia in the 90th.**

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**Enterprise in transition:  
institutional framework, economic behavior and the implications for  
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Retrospective look on Russia in the 90<sup>th</sup>.**

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*The transformation of Eastern and Central Europe presents an unprecedented challenge for policy makers in these countries as well as for the international community involved in financing and monitoring their economic programs. It is also an unusual challenge for the economics profession, mainly because there is hardly any past experience from which lessons could be learned for this transition process.*

**Michael Bruno**

Abstract.

The Russian experience showed that macroeconomic performance in the transition economy is crucially dependent of the right microeconomic fundamentals. The paper offers retrospective view on the initial stages of market transformation in Russia from the point of view of interrelationships between enterprise behavior and macroeconomic performance.

Key words: enterprise; transition; macroeconomic performance.

## 1. Introduction.

The economic system of the Russian Federation has undergone major institutional and structural changes in the 90<sup>th</sup> in the course of its transition from the central planning to the market economy. The major reform measures included:

- price liberalization in January 1992;
- tax reform in December 1991;
- liberalization of foreign trade regime in November-December 1991;
- unification of the exchange rate from July 1, 1992;
- mass privatization in 1992-1994.

The macroeconomic performance in Russia is summarized in Table 1:

**Table 1.**  
**Macroeconomic performance in Russia, 1992-2000**

	1992	1993	1994	1995	1996	1997	1998	1999	2000*
Real GDP growth, %	-14.5	-8.7	-12.7	-4.1	-3.5	0.8	-4.6	3.2	6.5
Change in CPI index, %	1,526	875	311	198	47.8	14.7	86.1	27.6	20.7
General government balance, % of GDP	-18.9	-7.3	-10.4	-6.0	-8.9	-7.6	-8.0	-1.0	2.0
Unemployment rate, %	5.3	6.0	7.8	9.0	9.9	11.2	13.3	11.7	na
Current account balance, % of GDP	na	na	2.1	1.4	1.7	0.1	0.8	13.6	17.2
Foreign direct investment, million USD	na	na	500	1,663	1,665	4,036	1,734	746	2,000
External debt, billion USD**	na	na	120.9	127.0	135.1	134.1	157.7	158.5	na
Exchange rate, ruble per USD, end period***	0.5	1.2	3.6	4.6	5.6	6.0	20.7	26.8	na

*Source: EBRD Transition Report 2000.*

\*EBRD projections

\*\*Includes public debt only

\*\*\* In denominated rubles

The Russian economy has recovered after the financial crisis in August 1998. The recovery was driven by:

- high oil prices at the world market and the high value of Russian exports ;
- growth of domestic production beyond the energy sector in the aftermath of ruble devaluation due to imports substitution.

But the new environment of the world economy at the end of 2000<sup>th</sup> shows the fragility of such type of economic growth. First, the oil and other resource prices at the world market are beyond the control of Russian producers and it makes the Russian economy dependent on the developments at the world oil market. Second, the weak ruble damages the national imports – and not only consumer imports, but also producer imports of equipment and technology – which impedes structural changes in the real sector.

At the same time the past decade showed the complexity of the enterprise reform and restructuring in the post-communist transition. The Russian enterprise sector (especially in manufacturing industries) faced serious problems in adjustment to the market system. One could observe that the economic behavior of enterprises in the period of transition differed in many important respects from that of the companies within the mature market system. In our opinion, the origin of these behavioral differences should be traced to the institutional and structural features of the enterprises in transition and their evolution over time (and especially at the initial stages of transition).

Policy makers should understand the logic of enterprise behavior in the transition economies because:

- enterprise reform and restructuring themselves are among the most important and difficult parts of the transition process to the market economy and hence should be in the focus of economic policies in the transformation period;
- design of any reasonable macroeconomic policy (including macroeconomic stabilization programs) should explicitly specify the microeconomic conditions under which such policy may be implemented.

The paper has the following main objectives:

- to make the brief outline of the nature of enterprise and the character of the industrial organization within the socialist system as the starting point of transformation and to describe the final goals of transition at the enterprise and industrial level;
- to characterize how the institutional framework (sets of formal and informal rules) within which the enterprise in the transition economies functions is evolving through the transition period (both internal and external) and how it in practice affects the incentives for and the behavior of main agents within the enterprise (managers, shareholders, employees, investors);
- to characterize the specific features of its economic behavior of the enterprise in the transition economies (with special emphasis on investment and financing decisions and the behavior in payments due to suppliers, financial institutions and governments);
- to derive the implications for macroeconomic management which follow from the specific features of the economic behavior of the enterprise in transition economies.<sup>1</sup>

The paper proceeds as follows. In Section II we deliver the analysis of key features of the enterprise in the socialist economy. In Section III we deal with the

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<sup>1</sup> The new classical macroeconomics requires specifying clearly the microfoundations of the macroeconomic analysis since individual economic agents in the market economy take all the decisions.

enterprise responses to market reforms. Finally, Section IV concludes on policy alternatives which President Vladimir Putin faced at the start of his tenure after the roaring 90<sup>th</sup>.

## **II. Enterprise in the socialist system: starting point of transition.**

The classical socialist system emerged in the Soviet Union in the 30<sup>th</sup> as a result of Stalin-led industrialization that was accompanied by collectivist reforms in agriculture and cultural revolution.<sup>2</sup> The main institutional features of such system could be characterized as follows:

- dominance of state ownership of the productive assets;
- central planning of the volume and structure of production *in natural units*;
- central resource management;
- central management of the national consumption, saving and investment;
- state monopoly of the foreign trade and foreign exchange transactions;
- subordinate role of money, credit and finance in the economic life;
- government regulation of all kinds of prices throughout the economy (prices of goods, wages and interest rates);
- administrative coordination of all economic activities in order to sustain macroeconomic equilibrium.

The macroeconomic decision making within the Soviet system was highly politicized and influenced by political priorities of the top leadership. The top priorities included high rates of growth of heavy and defense industries in order to sustain high level of military power.

Relatively high level of saving and investment, full employment, relatively stable official prices, extensive type of economic growth characterized the macroeconomic performance. The important feature of the socialist system was the permanent presence of shortages of goods and services throughout the economy.<sup>3</sup>

Under such system there were no direct interaction between the producers and consumers, all economic links were arranged through central planning and central resource management agencies. The role of enterprise within such system could be characterized as follows:

- enterprises *were not the independent units of economic activity and economic decision making* within the socialist economy;
- prevailing economic function of the enterprise was to arrange the current production process;
- all decisions on resource supply (and suppliers), shipment of products (and customers), investment, innovation, changes in the structure of production, prices and wages, financing were taken by the central governance bodies;
- principal agents within the enterprise were top managers-which were appointed by the government bodies and managed on behalf of the state-and the employees;
- managers of the enterprises were engaged in complicated bargaining with the government agencies over plan targets and resource supply.

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<sup>2</sup> For a comprehensive positive analysis of the socialist system see: Kornai J. "The Socialist System: Political Economy of Communism", 1992.

<sup>3</sup> See Kornai J. "The Economics of Shortage", 1980.

The industrial organization was characterized by dominance of large plants and industrial complexes with the rigid links among them. There was clear tendency to develop a wide range of economic activities within such complexes since managers often could not rely on their counterparts for efficient supply of goods and services.

The system evolved over time but preserved its key features. The successive economic reforms in the Soviet Union tried to increase the scope of authority of enterprise managers in economic decision making and their responsibility for economic performance.

The most comprehensive reform package was introduced in 1988. It included:

- Law on State Enterprise which created the formal legal framework for the functioning of state enterprises, state-enterprise relations and the interaction between main actors (management and employees) inside the state enterprises;
- abolition of natural planning and its replacement with indicative targets in monetary terms;
- more power to managers in investment, wage and pricing decisions;<sup>4</sup>
- Law on Cooperatives created legal framework for development of private entrepreneurial activities.

But the practical implementation of those measures led to disastrous results. Managers and employees used new possibilities to raise their incomes not via higher productivity but through increasing prices and redistributing funds from investment to consumption. They pursue short-term goals at the expense of long-term development. The state enterprises got much more power in decision making but the strict financial discipline has not been imposed.

The behavior of economic agents – who got more power but were not subject to strict financial discipline – led to severe macroeconomic imbalances. The situation worsened due to permanently high level of military expenditures even in the period of reform package implementation. The Soviet economy faced growing budget deficit, sharpening of shortages, rising open inflation, and increasing foreign debt.

### **III. Market transformation and enterprise responses.**

Disintegration of the Soviet Union after the failure of the Communist conservatives' attempt to revise the reformist policies of General Secretary Gorbachev and the transfer of real power in the Russian Federation to the newly elected President Boris Yeltsin opened the door to market reforms in the country. The team of economists led by Mr. Yegor Gaidar chose the radical approach to economic liberalization and orthodox approach to subsequent macroeconomic stabilization.<sup>5</sup>

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<sup>4</sup> The political decisions were influenced (though not followed strictly) by the theory of optimal planning which had been developed in the Soviet Union since 1960<sup>th</sup> as an alternative to the orthodox view of the socialist economic system. The fundamental ideas could be summarized as follows:

- the central management of the economy can be executed via optimal prices which are set by the central governance body;
- enterprises take production and investment decisions themselves on the basis of such prices.

The first comprehensive discussion of the ideas of the “market socialism” in the Western literature can be found in: Xayek F(ed.) “The Collectivist Economic Planning”, 1935.

<sup>5</sup> The analysis of the macroeconomic policies and relevant political debate in Russia is beyond the scope of this paper. But it's worthwhile to mention that “shock therapy” as the reformist team had designed it in 1992 failed in part of macroeconomic stabilization even at the stage of implementation.

The process of transition from the centrally planned economy to the market system included substantial changes within the enterprise sector. One could hardly say that the government pursued any comprehensive strategy towards enterprise sector or set any clear final goals for its transformation. But in the course of transition the following substantial changes took place:

- complete elimination of all forms of central planning and central resource management;
- economic decision making has been transferred to the enterprise level (including resource supply, sales to customers, investment and financing, innovation, foreign economic activities);
- the government started the process of privatization of state-owned enterprises in different forms (mass voucher privatization, loans for shares scheme, monetary auctions, investment tenders, etc.);
- the door was opened to establishment of new private firms and the emergence of potential competition within the country;
- the legal framework for entrepreneurial activities gradually emerged;<sup>6</sup>
- the new accounting standards and practices which satisfy the requirements of the market economy are gradually being implemented.<sup>7</sup>

These developments clearly gradually changed the rules and incentives for enterprises and the main actors within the enterprises. At the same time the process of transformation at the enterprise and consequently the industrial levels is by its nature the evolutionary process which requires considerable period of time for its completion. The economic history of the past decade provides evidence on the enterprise responses to market transformation and shows the problems in market adjustment.

### ***2.1 Enterprise sector developments: facts and figures.***

The overall dynamics of the development of the enterprise sector in the Russian Federation is summarized in the following Table 2.

The data shows that in the course of transition the total number of separate units in Russia gradually increased. In 1994-2000 (as of January 1<sup>st</sup> of each year) the total number grew 2.5 times. The positive permanent upward tendency characterized the majority of economic sectors.

The notable exception was agriculture where the increase in the number of economic units reversed to gradual decline. The primary factor behind this was the

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Many observers in Russia even before the choice of the reform strategy had predicted such an outcome. The main argument behind this reasoning concerned with the unique structural and institutional features that Russia inherited from the Soviet Union mostly due to the military oriented economic growth (See, for example, Y. Yaremenko "The Economics of Hypocrisy", *Pravda*, 1.09.1990). Russia actually had shock without the therapy.

<sup>6</sup> The most important achievement was the Civil Code of the Russian Federation that creates the legal framework for economic activities of the private agents and forms the basis for corporate law, contract law, securities market legislation, bankruptcy law, etc. Two parts of the Code has been implemented by now and the third part, which deals with the intellectual property rights and foreign economic activities, is yet to be worked out and approved by the Parliament.

<sup>7</sup> The new Russian Accounting Standards will be based on the International Accounting Standards. By now Ministry of Finance has issued major regulations on new accounting practices. Now the new Chart of Accounts is to be implemented in order to finalize the transition to the accounting standards and practices that are compatible with recognized international standards and practices.

decline in the number of the private farms that could be explained by low pace of institutional reforms in agriculture and the severe political struggle over the issue of private property for land. These political and institutional uncertainties create relatively unfavorable business environment for private farming.

**Table 2.**

**Enterprises and organizations in Russia, 1992-2000**

	1994	1995	1996	1997	1998	1999	2000	1994-2000,times
Total number, thousands	1244.9	1946.3	2249.5	2504.5	2727.1	2901.2	3106.4	2.5
<i>industry</i>	212.3	288.7	310.3	323.8	339.4	352.4	371.6	1.8
<i>construction</i>	164.4	235.4	258.6	273.9	286.9	298.0	309.4	1.9
<i>transport and communications</i>	36.0	47.5	53.1	62.7	71.2	79.5	86.8	2.4
<i>agriculture</i>	120.7	287.2	335.1	338.7	338.4	332.0	324.0	2.7
<i>financial services</i>	21.9	36.6	43.6	47.7	50.9	52.4	53.5	2.4

*Source: Goskomstat*

The increase in the number of independent economic units in the economy is of vital importance for the whole process of market transformation in Russia. This is a pre-condition for achieving of more flexible economic structure and reviving domestic competitive forces within the economic system.<sup>8</sup>

The data in Table 3 shows the changes in the shares of enterprises and organizations of different types of ownership. It follows that in the past decade there was a substantial change in the distribution of property rights in Russia. The state ceased to be the dominant owner of the productive assets, and by the year 2000 the private sector accounts for ¾ of all enterprises in the country.

**Table 3.**

**Distribution of enterprises and organizations by type of ownership, 1996-2000 (in percent)**

	1996	1997	1998	1999	2000
Total, percent	100	100	100	100	100
state*	14.3	9.3	5.4	5.1	4.8
municipal	8.8	7.4	6.5	6.3	6.4
non-profit organizations	4.2	5.2	5.8	6.3	6.9
private	63.4	69.1	73.9	74.0	74.4
other	9.3	9.0	8.6	8.3	7.5

*Source: Goskomstat*

\* Federal and regional levels.

The market transformation of economic structure requires the development of the small business that may make significant contribution to economic growth and employment. The data in Table 4 shows that this sector experienced substantial

<sup>8</sup> It's worthwhile to mention that under the classical socialist system the number of separate economic units was much smaller than in the mature market economies. The central governance bodies tried to achieve the sizes of the units and to reduce their number since they believed this would:

- increase efficiency via economies of scale;
- make it easier for them to plan and manage the economic activities within the system.

increase in the past decade but the rates of growth of the number of small businesses fell in the second half of the 90<sup>th</sup>. Almost all small businesses in Russia belong to non-state types of ownership (more than 95%).

**Table 4.**  
**Small enterprises in the Russian economy, 1993-2000\***

	1993	1994	1995	1996	1997	1998	1999	2000
Total number, thousands	560.0	865.0	896.9	877.3	841.7	861.1	868.0	890.6
<i>industry</i>	60.0	94.7	127.2	128.5	131.9	134.8	136.1	136.2
<i>construction</i>	72.9	92.2	123.5	145.5	138.0	142.1	137.5	135.9
<i>retail trade</i>	275.5	397.5	419.4	374.6	359.3	372.8	386.1	399.7
<i>wholesale trade</i>	15.2	18.2	15.5	16.2	14.6	14.3	13.2	14.7

*Source: Goskomstat*

\* *The following criteria are applied to define the small enterprise:*

- *enterprises and organizations which are engaged in commercial activities;*
- *share of the state, municipalities or non-small businesses in the capital of such enterprise doesn't exceed 25%;*
- *the average number of employees doesn't exceed: industry, construction and transport – 100; agriculture – 60; retail trade – 30, other activities – 50*

On the whole, the data shows substantial structural changes in the Russian enterprise sector that took place in the course of market transformation and corresponding institutional reforms.

## ***2.2 Liberalization, macroeconomic management and enterprise behavior: corporate finance, barter and money surrogates.***

Liberalization of the Russian economy and subsequent first attempt of macroeconomic stabilization took place before privatization, development of new market-oriented civil legislation and other institutional reforms at the enterprise sector. The market rules of the game were given to the economy dominated by state-owned enterprises whose management routines and procedures and organizational structures had taken shape under the socialist system and which still existed within the industrial structure that was inherited from Soviet times.<sup>9</sup>

The phenomena of payment arrears and subsequently of non-monetary settlements and monetary surrogates emerged at that moment. They permanently existed in the Russian economy throughout the past decade and up to now pose the serious challenge for macroeconomic management in Russia.

The history matters... It turned out that price increase after the price liberalization far exceeded “the monetary overhang” of the late Soviet system and caused the severe payment arrears throughout the economy. The managers of the state-owned enterprises tried to support output and employment, keep existing supply

<sup>9</sup> Such choice is usually explained not on the basis of economic reasoning but rather on the grounds of political argumentation – the first post-Communist government wanted to exploit the political opportunity window in 1991-1992. See Гайдар Е. «Государство и эволюция», 1997.

At that time it was totally unclear how the government was going to deal with the issues of huge military-industrial complex in the national economy. In an attempt to implement orthodox stabilization program the government drastically cut military expenditures and left the whole chains of enterprises without financing (defense enterprises and their suppliers).

and sales chains and showed tolerance to the payment arrears.<sup>10</sup> Clearly such situation was unsustainable in the long run.

In response to the problem the economic subjects in the past decade developed the impressive complex net of non-monetary settlements and money surrogates. The net encompassed also the budgets of different levels (primarily regional and local budgets). These arrangements proved to be sustainable in Russia and continued its existence throughout the period of institutional changes<sup>11</sup>. The most important forms of such settlements are:

- barter transactions;
- payments of wages in kind;
- arrears mutual offsets;
- promissory notes.

There is no comprehensive statistics available regarding the role of different forms of non-monetary settlements in the economy. But there are data on different aspects of these phenomena e.g.:

- *Russian Economic Barometer* provides survey data of the share of non-monetary settlements in the sales of the representative sample of Russian industrial firms;
- RAO Gazprom and RAO UES provide such data for their settlements with customers;
- Ministry of Finance and regional administrations provides data for budgets of different levels.

In the spring of 1997, some observers estimated the total amount of outstanding promissory notes (issued by all type of economic subjects) to vary between Rub 200-500 billion (in denominated rubles), which would make up at least about 2/3 of ruble M2<sup>12</sup>. In accordance with *Russian Economic Barometer* the share of barter in industrial sales increased from 18% in 1994 to 45% in spring 1997. The accounts of 32 regions of the Russian Federation showed the average share of non-money instruments in tax collection and budgetary expenditures of consolidated regional and local budgets in 1996 to be 50% and 39%, respectively.<sup>13</sup>

The econometric analysis of the results of survey of over 500 firms in Russia (conducted as part of a large survey of enterprises in 20 transition countries in the early summer of 1999 by the EBRD and the World Bank)<sup>14</sup> revealed positive and statistically significant correlation between financing problems and use of barter and non-monetary settlements by the firms.<sup>15</sup> Among the explanatory variables there were:

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<sup>10</sup> Under normal market conditions this would cause the decline of output and/or price fall. This was not the case in Russia where the problem of payment arrears gave birth to non-monetary settlements and monetary surrogates. But the overdue debts still remain high themselves – in 1999 the overdue payables amounted to 30% of GDP and overdue receivables amounted to 18% of GDP.

<sup>11</sup> The national legislation on promissory notes, articles of the Civil Code on barter (non-monetary exchange) transactions and mutual offsets and government regulations on tax offsets form the legal base for functioning of non-monetary arrangements.

<sup>12</sup> See Annex 1 for M2/GDP ratio in 1993-1999.

<sup>13</sup> “OECD Economic Surveys: Russian Federation 1997”, OECD, Paris, 1997.

<sup>14</sup> See *EBRD Transition Report 1999* for a description of the survey.

<sup>15</sup> See Carlin W., Fries S., Schaffer M., Seabright P. “Barter and non-monetary transactions in transition economies”, EBRD Working Paper 50, 2000

- financing problems in general;
- access to long-term bank credit;
- high interest rates;
- payments overdue to suppliers;
- receivables overdue from customers;
- tax arrears;
- frozen bank accounts;
- tax offsets.

Corporate finance proved to be a serious problem throughout the transition period in the aftermath of liberalization. Commercial banking system in Russia provided only very limited access to financing for the enterprises of the real sector. Bank credit to the non-financial sector as share to GDP fell from 33.6% in 1992 to 9.1% in 1997 and slightly increased by 1999 to 10.4%.<sup>16</sup> The development of the capital markets was extremely slow and they haven't become vehicles of financing for enterprises.

The evaluation of this net of payment arrears and non-monetary settlements is a difficult task. In fact trade credit and barter exists in the mature market economies on a large scale. But its scale in Russia far exceeds even the level of majority of transition economies (see Chart 1).

Such scale of non-monetary transactions in the economy causes certain distortions:

- increase in transaction costs<sup>17</sup>;
- possibility of production of goods which are non-tradable under normal market conditions;
- numerous opportunities for managers to get personal benefits when they sanction the arrangement of non-monetary settlements.

On my opinion, the existence of this complex net of payment arrears and non-monetary arrangements modifies the money demand function of the enterprises (they are able to execute many transactions without using money) and the relationships between money supply and price dynamics. In fact enterprises themselves turned to be providers of liquidity within the economic system<sup>18</sup>.

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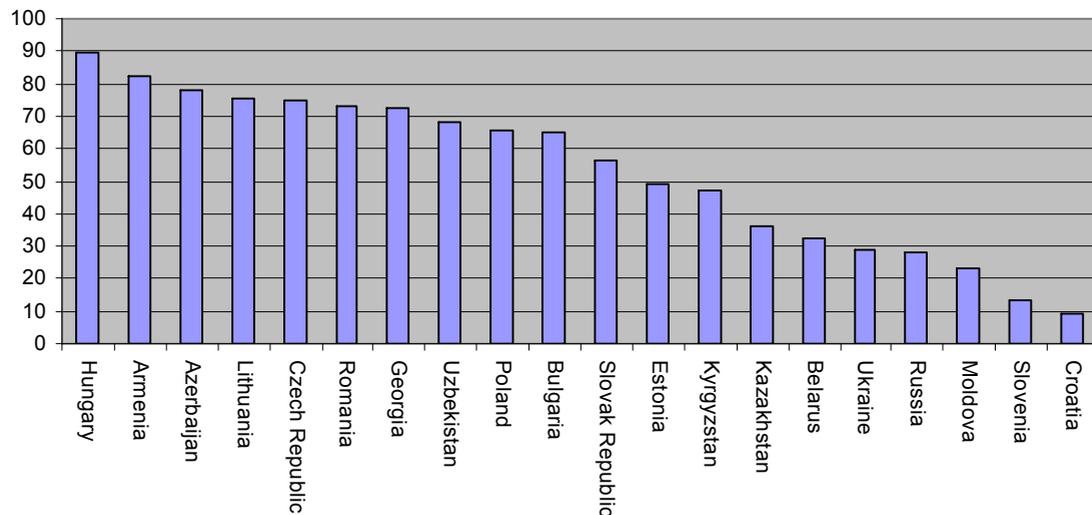
<sup>16</sup> "OECD Economic Surveys: Russian Federation 1997", OECD, Paris, 1997; author's computations on the basis: «Россия в цифрах», 2000, стр. 27, 291.

<sup>17</sup> There is some evidence that more the firm is engaged in barter and non-monetary transactions more likely it undertakes the organizational change. But it has nothing to do with such types of restructuring as upgrading existing products or introducing the new ones. See Carlin W., Fries S., Schaffer M., Seabright P. "Barter and non-monetary transactions in transition economies", EBRD Working Paper 50, 2000

<sup>18</sup> The real picture is even more complicated. Now the managers of the enterprises make the choice how to arrange transactions – using money payments or non-monetary arrangements. The decision depends on the bargaining power of the transaction parties, tax considerations, and personal interests of the managers. The declining output and rising unemployment weakens the bargaining power of employees and enable managers to delay payment of wages.

**Chart 1.**

**Percentage of firms in sample of 1999 survey reporting zero level of barter and non-monetary transactions, by country**



*Source: Carlin W., Fries S., Schaffer M., Seabright P. "Barter and non-monetary transactions in transition economies", EBRD Working Paper 50, 2000.*

### ***2.3 Privatization, corporate governance and issue of incentives for restructuring and development.***

Russia started privatization of state assets in autumn 1992. The initial social and political conditions determined the choice in favor of mass privatization as an initial scheme for transfer of property rights to the private hands. These conditions encompassed:

- national perception of justice and equality;
- strong bargaining position of the managers of state-owned enterprises;
- lack of domestic financial resources for sale of state assets.

Later the privatization programs of Federal, regional and municipal authorities have focused on the sales or transfers of remaining blocks of shares to the private sector through monetary auctions, investment auctions, tender offers, etc.

The important phase of the privatization process in Russia was loans-for-shares scheme<sup>19</sup>. This scheme was the most serious step towards establishment of financial industrial (oligarch) groups in Russia (see Table 5).

But it turned out that the privatization itself is not sufficient for enterprise reform and restructuring and creation incentives for investment and development. In some of his public speeches President Vladimir Putin stated the acute need for efficient owners of the companies<sup>20</sup>. We come now to the understanding of the fact that the formal transfer of property rights is necessary but not sufficient condition for

<sup>19</sup> See "OECD Economic Surveys: Russian Federation 1997", OECD, Paris, 1997, pp. 138-142.

<sup>20</sup> In a private meeting with President Putin the famous Russian writer Nobel laureate Alexander Solzhenitzyn talked about the possibility to revise the outcome of the whole privatization process in Russia in the 90<sup>th</sup>. (*National News Service* on the Internet)

**Table 5.**

**The largest deals in the shares-for-loans auctions, 1995.**

	Date of auctions	Packet in auction (% of shares)	Starting price, USD million	Winning bid, USD million	Formal winner (guaranteeing bank)	Actual winner
Norilsk Nickel	17 Nov	38 (51% of votes)	170	170.1	Uneximbank (MFK)	Uneximbank
YUKOS	8 Dec	45	150	159	Laguna (Menatep, Tokobank, SBS Bank)	Menatep
Sidanko	7 Dec	51	125	130	MFK (Uneximbank)	Uneximbank
Sibneft	28 Dec	51	100	100.1	SBS Bank and OIL Finance Company (Menatep)	Sibneft
Surgutneftegaz	3 Nov	40.12	66.7	88.3	Surgutneftegaz Pension Fund	Surgutneftegaz Uneximbank
Lukoil	7 Dec	5	35	35.01	Lukoil, Imperial Bank (Slavianskii)	Lukoil, Imperial Bank
Novolipetskii Metallurgical Kombinat	7 Dec	14.84	30	31	MFK (Uneximbank)	Uneximbank

*Source: "OECD Economic Surveys: Russian Federation 1997", OECD, Paris, 1997, pp. 138-142.*

efficient development of the enterprises. The attention now is focused on:

- the importance of corporate governance and efficient ownership structures<sup>21</sup>;
- promotion of competition and efficient regulation on the industrial level which imposes discipline on the enterprises;
- reform of tax system.

The enterprise as an economic institution goes through major changes in the process of market transformation<sup>22</sup>. The new actors appear on the stage-shareholders, the enterprise changes its relations with the state, private credit institutions, and outside creditors, customers and suppliers.

<sup>21</sup> The analytical framework on corporate governance institutions and ownership structures is provided in Dyck A. "Ownership Structure, Legal Protections and Corporate Governance", *Harvard Business School*, 2000, mimeo. The author stresses:

- necessity of effective national legal protections that require complementary governance institutions including political structure, the location of judicial authority, norms, and information/reputation intermediaries;
- beneficial effect of identity and concentration of ownership for corporate governance in the absence of effective legal protections.

<sup>22</sup> The new institutional economics has assigned more rigors to the notion of institution-as certain type of organization, on the one hand, and certain rules and norms, on the other-and showed its importance for economic analysis. The recognition of this research paradigm by economics profession was manifested in the last decade by awarding the Nobel Prize to Professor Ronald Coase and Professor Douglass North.

The key result of Russian mass privatization was insider control. Managers and employees have acquired majority stakes in more than 75% of the privatized companies<sup>23</sup>. The speed of Russian privatization was achieved due to the prevalence of the management-employee buy-outs (see Table 6).

**Table 6.**

**Methods of privatization for medium-sized and large state-owned enterprises in some transition countries (% of total by number, as of end 1995).**

	Sale to outside owner	Management-employee buy-out	Equal access voucher privatization	Restitution	Other	Still in state hands
Russia	0	55	11	0	0	34
Poland	2	30	6	0	8	54
Hungary	38	7	0	0	33	22
Czech Republic	32	0	22	9	28	10

*Source: Aghion P., Carlin W. "Restructuring outcomes and the evolution of ownership patterns in Central and Eastern Europe" in "Lessons From the Economic Transition", OECD, 1997.*

Later the data showed the increase in the share of outside ownership but it's not clear whether they show the emergence of real outside owners or just mask increasing ownership stakes by managers (see Table 7).

**Table 7.**

**Ownership structure in medium and large privatized companies in Russia.**

	1994	1996	1998	2000
Direct insider ownership	60-65	55-60	50-55	30-35
Outside ownership	12-25	30-35	35-40	50-55
State	15-20	9-10	5-10	10-12

*Source: Nestor S. "Corporate reform in Russia and the former Soviet Union: the first ten years", East-West Conference, November 5-6, 2000, Vienna, Austria.*

On the whole managers have very high degree of control in major of Russian privatized companies (as well as in formally state-owned enterprises). At the same time employees have relatively weak bargaining positions under the conditions of output decline and rising unemployment. It turns out that managerial incentives are substantially distorted. Much of their interest is focused not on the investment and development but on asset stripping through pocket outside firms or rent seeking. They

<sup>23</sup> Nestor S. "Corporate reform in Russia and the former Soviet Union: the first ten years", East-West Conference, November 5-6, 2000, Vienna, Austria.

pursue short-term personal benefits rather than goals of long-term development of their companies<sup>24</sup>.

Privatization failed to promote the domestic competitive environment in Russia. Concentration in many sectors of the economy is very high and getting higher; recent data indicate 4-firm concentration ratio in Russian industries at 95% when measure at regional level<sup>25</sup>. The presence of powerful financial industrial (oligarch) groups creates additional pressure for concentration through mergers and acquisitions.

The tax system in the Russian Federation is being reformed at the moment. The first part of the Tax Code was implemented from 1999 and the second part will be in force from 2001. The key issue is to rationalize the system, to make it more simple and transparent and to improve tax administration in practice. The government is a stakeholder for the enterprise sector and the tax relations should be rationalized.

At present the incentives for substantial investments (with emphasis on long-term development) remain weak for the Russian enterprises<sup>26</sup>. They undertake more reactive restructuring activities than deep restructuring activities<sup>27</sup>. And the corporate governance system plays extremely important role for the transaction of investing in the enterprise.

### **III. Policy alternatives: revision of the privatization results or development of efficient corporate governance system.**

President Vladimir Putin from the beginning stressed his commitment to respect and protect property rights. At the same time the situation with the corporate governance at the start of his tenure was declared unsatisfactory. Russian authorities faced real dilemma either to revise the privatization results (and often on a purely legal ground) or to accept the existing ownership structure as the starting point for further actions and put special emphasis on the policy measures that promote efficient corporate governance system:

- to develop national legal protection system so that the law is properly enforced by the state but not by the criminal groups;
- to protect the rights of all shareholders;
- to fight the phenomenon of state capture by private vested interests.

The impressive net of barter and non-monetary settlements was also the important factor of the business environment in Russia. There was no easy and straightforward solution to the problem but the Government and the Central Bank should:

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<sup>24</sup> The world of fantastic opportunities for managers emerged in the period of perestroika, it substantially widened in the period of the market transformation. The state withdrew its control from the enterprise sector and no efficient owner emerged.

<sup>25</sup> Nestor S. "Corporate reform in Russia and the former Soviet Union: the first ten years", East-West Conference, November 5-6, 2000, Vienna, Austria.

<sup>26</sup> See: Annex 2 for fixed capital investment performance in Russia; *EBRD Transition Report 1999*, Chapter 9.

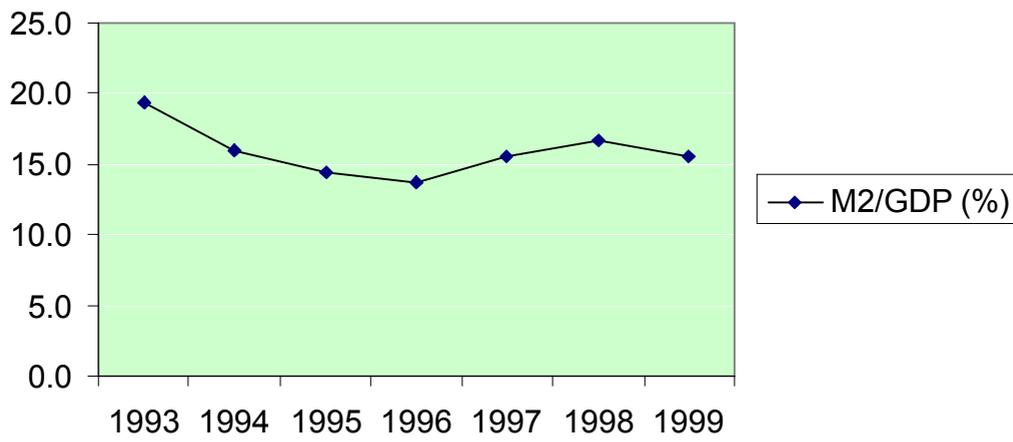
<sup>27</sup> See *EBRD Transition Report 1999*, Chapter 9 for discussion of the reactive restructuring vs. deep restructuring.

- harden budget constraints with regard to tax arrears;
- enforce bankruptcy law with regard to all types of arrears;
- consider the possibility to develop the procedures of discounting certain types of high quality promissory notes by the Central Bank via the commercial banks.

These alternatives clearly stood behind many reform steps which were put on the agenda in Russia in the first decade of this century.

Chart 2.

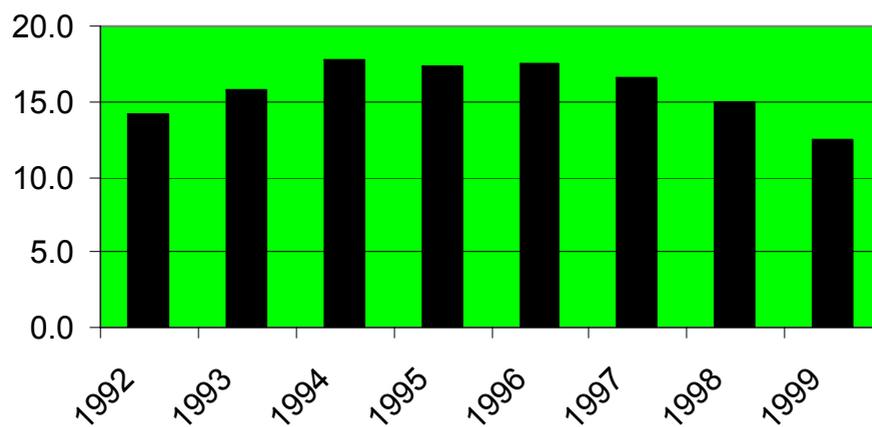
### Russia: M2/GDP ratio 1993-1999 (%)



Source: Goskomstat, author's calculations.

Chart 3

**Russia: Gross fixed capital investment/GDP ratio in 1992-1999, %**



Source: Goskomstat, author's calculations.