The Politics of Russian Enterprise Reform: Insiders, Local Governments, and the Obstacles to Restructuring

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Russia and other countries in the Commonwealth of Independent States that have implemented voucher privatization programs have to account for the puzzling behavior of insiders—manager-owners—who, in stripping assets from the firms they own, appear to be stealing from one pocket to fill the other. This article suggests that asset stripping and the absence of restructuring result from interactions between insiders and subnational governments in a particular property rights regime, in which the ability to realize value is limited by uncertainty and illiquidity. As the central institutions that govern the Russian economy have ceded their powers to the provinces, regional and local governments have imposed a variety of distortions on enterprises to protect local employment.

To disentangle these vicious circles of control, this article considers three sets of institutional changes: adjustments to the system of fiscal federalism by which subnational governments would be allowed to retain tax revenues generated locally; legal improvements in the protection of property rights; and the provision of mechanisms for restructuring and ownership transformation in insider-dominated firms. The aim of these reforms would be to change the incentives that local governments, owners, and investors face; to convince subnational governments that a more sustainable way of protecting employment lies in protecting local investment; to raise the cost of theft and corruption by insiders and local officials; and to allow investors to acquire controlling stakes in viable firms.

Russia implemented real sector reforms—including the privatization of 15,000 enterprises through vouchers—with the goal of making the transition to the market credible, irreversible, and rapid. The objective of the mass privatization program was to establish a critical mass of profit-seeking corporations that were no longer dependent on state support for their survival, and a class of owners willing to invest in their enterprises and manage their restructuring. However, the mass privatization program has brought few tangible benefits to enterprises privatized in voucher auctions. In-
effective corporate governance, little new investment, and the distortions of continuing government intervention have limited the amount of restructuring these firms could undertake in practice. A diverse constellation of indicators suggests that, among firms in transition countries of comparable wealth, Russian firms are ranked at the bottom in terms of output, factor productivity, profitability, and cost-efficiency. Moreover, recent surveys of Russian industrial sectors conclude that the policies of subnational governments tend to favor low-productivity incumbents, protecting them from takeovers and more productive new entrants (McKinsey & Co. 1999; ebrd 1998; Commander and Tolstopiatenko 1996; Earle and Estrin 1997).\(^1\)

In this article, we suggest that the absence of restructuring and investment are the consequences of interactions between insiders (manager-owners) and subnational governments within a particular property rights system. Two interrelated features of this system are consequential to problems in the real sector in Russia. First, subnational governments still use enterprises to protect local employment. In the Russian regions, governments face a tradeoff between enforcing cash-based tax collections and maximizing tax revenues, on the one hand, and extracting social benefits in the form of excess employment on the other. If the manager-owners were to maximize the value of the firm, it would be left vulnerable to expropriatory policies that alter the net return on investment—for example, costly regulations, tariffs, or restrictions on layoffs. Anticipating that, managers choose instead to maximize the private benefits of control, and no restructuring is accomplished. The subnational governments, knowing that the taxable revenue of the firm will have been reduced as a result of cash-flow diversion, respond by collecting revenues in kind and enacting policies that force firms to maintain employment levels. These subnational governments, then, are as vested in maintaining the status quo as are enterprise insiders. The governments shield insiders from takeover attempts, obstruct the enforcement of outsiders’ property rights, and perpetuate the enterprises as a source of private benefits for the managers, and as a source of social and political benefits for the region.\(^2\)

Second, control rights are not automatically granted along with ownership rights, due primarily to the unenforceability of investment contracts in the Russian economy. In economies with fully enforceable property rights, investment decisions would be contractually accompanied by the transfer of control rights. Where control rights and cash-flow rights are separable, the transfer of control becomes, to a large extent, a matter subject to considerable uncertainty and managerial discretion. Outsider investors therefore have little confidence that they will achieve effective control even if they buy (nominal) majority stakes in a company, or that subnational governments will resist imposing distortions once the investment takes place.

The following section details the system of enterprise insider ownership that evolved as a result of the mass privatization program. The next section examines the role of subnational governments in using enterprises to protect employment and derive other benefits. It describes recent attempts by subnational governments to reassert control
over local enterprises. The section on disentangling vicious circles outlines three sets of institutional changes needed to transform the incentives that subnational governments, managers, and investors face: (1) the elimination of tax sharing between local, regional, and federal levels; (2) the establishment of a credible system of protection of property rights; and (3) the provision of mechanisms for restructuring and ownership transformation in insider-dominated firms.

Insider Control

Property rights over enterprises were allocated de facto during the Soviet era. Well before the collapse of the Soviet Union, state-enterprise directors benefited—even profited—from many of the rights associated with “ownership.” The outcome of the privatization program adopted in 1992 reflected these preexisting institutional constraints (McFaul 1995). Following the 1989 Law on State Enterprises, entrepreneurial state-enterprise directors set up the numerous Gorbachev-era entities—cooperatives, collectives, and joint ventures—that fed off large state enterprises. Article 7 of the law gave directors (and employees) in an enterprise the right to lease its assets; ultimately, these leased assets could be purchased at once or in installments through the cooperative or collective (Grigoriev 1992). Subsequent decrees in 1989 and 1990 on lease and leasing relations expanded the ability of employees to propose lease arrangements. Although leases were to be awarded on a competitive basis, no competitions were held in practice, and nearly all leases were awarded by enterprise insiders to themselves (Frydman and others 1993). In 1991–92, the number of lease enterprises increased from 2,400 to almost 9,500.

The intent of the law, of course, was to decentralize the elaboration of annual plans. Indeed, at the time, some viewed lease buyouts as an embryonic form of privatization, which, if regulated, might engender a smooth (stable, controlled) transition (Filatochev and others 1992). However, the buyouts were little more than profit-sharing arrangements for the management and employees. Buyouts were often set up for arbitrage purposes to secure inputs at subsidized prices, sell goods at uncontrolled prices, and pocket the difference. Directors thus reaped the benefits of their control rights while the costs and liabilities associated with ownership remained socialized.

When the Russian privatization law was passed in 1992, all lease enterprises whose agreements were entered into prior to the passage of the law were treated in a separate category of enterprise. In these circumstances, redemption was carried out as specified in the lease. But in an untold number of cases, the redemption terms were unclear or unspecified. In these situations, lease enterprises were privatized with other enterprises, but leaseholders were given priority in purchasing shares. Thus it is difficult to estimate the overlap between enterprises privatized by voucher and enterprises that were part of the leasing program.
Unlike enterprise directors in such countries as Czechoslovakia and Poland, where state-owned enterprise reform laws enabled the Communist Party to remove underperforming managers as late as 1989, the Soviet Union had no such opportunity. Here, enterprise insiders—managers and employees—had both the incentive and the power to defend themselves against President Yeltsin’s attempts to reallocate property rights through rapid privatization. In the Soviet Union, workers did not constitute a distinctive group with interests opposed to management. This was because of the paternalistic relationship between managers and workers, the absence of labor markets, the lack of sector-based trade unions, and the direct provision of social services by enterprises. Workers and managers were traditionally more or less united in their common struggle to bargain for lower production quotas (Willerton 1992; McFaul 1993). Consequently, workers made no claims against property rights distinct from managers. Together, workers and managers constituted a pressure group that dedicated itself toward ensuring that enterprise insiders received the numerous privileges that ultimately made their way into the Russian mass privatization program. As former Prime Minister Gaidar himself later conceded, “Beginning in May and June [1992] it was impossible to stand up to the pressure of the industrial lobby.” Thus, the designers of the Russian mass privatization program confronted the following political reality: Preexisting institutional arrangements that distorted free markets could not be wiped clean by governmental fiat.

A central difference between the mass privatization program in Russia and similar programs in Czechoslovakia, the Slovak Federal Republic, and Poland was the tradeability of Russian vouchers. Under the three variants of the Russian program, insiders could purchase up to 51 percent of enterprise shares. However, the tradeability of vouchers allowed insiders to purchase additional shares up to 65 percent on average (Blasi and Shleifer 1996). Tradeable vouchers, then, may have turned out to be an instrument of insider control, rather than the intended means of consolidating outsider ownership.

Despite conflicting evidence on managerial turnover in the past year, there is general agreement that managers and salaried employees continue to hold approximately 50–60 percent of shares in privatized enterprises (Radygin 1999a). Estimates of ownership structure have varied across different enterprise surveys, which are difficult to compare over time. Table 1 presents estimates of stock ownership in privatized Russian enterprises. The greatest variation tends to be for employees and managers as owners, perhaps reflecting the empirical (as well as theoretical) difficulties in separating the two.

Nevertheless, one of the critical shortcomings of the Russian mass privatization program was that it did not enable an institutional concentration of ownership through financial intermediaries, such as investment funds, as did the Czech and Polish programs (Goldberg and others 1997). The Russian designers believed that consolidation would occur spontaneously as the investment funds, acquiring vouch-
ers from employees, would use them to gain sufficient blocs in privatized enterprises. More important, table 1 shows that domestic corporations—including Russian holding companies and industrial groups—and other foreign and domestic outsiders increased their shares in enterprises, on average, from around 20 percent to more than 40 percent between 1994 and 1999.

Even in those enterprises in which management-held shares were nominally in the minority, managers had at their disposal a variety of techniques by which their de facto control exceeded their nominal share ownership. Where outsider shareholders were fragmented, control was effectively ceded to managers. Employees were the largest category of shareholder in most enterprises put through the mass privatization program, yet many of their shares are nonvoting. In addition, managers have often taken to imposing (illegal) bans on selling shares to outsiders, limits on share ownership, and implicit threats (dismissal, wage cuts, and limitations on access to social assets) on workers who violate these rules. Faced with the prospect of takeovers, managers typically issued new shares (also often illegally) to dilute the power of outsiders.

Meanwhile, although the fiscal situation of the Russian government has been improving since early 1998, the enterprise sector has remained in a low-investment, low-productivity trap. Large enterprises have been able to build up significant wage, supplier, and tax arrears, while bartering whatever goods they did produce in their place. According to Goskomstat’s (the state statistical agency’s) own figures, by mid-1999, overdue accounts receivables on enterprise balance sheets amounted to 40 percent of gross domestic product (GDP), while barter reached approximately 50 percent of all industrial sales (RECEP 1999). Figure 1 shows the evolution of arrears and

Table 1. Estimates of Ownership in Russian Enterprises, 1994–99
(percentage of share capital)

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Note: Estimates vary considerably depending on when, during the course of the year, the survey was taken, and on the sample size.

a. No survey was undertaken in 1998.
b. Includes investment funds, all other firms (including holding companies and financial-industrial groups), and banks.

Sources: Figure ranges are taken from the following: for 1994, Blasi and Shleifer (1996) and Radygin (1995); for 1995, Blasi (1997) and Radygin (1996); for 1996, Blasi and others (1997), Radygin and others (1998), and Institute for Economies in Transition (1996); for 1997, Djankov (1998) and data from Institute for Economies in Transition; and for 1999, Radygin (1999b).
the composition of the main enterprise liabilities in industry, agriculture, construction, and transportation. Total enterprise arrears have more than doubled as a share of GDP between 1995 and 1998. Most firms have resorted to arrears as a source of trade credit at a time when the volume of bank credit has been shrinking.

Why Insiders Do Not Maximize Value

Every system of corporate governance is a structure of control rights such that suppliers of finance assure themselves that their investment will not be squandered by those to whom it is entrusted. In the classic agency perspective, agency costs arise from (1) monitoring expenditures by the principals; (2) resources spent by insiders to guarantee to outside shareholders that shirking shall be limited, or bonding expenditures by the agents; and (3) the residual loss, or the reduction in the value of the firm that obtains when the owner dilutes his ownership stake (Jensen and Meckling 1976; Williamson 1988). Firms that are owned by managers and salaried employees, from this perspective, should face smaller agency costs of corporate control than

Figure 1. The Structure of Russian Enterprise Debts, 1994–99

*As of March 1999.
Source: RECEP (various issues)
those held by outsiders. There should be no need for a governance system in enterprises wholly owned by those who initiate and implement decisions, provide the financing, and bear the residual risks (and returns) associated with those decisions. Thus we are faced with having to account for the puzzling behavior of insider-managers in Russia—as well as other postsocialist environments in which privatized firms are dominated by insiders—who, in stripping assets from the firms they own, appear to be stealing from one pocket to fill the other.

The central problem of corporate governance in Russia, however, does not involve the protection of minority shareholders or other financiers. Here, manager-owners do not face sufficient incentives to restructure the firm and maximize its value over the long run for three possible reasons. First, due to the problems of delineating property rights, manager-owners perceive titles as uncertain, temporary, and potentially subject to expropriation. With short time horizons, their expected gain from increasing value and share appreciation or dividends is typically less than the value of stripped assets. Second, maximizing value is a reasonable long-term objective only if value can be realized. Manager-owners have limited confidence that if they increase value it can be realized by selling their shares. Insider control is so entrenched that outside investors have little confidence in taking effective control of the firm even if they acquire a significant share. Given this illiquidity of secondary markets, managers have little incentive to increase value and might instead sell the actual assets themselves as a way of alienating their control rights. Third, because in many cases the managers do not have formal claim to shares of employees (although managers control employees’ voting rights), distribution of dividends and realization of capital gains creates the potential for severe conflicts between employees and managers. In addition, barter allows opaque accounting to hide income from employees (as well as from the authorities).

Asset Stripping and Diversion of Cash Flows

Although the original rationale for quick privatization was to prevent asset stripping by managers in state-owned enterprises, manager-owners have significantly degraded enterprise assets. Instead of increasing the value of firms through reinvestment, enterprise manager-owners have typically extracted income streams from firms at the expense of minority shareholders. The managers have diverted cash flows to offshore accounts and shell corporations, concentrated losses among subsidiaries held by outsiders (rather than evenly distributing them between an insider-owned holding company and subsidiaries), and delayed the payment of dividends. Because dividends are taxable and have to be shared with other stockholders, manager-owners are more inclined to withdraw cash flows from their enterprises through fictitious expenses or theft (Goldberg and Desai 1998).

In recent years, the Russian government has made efforts to halt or limit this kind of asset degradation through the enhanced supervisory powers of the Federal Com-
mission on the Securities Market (fcsm) or through the empowerment of the anti-monopoly office. These efforts have been successfully blocked by a coalition of enterprise insiders and subnational governments, together with their allies in the Duma (the Russian parliament). These beneficiaries of partial reform have effectively frozen in place the rents (and the opportunities for theft) generated by distortions in the Russian economy, namely, the absence of further reforms of the property rights and corporate governance regime (Hellman 1998). It has been suggested that enterprises in the interim period between corporatization and privatization are the most prone to asset stripping. However, in the Russian economy, one of the notable pathologies of the control of insiders and subnational governments over enterprises is that asset stripping and cash flow diversions occur under private ownership.

Insider Control and Barter

Tax arrears constitute subsidies by subnational governments to firms; however, there is reason to believe that insider control drives noncash settlements. The Russian system of taxation and payments (for example, the freezing of bank accounts) has been frequently cited as a key rationale for barter (Hendley and others 1999b; Commander and Mumssen 1998; Gaddy and Ickes 1998). If this explanation were true, Russia, in this sense, would have been something of an anomaly. Although it is likely to promote financial disintermediation (cash being less traceable than bank transfers and checks), excessive and arbitrary taxation in middle-income countries does not necessarily prompt barter. In Russia, the State Tax Service has taken to deducting tax payments directly from the ruble bank accounts of debtor companies, and these same firms have used offshore banking whenever cash transactions have been necessary.

Our analysis leads to an additional explanation for the prominence of barter in the Russian economy, namely, that barter is a consequence of the failure of corporate governance. In this sense, barter is both a means of avoiding the payment of private or public debts in cash and a way of concealing the real state of affairs not only from tax authorities but from minority shareholders (indeed, even passive shareholders, such as employees). Noncash settlements also enable manager-owners to degrade assets in a less transparent environment.5

Therefore, noncash transactions are an instrument by which manager-owners hide transactions from employees and from outsiders—both minority shareholders and tax authorities. Those who argue that changes in enterprise ownership will have no effect until hard budget constraints and payments discipline are ensured have the sequence reversed. In the Russian economy, both nonpayment and barter—in addition to allowing nonviable enterprises to remain in operation—are used by enterprise insiders to preserve their power through opaqueness and fraud. Payments discipline cannot be improved unless there are, in parallel, significant changes in the incentives of manager-owners and subnational governments.
Subnational Government and Enterprise Control

Although the Russian federal government has perhaps given up attempts to intervene in company management, local and regional governments have continued to exert a strong influence over the actions of key enterprises, regardless of whether they have been formally privatized. Indeed, subnational governments show an unwillingness to draw sharp distinctions between public and private property, or to impose hard budget constraints on large enterprises. The governments want to avoid unemployment and to preserve rent-seeking opportunities for vested interests. Thus there is a continuing source of ambiguity in (and unenforceability of) property rights and ownership.

The central organs of the Russian state have lost their powers of regulation and control to the provinces; therefore, municipal, oblast and okrug (subnational government units), and autonomous-republic administrations have seized these powers. This represents a bid to maintain the economic operations of major local enterprises as well as to protect the local workforce from economic change. One recent study concludes that the devolution of economic control to the regions has preserved the subnational administrative and hierarchical structures of the Soviet system, as well as the power and influence of those who manage them (Ericson 1999). Attempts by subnational governments to protect employment by preventing firms from changing production lines or employment levels constitute a significant distortion of enterprise operations. Anticipating such distortions, managers have often engaged in a “preemptive” diversion of cash flows.

Moreover, in certain regions (especially in one-company towns), the nexus of interdependence between government officials and enterprise management typically grants management quasi-governmental powers. These powers include influence over the apparatus that executes and enforces the law in a given locality, making the enforcement of shareholder rights difficult despite a panoply of recent legislation intended to protect shareholders (Law on Joint-Stock Companies 1996, Company Law 1996, Privatization Law 1997, Investor Protection Act 1999). In those cases where there is significant residual shareholding by the state, there is often tacit cooperation between government representatives on supervisory boards and management opposed to takeovers, consolidation of outsider ownership, or enforcement of the ownership prerogatives of outsiders. These, of course, are long-standing allegations for which systematic evidence is difficult to marshal. Studies have detailed several incidents of managerial obstruction, foot-dragging, and noncompliance (Johnson 1997; Black and others 2000).

The Effects of Tax Bargaining and Tax Sharing

For the largest Russian enterprises, tax payments have been bargained ex post. Tax payments with goods and through the use of offsets have allowed firms to economize
on cash payments to tax authorities. Domestically, these firms have been driven further into the barter economy to avoid leaving a cash trail for the state to pick up. Because subnational governments have been unwilling to enforce the liquidation of insolvent firms, profitable companies as well are encouraged to masquerade as bankrupt ones. Thus both profitable and insolvent Russian firms have incentives to avoid taxes.

Subnational governments in the Russian Federation share all revenues collected, thus drawing taxes from a common pool of taxable resources. Regional and local governments have little incentive to preserve the tax-paying ability of local firms, but rather are more likely to preempt federal tax collectors by accepting services in lieu of tax payments—something federal authorities cannot do easily.

The fact that goods or services used to pay taxes may not have an immediate use constitutes an implicit subsidy granted by the tax collector to the firm and may explain the increasing use of this practice among regional and local governments interested in maintaining employment levels and the social benefits that firms grant employees. Moreover, bartered goods, in-kind payments, and promissory notes are usually greater in price than their cash equivalents (Commander and Mumssen 1998). Pricing noncash instruments at a premium can serve as an implicit subsidy. Tax authorities issuing tax offset notes are often complicit with inflated pricing because it enables the state to increase its revenues. The managers are interested in inflating revenues because it magnifies the perceived size of the enterprise, which may prove useful as the firm bargains with subnational governments.

Subnational Governments and Enterprise Restructuring

Incumbent managers of loss-making enterprises may have given up on the long-term route of deriving wealth through increasing the value of the enterprise. Selling their shares is a limited option because of the costliness of exchanging ownership rights in the Russian economy. Although the rational short-term strategy of the manager-owners is asset stripping, the longer-run strategy is underutilization of the remaining assets, barter, and accumulation of arrears. Subnational governments tolerate this to maintain employment levels in their regions. The employment incentive also explains the liberal forbearance granted by tax authorities toward enforcing tax debt collection from these firms. Eventually, the enterprise may be viewed as an instrument of social policy in a particular region, as well as a real estate bequest to the heirs of the manager-owners.

Subnational governments actively obstruct enterprise restructuring by perpetuating soft budget constraints and in some cases by imposing formal limitations on enterprise activities. Subsidies can take the form of preferential tax treatment, implicit regionally channeled subsidies through discounts on utility bills, and favored status in public procurement, all of which are intended to prevent companies from shut-
ting down and laying off employees. This puts potentially productive companies at a
cost disadvantage, blocking investments and growth on their part.⁸

More directly, regional and municipal governments may effectively ban compa-
nies from laying off excess workers. Local authorities have the means to discipline
disobedient managers, for example, by subjecting them to troublesome fire, safety,
health, and other inspections.⁹ Finally, local officials may require bribes or otherwise
extract rents that can remain hidden from other levels of government and, unlike
taxes, are not shared.

Renationalization

Regional and municipal governments have reasserted their claims to property rights
in the wake of the August crisis. Since mid-1998, de facto renationalizations of pre-
viously privatized property have taken place among several well-known corporations.
The Belgorod iron ore combine, Alkar Aluminum in Sverdlovsk, the Krasnoyarsk
Metallurgical Works, the Mikhailovsk Iron Works, Tatneft, Kamaz, AvtoVaz, Zil, and
Moskvitch all underwent partial renationalization by the end of 1998. In 1999,
further takeovers occurred in the regions of Sverdlovsk, Ulyanovsk, Krasnoyarsk,
Voronezh, Primorye, Chelyabinsk, and Moscow (Ericson 1999).

In oil-producing regions, shares of several oil companies found their way into re-
gional governments or regional government-owned companies—including Kominenft
(Yamalo-Nenetsky) and ANKH (Irkutsk). First, several regional investment vehicles
under the protection of local governments were set up to consolidate local or regional
government holdings in important local industries. In some cases, these were simply
regional government–owned holding companies, which may have attempted to in-
crease their shares through a capital increase. In other cases, the subnational gov-
ernments restructured debts owned by corporations by converting those debts into
equity. Second, companies invoked a 1996 presidential decree on wage and tax ar-
rears, repaying their tax debts to regional and federal budgets by issuing new stocks.
In one case—yukos—newly issued shares wound up in the hands of a private owner
(in this case, the Menatep Group), and the revenues from those shares were trans-
ferred to the budget. In all the other cases, government shares have increased in com-
panies under this arrangement (Radygin 1999a).

Disentangling the Vicious Circles

Attempts to reform the property rights system in the Russian Federation have often
involved the following dilemma: The enforcement of the rules needed to improve
corporate governance is typically in the hands of those who derive significant rents
from ensuring that these very rules are not enforced. Therefore, the success of any
reforms will hinge on the extent to which the incentives of the major actors are transformed. In this section, we analyze some prospective reform agendas intended to improve the institutional underpinnings of the relationship between federal and subnational authorities in the corporate-legal environment and of the market for corporate control.

Fiscal Federalism and Subnational Incentives

Analyses of the role of federalism in the development of markets confirm the major role that regional and local governments can play in the growth of the private sector or in its obstruction. Russian subnational governments have impeded the growth of the private sector through a combination of taxation, regulation, and corruption (Shleifer and Treisman 2000).10 “Spontaneous decentralization” in Russia left its fiscal system without stable or transparent rules for tax sharing and expenditure assignments and failed to provide subnational governments with incentives to support their local tax base or to limit rent extraction from local firms (Lavrov 1996).

In general, administrative and fiscal decentralization in Russia has produced several adverse effects. First, both regional and local governments—municipalities and rayons (districts)—face few incentives to limit their own extraction of rents from local firms (Blanchard and Shleifer 2000; Frye and Shleifer 1997). Second, capture by large enterprises, whose continued operations were vital to subnational economies, led subnational governments to protect them from competition by new entrants (McKinsey & Co. 1999). Third, without clearly specified rules, revenue sharing remains highly discretionary, and revenues retained at subnational levels are subject to yearly local-regional-federal bargains (Freinkman and others 1999). Local governments, in particular, benefit the least from these ad hoc arrangements: Most of their tax revenue is shared with regional governments, and any increase in local revenues will be almost entirely offset by changes in shared revenues. Fourth, low tax retention rates among local governments have created few incentives to support enterprise restructuring, to limit the extraction of rents from local firms, or to prevent capture by local firms (Zhuravskaya 2000; Shleifer 1997).11

Comparison with China suggests striking differences between Chinese and Russian fiscal federalism in terms of the powers of the central government and the mechanisms of intergovernmental finance. In China during the reform period, a central government under the tight control of the Communist Party was in a stronger position to reward and punish local officials than was the case in the politically fragmented Russian Federation. The Chinese Communist Party retains the power to appoint and fire governors through the Party-State’s system of promotions and punishments. Consequently, top provincial officials are bureaucratically integrated with the central government (Huang 1996). Moreover, unlike the Russian state, China’s central government did not see the need to renegotiate revenue sharing agreements with its
regions. In addition, since 1979, the Chinese provinces have assumed primary responsibility for governing the provincial economies. Local expenditures are closely linked to revenue generated, and thus the provinces have been limited in their ability to borrow. Consequently, revenue-sharing arrangements in China are characterized by far less center-province bargaining and by greater local retention of tax revenues (Jin and others 1999).

Russian federal authorities have recently embarked on a campaign to bring wayward regions back in line and to recentralize several powers that had devolved to regional governors. In the short run, a more direct approach may be to eliminate tax sharing between the three levels of government. The current system of revenue sharing has fostered a race between federal, regional, and local authorities to collect revenues from the same taxable base—through multiple overlapping taxes, special levies, or extortion. This is a “tragedy of the commons” of sorts in that none of the three levels of government has an incentive to halt its own extraction of rents from tax-paying firms or to protect the corporate sector from these distortions. Eliminating tax sharing and allowing local budgets to be the sole beneficiaries of taxes paid by local enterprises would end the overlapping claims of different layers of government to the common tax pool. It would also provide the subnational authorities with stronger incentives for maintaining a favorable investment climate in their localities. In particular, local budgets should be the single beneficiary of taxes paid by local enterprises.12

Property Rights Enforcement and the Legal Environment

In recent years, the legal basis of the Russian property rights regime has been substantially improved by two laws designed to prevent the abuse of power in corporations. For example, the Company Law of 1996 attempts to break the power of the general directors by prohibiting them from serving simultaneously as the chairman of the board. To prevent insider trading, the Company Law restricts the general director from conducting important transactions without the consent of the board. The Company Law also offers a number of legal recourses for minority shareholders. These include the right of appeal against any resolution adopted by the annual general meeting, the ability to seek the annulment of major transactions, and the right to sue for invalidation of a transaction involving conflicts of interest.

The Investor Protection Act of 1999 promotes the equitable treatment of shareholders by strengthening disclosure requirements for joint stock companies. It also grants the securities commission (FCSM) greater freedom to initiate court proceedings on behalf of individual shareholders. As a result of the Investor Protection Act, the other Russian self-regulated organizations—the Professional Association of Registrars, Transfer Agents, and Depositories (PARTAD) and the National Association of Securities Market Participants (NAUFOR)—can investigate the violation of shareholder rights by registrars, depositaries, custodians, or brokers. Although Russian legisla-
tion does not specifically provide for class action suits, a joint complaint by shareholders is possible during appeals procedures and by filing a collective claim through the fcsm. Although the fcsm has successfully brought a number of cases to court and has won more than 80 percent of them, it still has relatively few weapons for forcing compliance with existing laws compared with its counterparts in Organisation for Economic Co-operation and Development (oecd) countries.

Nevertheless, governmental foot-dragging (particularly at the subnational level) and the absence of impartial, independent adjudication have repeatedly obstructed the enforcement of the growing body of sophisticated Russian corporate laws (Carothers 1998). The adoption of these laws and expanded protection for investors have not prevented asset stripping or the defrauding of minority shareholders and creditors. Thus the credibility of legislation can be severely undermined when weak states introduce well-intentioned but unenforceable laws; indeed, such laws may be counterproductive (erdr 1999). For example, both the Company Law and the Investor Protection Act have been thwarted by the widespread use of offshore corporate vehicles, which have diverted assets or cash flows from companies to affiliated parties (that is, management or controlling shareholders) hidden from the principal regulators (Jesover and Nestor 2000).

Efforts to strengthen the rule of law as it relates to enterprise restructuring should focus not only on the form and content of the laws themselves but on increasing government compliance, judicial independence, and safeguards against corruption. In part, the solution may simply require increased funding. Currently, the shortfalls in federal funding for the judiciary are supplemented (inadequately) by funds from oblast governments. This encourages courts that often favor local interests, which are frequently unable to enforce judicial decisions and are left vulnerable to corruption. But ultimately, long-term improvement in formal enforcement mechanisms will come to rely on institutional building efforts within the Russian systems of courts—especially the arbitrazh courts, which adjudicate cases of a commercial nature—and bailiffs.

The establishment of a genuine system of administrative review in the Russian Federation would serve as a check on executive authority and would be a step toward ensuring predictability and transparency in governmental decisionmaking. Well-designed, legally based administrative reviews require the content and time frame of decisions to be made public and clearly specified in advance. They require government bodies to supply explanations when public inquiries are made and to provide mechanisms for recourse. Such mechanisms can include rights of appeal, judicial review through administrative courts or tribunals, or external complaint and mediation through the use of ombudsmen. Such reforms are expensive and painstaking but integral to curbing abuses of public office.

The bailiff corps, which is charged with enforcement of the decisions of the courts, is typically underfunded in transition countries. Some countries, such as Slovakia
and Latvia, have semi-privatized or are in the process of privatizing enforcement based on French-style civil codes, according to which bailiffs behave much like public notaries. The bailiffs are certified by the state and charge government-regulated fees, but they are permitted to advertise and find their own customers.

**Enterprise Restructuring and Ownership Transformation**

Loss-making private or privatized firms should be properly rationalized by market mechanisms that either promote restructuring from within or allow coalitions of outsiders to come together and dislodge incumbent owners. We examine two such mechanisms in turn.

**Creditor-led restructuring.** In Russia, improved bankruptcy procedures that have been in place since 1998 should have facilitated the reorganization of insolvent companies. Two fundamental changes to Russian bankruptcy procedures were put in place following the passage of the 1998 Bankruptcy Act. First, the law removes the requirement of the previous law that courts undertake independent valuations of debtors’ assets and liabilities to determine whether a debtor was insolvent. Regional courts often refused to base insolvency on cash flows (basing them on net worth instead), thus preventing creditors from being paid. Second, creditors faced no incentives to cooperate in their petitions against a debtor, resulting in coordination problems. The new law bases insolvency on cash flows, that is, an inability to service debts over a prescribed period. In addition, the new law requires a creditors’ committee to implement interim management of an insolvent firm and to share in court costs.

Any creditor, including a government authority that owns tax debts, can initiate a bankruptcy petition against a delinquent firm; however, in practice there are four critical problems in relying on bankruptcy procedures to initiate ownership transformation. First, traditional creditors may be simply unwilling or unable to initiate bankruptcy. Due to the tight industrial and financial links between suppliers and customers in monopolistic settings, it is unlikely that suppliers would bankrupt their main customers. Moreover, in Russia as in most countries in the Commonwealth of Independent States, total liquid liabilities in the financial sector comprise less than 15 percent of GDP (compared with 50–70 percent in Central Europe and the Baltic states). Thus banks are in a fragile position for initiating debt conciliation. Most outstanding liabilities are not to banks, but rather to governments, workers, suppliers, and nonbudgetary funds.

Second, given the requirement of creditor coordination, it is impossible to ensure that an investor can take ownership of a bankrupt firm. The creditors are given equity shares pro rata, and they must agree to a sale to a third party. Bankruptcy is collective in nature; therefore, all creditors must share the costs of the bankruptcy proceedings and all must agree on external management and other matters.
Third, ownership transformation based on bankruptcies will ultimately rely on court procedures and on the capacity of the judicial system to ensure success. These are significant burdens to entrust to an already overloaded system.

Fourth, bankruptcy is a disruptive and often lengthy process. If an amicable agreement is not forthcoming, the proceedings might encourage the antipathy of regional authorities opposed to bankrupting a company to change ownership.

In view of these problems, using arrears as leverage to induce restructuring or the sale of assets may be a more appropriate solution than bankruptcy. The major creditors in Russia are the state-owned utilities (UES and Gazprom), local gas and power distributors, and tax authorities. However, neither voluntary restructuring nor sale is feasible as long subnational governments continue to subsidize loss-making enterprises by tolerating tax arrears, energy companies continue supplying enterprises that do not pay, and insiders can costlessly divert the income streams of their enterprises.

Investor-led restructuring and markets for control. Alongside bankruptcy rules and other mechanisms that permit holders of debts to acquire control of loss-making enterprises, market economies usually possess a variety of other means by which control rights in enterprises can be transferred to new owners. The development of these markets for corporate control and takeovers in the Russian Federation would constitute major progress in releasing loss-making enterprises from their role as a source of private rents for owners and political benefits for public officials.

Experience suggests that investors are more willing to contribute capital when the web of firm obligations is untangled and settled, and when the acquisition of controlling stakes in enterprises is ensured. Along these lines, government-supported mechanisms can be established to resolve certain outstanding liabilities, while at the same time offering residual stakes and converted tax debt to equity to new investors. The objective behind such a move would be to create new majority owners by converting tax debt into equity that would be sold immediately to external investors in competitive auctions. These converted shares, along with residual shares owned by government authorities, would constitute significant percentages of share capital in several cases, and would effectively dilute the controlling shares of insiders. Box 1 proposes an example of such a mechanism through investment-based ownership transformation.

There are two major pitfalls to building takeover markets by government fiat: investor capture and government capture. The risk of investor capture is simply that takeover markets will, once again, open the door to current enterprise insiders eager to expand their control over productive assets in the Russian economy. As with the loans-for-shares program, there is a risk that firms acquired in takeovers will go to investors with hidden connections to the enterprise who have submitted inflated bids, restricting competition for corporate control. Government capture will occur if takeovers result in the renationalization of private enterprises. Piecemeal takeovers—by
Box 1. Investment-Based Ownership Transformation: A Pilot for the Russian Regions

1. A regional government receives a technical assistance/institutional building loan from a multilateral donor to hire an investment brokerage. The investment brokerage selects a pool of companies based on the following criteria: (i) basic viability; (ii) a minimum stock of tax arrears; and (iii) an agreement between the regional tax authorities and the management-owners to dilute the latter’s share in ownership in exchange for part of the proceeds from the transaction. The regional government, interested in collecting revenue from overdue and uncollectible arrears, convinces management, under threat of bankruptcy, to accept the dilution.

2. The regional government, according to the procurement rules of the multilateral lender, conducts an open tender to select an investment brokerage, in effect, to reprivatize the selected pool of companies. The formula for compensation of the investment brokerage is based on a fixed fee that covers the expenses of valuing the whole pool, in addition to a success fee for each company successfully resold.

3. The selected investment brokerage conducts a tender for the sale of selected companies. The value of these companies will provide a benchmark tax debt-to-equity conversion rate, and the bids will, in effect, represent the market valuation of this rate.

4. The investment brokerage, as part of the sale of the enterprise shares, will assist in the conversion process of the outstanding tax debts to equity. The conversion would take place only as part of the transaction.

5. Given the layoffs likely following the investment-based ownership transformation, such a scheme should be supported by a compensatory program to assist the unemployed and to reduce their dependence on enterprise-based social resources (for example, a severance pay program financed by an international financial institution).

In this example, all debts are held by tax authorities; the example leaves out liabilities to suppliers, lenders, and labor. Most important are the arrears of the companies to the local gas and power distribution companies, which are often controlled by regional governments. In principle, all of these liabilities could be converted to equity and auctioned in a similar fashion, with the proceeds from the sale being divided among all the claimants pro rata. The control of local governments over suppliers—mainly the distribution companies—could help in coping with the creditors’ coordination problem (referred to in the section on enterprise restructuring and ownership transformation). It is advisable to convert all claims and sell them simultaneously to avoid the unintentional dilution of a buyer’s expected ownership.

We have avoided distinguishing between levels of government. Although a large proportion of total tax arrears is currently held with the federal government, the probability of collection of these is lower than that of the debts to the regional governments. The investment-based ownership transformation will have to include agreements between the federal and regional creditors about offsetting these debts as part of the fiscal relationship between the two.


which a governmental body converts tax debts into shares, then awaits an acceptable investor—can also encourage government administrators to restrict bidding to favored parties or to otherwise bias the auction in the interim.

Investor-led restructuring and takeover markets require that the property rights of investors be protected from expropriation or other arbitrary distortions. An important component of this protection is that owners of private property and buildings also hold the right to the land on which these assets are located. Land privatization
will raise the investment potential and collateral value of privatized enterprises and consequently will prevent governments from exercising control through their ownership of the land. In the same vein, rules for expropriation, forfeiture, and nationalization should be critically examined to limit state intervention in private ownership.

Conclusion

In the absence of property rights enforcement, there are stronger incentives for theft than for restructuring. In manager-owned firms in the Russian Federation, managers can benefit far less from the appreciation of their stock than from siphoning off profits. Moreover, the complex of mutual dependence between subnational authorities and enterprises encourages local and regional governments to rely on enterprises for social benefits rather than as sources of local development. In the Russian Federation, these two groups face few incentives to promote new investment or to respect the rights of shareholders or minorities. The Russian enterprise dilemma can be partially resolved through a combination of institutional reforms aimed at changing the incentives of subnational governments, improving enforcement, and providing mechanisms for enterprise restructuring and for outsiders to acquire controlling interests in firms.

The proposition that conventional liberal reform will provide universal benefits in the long run has not persuaded vested interests that have acquired control over the political process to change the status quo. Ultimately, the sustainability of the reforms suggested here will depend on the presence of constituencies that can lobby, persuade, or otherwise circumvent the coalitions that support existing economic distortions. Whether such constituencies capable of demanding reform are emerging in the Russian Federation will become clearer as the aftermath of the financial crisis and the policies of President Putin’s government unfold. Here we mention some conditions under which two constituencies—investors and subnational governments—could be effective.

Investors are either reformed enterprise insiders or outsiders. As we have suggested, once insiders recognize that the subsidization of loss-making enterprises is not sustainable, they may consider selling assets or restructuring voluntarily to raise finance. At the same time, outside investors must be confident that they can acquire sufficient control in enterprises. Several types of outside shareholders—investment companies and nonbanking financial institutions, domestic enterprises, and foreign investors—are likely to respond favorably to the strengthening of enforcement regimes. Several investment companies, for example, have become active players in the Russian takeover market. The better-known brokerages facilitate mergers and acquisitions on behalf of foreign and local investors. There is some indication that shareholders in Russian firms have begun to increase their activism in Russian boardrooms. In this regard, it is encouraging that empirical evidence suggests that outsiders’ shares in
Russian enterprises are steadily rising (see table 1), and that companies increasingly rely on the resources of the legal system. Subnational governments comprise another constituency. Changing the fiscal incentives for regional and local governments, in particular, allowing greater control over locally generated tax revenues, will raise the costs of rent extraction from firms in two ways. First, it will encourage governments to lift formal and informal restraints on restructuring. Second, these governments are likely to take steps to protect investors in local firms, to comply with and enforce laws, and, consequently, to limit theft by management. In this way, subnational authorities will recognize that a more sustainable way of protecting employment lies in providing managers with incentives to increase the value of their enterprises and attract outside investment.

The critical role that regional governments play in limiting enterprise restructuring in Russia should no longer be ignored. However, it is important to keep in mind the potentially positive role the regions could play in reviving growth in the real sector. The proposals in this article are intended to be a step in this direction.

Notes

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1. Russia’s labor productivity has fallen from 30 percent of the level in the United States in 1991 to 19 percent in 1999.
2. For a game-theoretic elaboration of this argument, see the annex in Desai and Goldberg (1999).
3. Leases would run between 5 and 15 years, and a redemption clause simply allowed the lessor to purchase the property at the end of the term. But in many cases, the property sharing arrangements on the conclusion of the lease were extremely vague—typically based on principles of self-government and worker participation, but leaving unspecified the governance structure of the enterprise.
4. The “industrial lobby,” in Gaidar’s retelling, consisted of the Russian Union of Industrialists and Entrepreneurs; its political affiliate, the Civic Union; the Russian Assembly of Social Partnership (an umbrella trade union); and, most important, the legislators in the Congress of People’s Deputies. See New Times (1993).
5. In a typical scheme, for example, managers could transfer assets from company A, in which minority shareholders have a stake, to company B (for example, a management-controlled pocket company), in which they do not in the following way. Managers of A require A to sell some output to B at a controlled price. B pays A in goods rather than in cash, then sells the output on domestic or international markets at normal prices. Under these conditions, managers are able to turn A into a cost center and B into a profit center as in a normal case of transfer pricing. But the addition of interfirm barter without the premium allows managers to hide A’s true cost of production and to exaggerate the amount transferred to B.
6. According to Commander and Mumsen (1998:18), in addition, the fact that goods used to pay taxes may not have an immediate use constitutes an implicit subsidy granted by the tax collector to the firm.
7. Without a property tax on unutilized property offset against a positive profits tax for profitable enterprises, there are few disincentives to hold enterprise real estate for this purpose.
8. Obsolete (subscale and/or inefficient in their use of energy) steel and cement plants avoid shutdowns by paying for only a fraction of their energy bills—their largest cost component. Because these
companies are often the major employers in a town, municipal and regional officials go to great lengths
to keep them operating. Regional governments channel implicit federal energy subsidies to these com-
panies by letting arrears to federal suppliers (Gazprom and others) accumulate at the local gas and elec-
tricity distribution companies. These energy distribution companies are often under effective control
of the regional governments, making their bankruptcy practically impossible. Subsidies slow down
recovery in many manufacturing sectors by preventing upgrading investments and industry consoli-
dation in and around viable industrial assets (McKinsey & Co. 1999).

9. The Novgorod region of Russia is a rare positive example of what can be done by regional gov-
ernments in today’s Russia. It managed to attract more foreign direct investment than almost any other
Russian region, including nearby St. Petersburg, by removing red tape, facilitating access to land, and
offering tax holidays to investors. As a result, the region has enjoyed economic growth since 1995,
and over half of industrial output comes from productive foreign companies.

10. Russia has failed “to construct a democratic, fiscally stable, federal order on the ruins of a Com-
munist state,” and the significant power accorded regional potentates has provided much space for
regional and local patron-client relationships (Shleifer and Treisman 2000).

11. Shleifer (1997) finds that Russian oblasts, compared with Polish regions, received much higher
portions of their total revenue from the central government, prompting Russian regions to devote
greater efforts to bargaining for federal transfers rather than to fostering growth in the local private
sector and the local tax base.

12. At the time of this writing, there have been several indications that the Russian government is
inclined to follow these reforms. See Economist Intelligence Unit (2000).

13. It has been argued, in the context of the recent wave of efforts to promote “rule of law” in devel-
op ing and transition countries, that there are three basic categories of rule of law reform (Carothers
1998). The first type concentrates on efforts to reform or rewrite the laws themselves. The second type
emphasizes reform in the basic legal institutions, especially the judiciary and the bar. The third type
aims at increasing government compliance with the law and true judicial independence. Most inter-
national rule-of-law aid to date has focused on the first two types of reform; the third—the most diffi-
cult and important—has received much less attention. Against this background, the rule of law in the
context of enterprise restructuring in Russia would focus on laws, institutions, and government com-
pliance (including implementation of laws and prevention of corruption) as they relate to corporate
governance and enterprise restructuring.

14. A recent study finds that improvements in contracting procedures, monitoring, and enforce-
ment provide benefits for both transacting partners, coordinating expectations during implementation
and making the outcome of disputes more predictable (Hendley and others 1999b).

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