n the transition from a command to a market economy, property rights are poorly defined, with the excessive control rights of the politicians and bureaucrats as the leading example. The most obvious way of getting around political control is corruption, but this strategy has many problems beyond breaking the law, including the limited enforceability of corruption contracts.

At the Bank’s sixth Annual Conference on Development Economics, Andrei Shleifer suggested three alternative strategies for establishing property rights in transition economies: giving equity to the bureaucrats (and other parties that have control), reforming the civil service, and politically removing bureaucratic control rights (privatization).* Looking at Russia, he shows how privatization—combined with equity incentives for enterprise insiders—transfers control rights from the bureaucrats and stimulates political and economic pressures for the genuine protection of private property rights.

Managers grab rights
In the early 1990s, after the collapse of communism, control over the Russian industrial enterprises went from the central ministries to several other stakeholders.
- The enterprise managers got substantial control over investment, employment, product development, and many other decisions previously controlled by central ministries.

Privatization transfers control rights from the bureaucrats
- The workers (unlike those in Poland) did not have much control over decisions in the firm. But they did have, through their allies in the Parliament, effective veto power over any change in the legal ownership structure of the enterprise.
- The local governments wanted enterprises to maintain employment and provide social services for the local residents—and they controlled the supply of water, electricity, and other services to firms.
- The central ministries retained some control over firms in part because they could coordinate supply and distribution much better than enterprise managers.

The devolution of control rights from the ministries in the early 1990s followed the decision of the Gorbachev government to refuse to protect these rights. As a result, the rights were effectively grabbed by the managers, not peacefully turned over.

Privatization reallocates rights
A workable privatization program had to combine political reallocation of control rights away from the central bureaucracy to private shareholders with awards of equity and other benefits to the stakeholders who would support the program. The Russian large-scale privatization program explicitly rejected “nomenklatura privatization,” which would offer equity to existing bureaucrats, since the political imperative dictated that they should be marginalized rather than empowered. Even under this constraint, the Russian privatization program showed how a small political mandate could be built into a successful reform.

The Russian program combined the elements of political redistribution of control rights (using managers, the public, and the local governments to undermine the power of Moscow bureaucrats) with equity awards to parties that already had control rights (managers and workers). As a mechanism of transferring control rights from politicians, the program was very successful. In 1993 alone, almost 10,000 industrial enterprises, with 40% of industrial workers, were privatized. By July 1, 1994, when the program was scheduled to end, more than 15,000 industrial enterprises, with almost two-thirds of industrial workers, were to be private.

This success is clearly the consequence of the program's reliance on a politically viable approach to transferring control rights.

**Now, the hard part**

But the transfer of control from politicians is only a first step in establishing property rights. Indeed, the Russian managers (but probably not the workers) have emerged from privatization with quite enormous control rights, including the ability not only to make most corporate decisions, but also to select directors, to control shareholder votes, and often even to control the trading of shares through physical control over share registers. While Russian management teams on average own about 15% of the shares of their companies, through their influence on the workers and on the government property funds that still own some shares many managers almost fully control their firms. Control by managers is probably better than control by politicians. While managers are interested in empire-building and preserving their jobs, their welfare is more closely tied to the profits of the firm than is that of the politicians, particularly when managers have an equity stake. Still, to establish property rights in these enterprises, managerial control must be curtailed and that of outside investors increased.

As a result of privatization, many Russian companies have ended up with large outside investors—investment funds, wealthy Russian entrepreneurs, or even foreigners. These investors, interested primarily in profits, use whatever control rights they have (votes at shareholders' meetings, jawboning the managers) to demand value-maximizing strategies. In a few cases, these outside shareholders ally themselves with the workers to dismiss incompetent managers and replace them with outsiders or more competent insiders.

Even more important, outside investors, including investment funds, have begun lobbying the government for regulations that protect their control rights, including independent share registrars, laws protecting investor rights, secret corporate voting, and so on. These investors have also lobbied for the creation of a securities and exchange commission that will have the mandate to enforce unrestricted trading of shares. Toward the end of 1993, these investors began to succeed politically, and the government adopted a variety of regulations protecting shareholder rights. In this way, privatization, while not establishing full property rights by itself, has stimulated policies increasing the protection of these rights.

As property rights become established, the restructuring of the Russian enterprises begins. Even before privatization, as managers got control rights but before they received cash flow rights, the employment in state enterprises in Russia began to fall. Most firms continue to consider themselves substantially overstaffed.

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**Some useful lessons**

The Russian privatization shows that allocations of control rights can be improved through a combination of allocating cash flow rights to parties with control rights and political transfer of control rights, even under a very weak government. To do that, the reformers must build a political coalition strong enough to counter the bureaucratic opposition to loss of control. The Russian privatization also shows that genuine establishment of property rights comes after the transfer of control rights from the politicians, as private investors begin to use their economic and political resources to protect their rights.

At the same time, the Russian experience shows how difficult it is to destroy political control. The privatization of shops in Russia has worked much less well than that in Eastern Europe because local governments continued to control businesses through leases and regulations. Land reform has been similarly stymied by government agencies committed to controlling all land transactions. Even with large-scale privatization, proposals for consolidating firms into industrial groups and other quasi-governmental structures continue to resurface even after most firms have been privatized. Moreover, credit policy has served as a continually effective instrument of political control of privatized firms.

Last, it is plausible that politicians have delayed the protection of private property rights in Russia—and perhaps even condoned crime, since fear of the mafia often brings entrepreneurs to seek political protection, an action that of course only gives the bureaucrats more control over firms. If nothing else, the Russian experience reveals the many difficulties of escaping the political control of firms.