Improving the Performance of Soviet Enterprises

John Nellis
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Improving the Performance of Soviet Enterprises

John Nellis

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ABSTRACT

In the period of perestroika the Soviet government has begun to increase the autonomy of state enterprise managers, and has allowed (in fact if not in law) new forms of production to emerge: cooperatives, leasing arrangements and collectively owned firms. Compared to the state enterprises, these new entities put assets to more productive use and pay incentive wages and salaries. But because ownership concepts and rights remain ill- or undefined, what has been produced is not a private sector in the Western, capitalist sense; it is a quasi-private sector. That is, the actors in this sector control, but only partially own, and are limited in alienating the assets in their hands; and they seldom have any personal capital at risk. There is thus a danger that they will concentrate on short-term gains and not pay adequate attention to the long-run health of these firms and assets. The essential next step for Soviet economic reform is to establish in law the concept of private property.

There are a mass of obstacles to rapid and massive privatization; thus, many enterprises will remain, temporarily or indefinitely, in state hands. To improve their economic and financial performance the government should "corporatize" them. This means in effect to create an ownership structure that protects the capital employed by:

- formulating a limited set of achievable, commercial goals for enterprises,
- imposing a "hard budget constraint,"
- providing sufficient autonomy to managers at the level of the firm, and
- creating mechanisms by which the representatives of the owner can monitor performance, reward success, and punish failure.
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PREFACE

The author was a member of the World Bank team that participated in the 1990 Joint Study of the Soviet Economy. This study was undertaken by the World Bank, the International Monetary Fund, the Organisation for Economic Cooperation and Development, and the European Bank for Reconstruction and Development. This paper was his contribution to the mass of materials from which was distilled both the Background Papers (to be published by the OECD) and The Economy of the USSR: Summary and Recommendations.¹ The paper was written in October of 1990 and has not been revised in the light of subsequent developments -- except to add one parenthetical note indicating the lack of fulfillment of one particular timetable, to correct a few small factual errors, and to alter slightly some wording.

In addition to the disclaimer regarding the World Bank printed on the inside cover, it should be noted that the views presented in this paper do not necessarily represent the position of the other participating organizations, their executive directors, or their member governments.

¹ Authored by the IMF, the World Bank, the OECD and the EBRD, the report was published by the World Bank, Washington, D.C., 1990.
IMPROVING THE PERFORMANCE OF SOVIET ENTERPRISES

THE PROBLEM

The overwhelming bulk of productive capacity in the USSR is, at present, the property of the state. Over the years, the Soviet state has not acted as a prudent "owner" of this property. It has not taken the appropriate steps to assure and enhance the long-run productive capacity of its assets. This failure to represent adequately the interests of capital is a deficiency that lies at the heart of socialist economies in general, and the Soviet system in particular. Property belonging to "the state" -- to society in general -- is often treated as though it belongs to no one. It tends to suffer from neglect, misuse and waste. Substantial financial and economic gains can be expected from market-oriented efforts to address this problem. This brief paper examines those aspects of the problem that relate to state enterprises. It looks in turn at ownership rights in state enterprises, privatization of state enterprises, performance improvement in enterprises that, temporarily or indefinitely are likely to remain in the hands of the state, and aspects of enterprise management.

SOVIET STATE ENTERPRISES

In the USSR, nonagricultural production is centered in the thousands of enterprises that make up the real sector of the economy. There are a reported 47,000 of these enterprises in the industrial arena alone. Adding energy, infrastructure, and large service-oriented firms, the number of state enterprises of all sorts is said to exceed 55,000. Moreover, many of these enterprises are large "amalgamations," "associations" or "concerns;" that is, multidivisional entities, containing subunits
of substantial size that in the West would often be regarded as self-standing companies. This suggests that the actual number of state-owned productive units is much larger than the official number indicates.

Until the mid-1980s, the Soviet enterprise system functioned roughly as follows: At the central or "All-Union" level, sectors of industrial and manufacturing endeavor were isolated as administrative "branches." All-Union Ministries were formed not simply to supervise but to direct and control the affairs of the enterprises in their branch. By the early 1980s there were close to one hundred branch ministries in industry; for example, the Ministry of Light Industry, the Ministry of Electronics, the Ministry of Metallurgy, the Ministry of Automobiles, and the Ministry of Machine Building and Machine Tools.

These ministries acted in close conjunction with the powerful central organizational pillars of the command/planned economy: GOSPLAN, GOSSNAB, GOSKOMTSEN, and GOSBANK; respectively, the State Planning Commission, the State Supply Authority, the State Price Commission, and the State Bank. Until the onset of the perestroika reforms, these four central agencies and the branch ministries determined generally what (and how much of what) an enterprise would produce; how much of which inputs it would receive to effect planned production; what investments were needed to maintain, expand, or alter production; where all current and capital inputs would come from, and what prices the enterprise would pay for them; and to where and at what price all production would be sold.

To complicate the picture, the All-Union coordinating agencies and the branch ministries were partially duplicated at the republic level, so that, for example, the Ukrainian Republic Ministry of Light Industry was responsible for a set of firms, the dealings of which took place within the Ukraine's borders, while strategic enterprises or those with trans-republic activities were dealt with from the center. Local governments or city councils too had a set of firms under their jurisdiction; these relatively smaller entities produced services and items for purely local consumption. For a perhaps unusual example, 20 percent of all enterprises located in the region of the Moscow City Soviet are "subordinated" to this local authority. Irrespective of the level of government to which an enterprise was officially attached, its objectives, inputs, outputs, and prices were dictated to it by government authorities.

In these circumstances the very term "enterprise" was a misnomer. The firms were simply not independent companies, but rather were production units that responded to the directives of superior government offices and decision-makers. Firm directors were much more production engineers than managers. They were
concerned first with meeting the physical targets of the plan and second -- often a distant second -- with the quality of the item produced. Questions of design, cost minimization and the division of retained earnings between rewards for the workers/managers and reserves for the expansion of the firm were not in the control of enterprise management (and the notion of a "dividend" -- a return to the owner on the capital invested -- was not even considered). By the beginning of the 1980s it was widely conceded, within the Soviet Union itself, that enterprises generally operated at low levels of efficiency, produced poor quality goods, mostly failed to maintain high technological standards, and were increasingly producing negative externalities such as pollution.

CURRENT REFORMS

Changes in the system of enterprise control began in earnest in 1985, were codified in a 1987 "Law on State Enterprises," spread and deepened in 1988, and were reconsidered and expanded in a June 1990 "Law on Enterprises," designed to go into effect in early 1991. The thrust of the various changes instituted and contemplated to date is twofold:

- To increase the independence of industrial enterprises by augmenting the autonomy of enterprise managers and assigning some policy and managerial authority to enterprise councils of one sort or another;

- To permit the existence of nonstate enterprise forms of production, and to place all production forms on an equal legal and regulatory footing.

The goals of these changes were to decentralize some decision-making to the level of the firm, to widen the scope for personal and private initiatives, and to substitute (partially) indirect financial signals for direct planning as a means to guide enterprises.

Thus, enterprise managers have been given an increased capacity to negotiate the amount of planned annual production, to modify product design in response to consumer demand, to seek foreign markets for their products and foreign partners in joint venture and coproduction agreements, to retain in the firm increased portions of foreign exchange earned, and to seek financing and credit arrangements from outside the traditional, official funding sources. Starting in 1991, many enterprises will be allowed to sell nonstate order, or above quota, production to any willing purchaser -- in many cases, it seems, at above state prices. (Some few enterprises have been doing this for the last two years.) All enterprises will enjoy a lighter and uniform rate of corporate tax. In 1987, enterprise councils were accorded the
power to name managers and given a say in determining the use of retained earnings. From 1991, a new form of enterprise board -- composed half of workers' representatives and half of persons appointed by the owner, that is, the state -- will have a potentially powerful role in determining the direction of the firm (though it will not appoint the managers).

On the question of production forms, since 1988 the state has tolerated the formation of nonenterprise entities. These include cooperatives, leasing arrangements, "collectively owned" enterprises -- in essence, worker-manager buyouts -- "small" enterprises employing low numbers (which thus escape certain regulations), and "limited" companies. These nonstate enterprise forms are quasi- or semi-private in nature. They are growing in number and in economic, financial, and social importance. There are reported to be 215,000 cooperatives in operation as of October 1990, employing 5.2 million people. One Soviet source asserted that cooperative production accounted in 1989 for 5 percent of GNP; he estimated that they would account in 1990 for 8 to 10 percent. It is reported that for the period June 1989 to June 1990 employment in cooperatives increased by 70 percent, while output went up by 130 percent. Another source said there were 12,500 leasing arrangements officially registered.

It is reasonable to think that similar or even higher relative employment and output figures apply to leasing operations and the growing number of "collectively owned" firms, though these latter types are far less numerous than the slightly older cooperatives. (Because of their lengthier history and the availability of information, the discussion below uses the example of cooperatives; the surmise is that their behavior reflects that of the nonenterprise sector as a whole.)

EFFECTS OF THE REFORMS

For the Soviet ministerial official, enterprise manager, or person in the street, the changes of the last five years appear major, indeed near revolutionary, when contrasted to the rigid centralism of the past. Many of the changes remain in the proposal stage and have not yet been fully effected, and data on the results of reforms implemented are fragmentary and inconclusive. Some ministries and firms report production increases; some do not. Overall industrial production has declined seriously in the past two years; whether because of or despite the changes is unknown. Nonetheless, this paper asserts that the changes are not sufficient to bring about large and sustained improvements in enterprise performance. What is the reasoning behind this assertion? First, with regard to enterprise autonomy, the announced reforms have not gone far enough; that is, they do not empower enterprise boards and managers to deal with the crucial set of parameters that determine
enterprise performance. Managers cannot now set output prices, and the debate over when they will be allowed to do so -- or even if -- is unsettled. They cannot hire or fire their management team and work-force. They cannot chose inputs, locate plants, or vary product lines and runs in accord with cost and demand structures.

Second, while the tolerance of new and different types of production forms is a more positive aspect of the reform process -- because in these entities assets are being put to more productive use and incentive wages and salaries are being paid to involved staff -- the promised "level playing field" is far from being established. Cooperatives, for example, pay higher prices -- sometimes by a factor of 10 -- than state enterprises for many inputs, much higher taxes on corporate profits, and far higher duty levels on imports, reportedly to the point where few cooperatives now import inputs of any sort. This systematic discrimination against the cooperatives adds greatly to their costs. Still, there is considerable evidence that they generally outproduce state enterprises. Cooperative authorities stated that their average costs as a percentage of revenues are one half that of enterprises, even though they pay (on average) double the state wage prevailing in comparable industries.¹ The reason offered is that people in cooperatives work "better, harder and longer."

Soviet cooperatives (and the other nonenterprise forms of production) are attractive to entrepreneurial officials and managers in state enterprises, who see a chance to evade bureaucratic controls and amass wealth; to workers attracted by the higher pay scales; to state enterprise directors who increasingly rely on cooperatives and leaseholders to produce inputs or finished goods that their regular work-force or suppliers cannot or will not make; and to liberalizing intellectuals who see the nonenterprise forms as eroding the monolithic command system and launching the market mechanism.

However, the cooperatives (at least) have a generally negative image among the populace as a whole. The public appears to view those in the service cooperatives -- which make up 63 percent of the total -- as speculators, gougers, exploiters; as people taking unfair advantage of the present unsettled circumstances to charge usurious prices and perhaps even manufacture shortages for high demand goods. In the production sphere the attitude is a bit less negative, though even here one

¹ As is discussed below, despite the claimed (and in many cases real) discrimination against them, some cooperatives are doubtlessly obtaining inputs at low or zero cost, through fraud or outright theft. Thus, this claim of generally lower costs to sales ratios would need examination in detail before it could be used as unequivocal support of the cooperatives' superior efficiency.
often encounters an attitude that the cooperatives consist of former nomenklatura who have found a way to enrich themselves by obtaining and using state assets at low prices.  

Detailed data on cooperative formation, location, and operation are sketchy. One industrial branch ministry visited comprised a total of 401 enterprises, of which: 370 were state enterprises, 28 were lease arrangements, 2 were independent cooperatives, and 1 was a joint stock company. But, in addition, the ministry's enterprises contained 55 "small enterprises," and some 361 cooperatives "within the framework of enterprises." Some managers interviewed (in other ministries) were somewhat reluctant to speak openly of the cooperatives in their organizations. When asked about cooperatives in his firm, one general director noted: "I don't tell anyone but we have quite a lot. Practically every employee is in this cooperative or that." It is clear that these quasi-private forms are numerous within state enterprises, and that they are spreading rapidly.

In the past the emphasis on equality, combined with a need to limit growth in ministerial wage bills in order to minimize budget deficits, created a system of very small wage differentials between firms or professions. Still today, enterprises whose wage bills exceed a stipulated percentage of revenues are subject to a confiscatory tax on the excess. But the tolerance of quasi-private production forms creates a large incentive for workers and managers to organize themselves in this manner, since they escape the wage restraints. Enterprise managers either allow their production units and work teams to form cooperatives or leases, or face the prospect of having their skilled, experienced workers resign from the firm and seek cooperative membership elsewhere. Many enterprise managers mentioned this new and, for them, disquieting phenomenon. Thus, in order to retain the best portion of the work-force and to maintain production, managers either actively assist, or at least turn a blind eye to, the formation of the quasi-private forms. (It should be noted that the predictable macroeconomic impacts of this phenomenon -- large increases in average wages and an increased budget deficit -- are now very much in evidence.)

One possible microeconomic disadvantage of the quasi-private arrangements has already been mentioned; the likelihood, despite the cooperatives' complaints of discrimination, that they

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Not surprisingly, in all the nonenterprise examples reviewed, the driving force behind the creation of a cooperative, a lease, or a buyout was a well-placed manager or official who perceived an opportunity, and persuaded the workers that a change in status was in their self-interest.
are obtaining some or much of their inputs from the state at excessively low or zero cost. An even more fundamental problem is that, as yet, none of the quasi-private forms create real owners of all the capital they work with. A lease group may, over time, come to own the tools, trucks, and so on, that it uses in its work, but by definition it does not own the full range of assets it deals with. The production cooperatives often work in much the same way.

The "collectively owned" enterprises come closer to a capitalist conception of private ownership, but in none of the buyout cases encountered could one find any capital involvement or risk on the part of the new owners. Rather, they "purchased" the assets by turning over to the parent ministry the reserve fund of the enterprise in question (with the price of the enterprise being the depreciated book value of the firm -- a method which may be systematically undervaluing the value of the assets). Further, it seems that there is no leverage in these buyouts, which would at least impose a debt discipline on the new owners. In the vast majority of transactions so far concluded, there has been a cash transfer from enterprise reserves and no debt incurred. Most of these quasi-private firms will in all likelihood perform better than state enterprises, and some of these new owners will undoubtedly perform well by the most rigorous of economic standards. But the fact remains that those in the quasi-private sector are not at risk. They will not suffer personal loss (other than having to find a new job) if the firm is decapitalized or goes bankrupt; they are still mainly using other peoples' money.

This is the prime reason why the ownership reform process must be deepened. In order to achieve large-scale, enduring efficiency and production enhancing effects, the Soviet government(s) must move beyond the quasi- or semi-private forms of production and embrace full private ownership. This will entail changes in legislation and indeed more; it will necessitate changes in economic philosophy.

Such a major shift will not be easy. Unlike other reforming socialist economies, there is in the USSR no portion of the population that retains direct memories of a functioning capitalist system. The level of exposure to the principles of the

3 The USSR Union of Lessees is aware of this problem. Officials of this organization made the point that 75 percent of existing leases contain an option to purchase for the lessee. The Union has asked the government to grant this option to the remaining 25 percent, and to include an option to buy in all future lease contracts. No data are available on how many lessees have already exercised their option, but the Leningrad branch of the Union said that "many" of their members had done so.
neoclassical approach to economics is lower, even among reformers, than elsewhere in Eastern and Central Europe. For example, a fair number of officials encountered claimed to support fully the free market approach, but when asked what should be done to solve a particular problem, tended to respond with an interventionist, state-dictated solution. An egalitarian ethic appears to have taken firm root in the Soviet political culture. Citizens seem more concerned with relative differences in wealth than with improving the general level of opportunity. Overriding these factors is the question of to whom, to what level of government, do the assets found in state enterprises actually belong? The resolution of these issues is urgently required, so that the process of privatization can move forward.

**PRIVATIZATION OF ENTERPRISES**

**WHY PRIVATIZE?**

The optimal and ultimate solution to the problem of poorly performing public enterprises -- particularly those producing tradeable goods and operating in competitive or potentially competitive markets -- is to privatize them. By privatization is meant the sale or transfer of a majority portion of the shares in an enterprise from a public entity to a private -- individual or group -- owner.' Private owners of capital have the most appropriate and powerful set of incentives to provide or employ competent management in the firms, and at the same time to watch over the long-run health of the assets. The performance of enterprises can often be improved under public ownership, but privatization appears to be the most effective way to "lock in the gains." That is, privatization does not in and of itself cure the disease of poor performance, but it does help in preventing a recurrence of the problem. Finally, under purely private ownership, in those cases where wrong decisions on the part of the owners and managers lead to insolvency and bankruptcy, the losses are private, not social; and poor performance acts as a signal for competing entrepreneurs to step in, acquire the assets, and try to put them back to productive use.

Some analysts use the word privatization more broadly to refer as well to lease arrangements, management contracts, the private purchase of a minority block of shares, and so on. Here the word is defined narrowly; it means to move to majority private ownership of the enterprise.
PROPOSALS UNDER CONSIDERATION

In the Soviet Union, in comparison to every other country (save perhaps Albania) in Eastern and Central Europe, debate on these issues is not well advanced. Why is this? First, the quasi-private production forms in operation in the USSR appear quite novel, advanced, and perhaps even adequate to many actors in the enterprises. Second, the lack of a legal foundation for full private ownership (land ownership, for example, remains expressly prohibited) is a serious obstacle to further practical reform. Third, there is little understanding among Soviet officials or citizens concerning just what private ownership is or entails; thus, even the most radical reform plans produced seem sometimes to confuse steps on the road to privatization with privatization itself. For example, there is a tendency to equate turning an enterprise into a joint stock company with privatization.

Some thinking is taking place on privatization mechanics, but the major and prior question of how enterprise ownership will be distributed among the levels of government -- Union, republic and local soviets -- has first to be resolved. Most of what concrete thinking exists is taking place at the republic and local soviet levels. Officials interviewed in one republic stated that privatization would begin in its territory on November 1, 1990; that the process would apply to all enterprises apart from some defense and strategic industries such as machine tools; and that "everybody" -- presumably meaning all citizens in the republic -- would be given 3000-4000 rubles worth of shares. (None of this took place.)

No other meeting yielded such specific statements. Most persons interviewed generally supported the concept, but they were quite uncertain as to when privatization would begin, the number or type of enterprises to which it would apply, whether the firms would or should be sold or given away, and how either one of these approaches would be carried out. Many officials vaguely thought that a cautious plan would be adopted, whereby enterprises would first be turned into joint stock companies. Their shares would then be sold to banks, enterprises, and other institutions. If this sales experience proved beneficial, sales or giveaways of shares first to the work-force, and then to the general public, would be considered. This complex process would obviously take some time to unfold. In general, there appears to be insufficient thinking about the specific mechanics of privatization, and in particular, on whether or how the population at large should be involved in the process of ownership change.

Some local officials interviewed, in both Moscow and Leningrad for example, assumed and asserted that a substantial percentage of enterprises located on their territories would be
theirs, to dispose of as they saw fit. One local soviet offered the following program for privatization:

- Enterprises would be transformed into joint stock companies and their assets valued by a Special Commission of the All-Union Ministry of Finance (asset valuation on the basis of depreciated, not-adjusted-for-inflation book value).

- Enterprises selected for sale (there was no mention of a giveaway) would first be offered to the existing "collective" -- the workers, technicians and managers in the firm; they, or any purchaser, would buy the enterprise but only long-term lease the land on which it stood.

- The members of the collective would use their own savings for the purchase, but if more funds were needed banks would become involved; and these banks would receive shares in the enterprises for their funding of the collectives' buyouts.

- If a collective did not exercise the option to purchase within six months, the enterprise would be auctioned to Soviet legal entities, meaning private individuals or groups, or other enterprises.

- Priority in the auction would be given to certified residents of the local soviet area, regardless of their area of origin within the USSR.

- If no suitable offer were made by a local resident, then the firm would be offered to any citizen of the USSR, regardless of area of residence.

- If no suitable offer were made by a Soviet citizen, then the enterprise would be offered to foreign buyers.

These proposals of the republican and local officials are revealing. They indicate a lack of an agreed-upon approach to privatization, a very optimistic view on the availability of paying
purchasers, both domestic and foreign, and an equally rosy assessment of how easily the process can be organized. In the main, they seem aimed more at minimizing political opposition than maximizing financial and economic returns. The notion of offering the enterprise first to its collective, and only broadening the market successively as preferred buyer groups decline the purchase option, is an illustration of this: the approach may make sense politically, but it sacrifices possibilities of raising revenues from the sale, and it relegates to the background the critical issue of bringing in managers and investors with needed experience and fresh capital.

In Yugoslavia, Poland, and Hungary, enterprise-controlling workers councils have established claims or rights that severely complicate the privatization process. The difficulties of resolving these claims, combined with widespread fears that uncontrolled or what has been termed "spontaneous privatization" was resulting in illegal and unjust transactions, has complicated, slowed, and sometimes halted divestiture efforts in those countries. In the USSR, workers councils have not had as much legal power, nor have they exercised what powers they possess for a lengthy period (since 1987 only). Soviet workers do not seem to have developed as strong a sense of ownership rights as workers in the three countries mentioned. However, as noted, a number of voices are now advocating giving, free of charge, the enterprises to their existing collectives. This position is, not surprisingly, finding a receptive audience among workers.

Some managers and ministries expressed a view that the Soviet experience with "free" property has been disastrous, and that any and all transfers of ownership must involve payments. To add to the concern, there is considerable and growing public unease over the supposed illegalities and perceived inequities of the quasi-private sector. But all of these discussions are preliminary and unsettled; they have not yet reached the stage of deliberation found in the three countries named above -- or Czechoslovakia or Romania for that matter. Unlike elsewhere, there is very little substantive discussion of mass distribution mechanisms; i.e., of "voucher schemes," "ownership coupons," or widely-held holding companies. The reason for this is that discussion of the extremely unsettled situation between the Union and the republics has taken precedence over consideration of technical details.

The issue of privatization techniques and mechanics will, however, probably soon come to the fore at the local soviet and republican, and perhaps at the All-Union level as well. If the notion of giving or selling enterprises to their collectives takes root, complaints will start to surface from the large number of people whose work positions would not automatically confer ownership rights under such a transfer system. These people include professionals, administrators, and intellectuals; that is, articulate groups. To assist in the process of formulating an
appropriate and workable privatization policy, and to minimize the possibility of disruptive disputes, Soviet authorities at all levels could profitably examine the experience in ownership change carried out or envisaged in neighboring reforming socialist countries, with a view to applying the lessons so far learned to the Soviet scene.

Even if the legal and policy frameworks were immediately settled and made conducive to sales, it would not be possible to sell 47,000 enterprises overnight. Indeed, it would be hard enough to give them away all that fast, even assuming that one could find competent people to take them. Nonetheless, many parts or bits of these enterprises could and should be divested with extreme rapidity. In Poland, many thousands of state owned small retail shops and service units were transferred to private owners -- usually those who had been working in the units -- in the course of a few months in 1990. Similar programs of "small" privatization are currently underway in Czechoslovakia and Hungary. Such activities were envisaged in the Shatalin reform plan; they could in many cases be implemented by local and republican authorities without waiting for the resolution of Union-republic relations. This process should begin as soon as possible.

PROBLEMS WITH THE QUASI-PRIVATE SECTOR

A critical question is whether and how to regulate the quasi-private sector. The dilemma is as follows.

On the one hand:

- The existing quasi-private sector appears to be more efficient and productive than the state enterprises.
- The larger it grows the more productive it will become.
- The more numerous the units within the quasi-private sector the greater the likelihood that competition, and all its attendant benefits, will emerge.

Therefore, the quasi-private sector should be unleashed: the bureaucratic barriers to entry in this sector should be eliminated, the discriminatory tax, credit, pricing and customs policies should be abolished, and the process of "hiving off" parts of enterprises, or entire firms, and turning them into quasi-private operations should be not grudgingly tolerated but actively encouraged.

On the other hand:

- Not being complete owners, the quasi-private operators may tend to reward themselves and their workers at the expense of the long-run health of the capital they employ.
The quasi-private sector has in many instances obtained the assets it controls for an excessively low price (sometimes zero cost), and this, as noted, may be a major reason for its higher productivity.

It often consists of enterprise employees doing at night, for a higher salary, that which they are supposed to, but do not, do during the day for their normal salary.

Through under the counter barter deals and outright corruption, some quasi-private operators are diverting a substantial flow of inputs to their own production needs, at the expense of the planned production schedules of many state enterprises.

Finally, a problem of a quite different sort is that the widespread negative attitudes of the public toward quasi-private operators in general, and service cooperatives in particular, could be used as a rallying point for conservatives who will wish to try to return to the administered security of the command system.

Therefore, the quasi-private sector needs to be regulated, to ensure that a reasonable price is obtained for state assets transferred, to minimize monopolistic practices of the quasi-private operators, to prevent other abuses so easy to perpetrate in an economy of acute scarcity and distortions, and to preclude the possibility of a backlash against what is perceived as theft and gouging. Faced with this dilemma, what should the Soviet authorities do?

The ideal response would be for the Soviet authorities, at the same time, to deepen and regulate the quasi-private sector. That is, they need to establish in law a full set of property rights that allows individuals and legal entities to purchase assets, including land, and to receive a legal, tradeable title to the assets bought. This by itself would open the floodgates to further and beneficial privatization transactions.6

6 It would not eliminate all remaining problems. For example, in a number of Soviet cities, it has become possible in the last two years to purchase the apartment in which one dwells. To date, few people have exercised the option. Why? Because the cost of housing is highly subsidized; the average citizen pays about 5 percent of total income for rent, heat, lights, and local phone charges. Since there has been no move or threat to remove the large degree of subsidy, there is little incentive to purchase an apartment. Indeed, there is a disincentive, in that obtaining the materials to effect repairs is both time consuming and expensive. Until the subsidy is removed and rents move
However, Soviet authorities also need a review mechanism to assure that assets and enterprises are being privatized in a transparent and fair manner. Other reforming socialist governments, facing similar problems, have established a State Property Agency, a Ministry for Ownership Changes or republican level Privatization Authorities (in Hungary, Poland, and Yugoslavia respectively). The purposes of these bodies are to see that the assets up for sale receive a valuation by someone outside the enterprise (other than the bidder); that the valuation method used is reasonable, consistent, and transparent; and that there is a process to examine the bidder's background, sources of funds and/or credit, and potential competence in running the enterprise. Finally, these government bodies either retain or share with legislatures the responsibility for the final acceptance or rejection of an offer. The divestiture issue is normally so sensitive that the grand questions must be resolved by the higher political levels; it is not a decision to be left to administrators.

All this sounds quite reasonable and straightforward. It seems to impose a tolerable minimum of review and control on an unavoidably contentious topic. The problem is that in Hungary and Poland, and elsewhere in nonsocialist countries, attempts to rationalize and regulate the privatization process have resulted in delaying it. That is, rather than make sales transparent and fair, regulation of this nature has slowed down divestiture, and sometimes brought the process to a halt. This is everywhere regrettable. But it would be particularly unfortunate in the Soviet Union, which is in desperate need of enhancing levels of efficiency and production, and where, to date, the quasi-private sector is performing comparatively well.

Thus, finding a way to promote the productive aspects of the quasi-private sector while preventing the chaotic grabbing of assets is a top priority. While recognizing the risks involved, I recommend that Soviet authorities tilt the scale in favor of deregulation, unleashing, and indeed actively encouraging the quasi-private sector. The reasoning behind this recommendation is as follows: First, despite the explosive growth of the quasi-

upward sharply, few Soviets will see any point in buying their apartments.

In capitalist countries the best general method for determining these factors is a bidder's willingness and capacity to pay a higher price than other bidders. This means that the larger the number of bidders in a sale, the greater the chances that the seller will maximize his objectives. This is another reason to be concerned over the suggestion in the USSR that privatization should proceed from narrow to broader markets.
private sector in the last few years, the state enterprise position remains absolutely dominant. Second, the chances are slight for diminishing this dominance through the channels of legal reform followed by the sale of individual enterprises. At the very least, this type of reform would take years to effect. Given these circumstances, the costs of the quasi-private sector's operations are outweighed by its production and efficiency benefits. Moreover, the larger the size of the quasi-private sector, the greater the possibility that internal competition will begin to mitigate its deficiencies.

The only alternative would be to wait for the resolution of the present political crisis, to wait for the promulgation of more appropriate laws, and then to wait for the definition and the implementation of a rationalist privatization policy. It seems evident that the wait would be interminable. It is preferable to support the growth of the quasi-private sector.

Still, some measures could be contemplated to guard against serious abuse. One possible mechanism would be to require existing branch ministries to review all quasi-private operations proposed in the framework of their enterprises, and to have the capacity to refer to republican and All-Union ministries of finance cases of dubious utility or legality. The branch ministries would not have any power to stop a proposed operation; rather they could only refer questionable cases to higher decision-making authorities. The idea is to avoid the creation of a licensing or administrative vetting agency with power to approve or disallow any proposal. Making every transaction or transformation reviewable by such authorities would create administrative delays and overwhelm the reviewers; better that they should review only questionable cases referred to them.

Another possible guarding mechanism might be to require all quasi-private operations coming into being to publish in the press a statement listing the names and addresses of the members of the cooperative, those involved in a leaseholding, or those participating in a "collectively owned" enterprise. The requirement would be to list the capital persons have contributed, the assets they have obtained, the price paid for those assets, the cash-debt ratio of the payment, and where the credit was obtained and under what conditions. This is a transparency requirement.

Some will argue that these proposals are too strict and constraining for quasi-private operators; others will see them as too lenient and permissive. It is difficult to find ways to both encourage and control the quasi-private sector. Whatever position the Soviets adopt, what they must not do is let the situation drift in its present unsettled manner.
IMPROVING ENTERPRISE PERFORMANCE

The private and quasi-private sectors may expand very rapidly, but given the present lack of clarity concerning basic policy, and the sheer number and weight of state enterprises, it is simply inevitable that the various levels of the Soviet state will -- temporarily or indefinitely -- remain responsible for a large number of firms. What can be done short of ownership change to improve performance in this mass of companies?

Two prefatory points: the first is that in both socialist and nonsocialist countries improvement efforts short of privatization have generally yielded only modest results. Nonetheless, it is possible to recommend a reform package that has a chance both of being implemented and of improving performance. The second is that, as noted, the Soviet authorities have already initiated a set of reforms; but these are reminiscent of efforts tried much earlier in other socialist economies, particularly Hungary and Poland, both in terms of the type of changes instituted and meagerness of achievements. To reiterate: the problem with past Soviet reforms is that they did not create an owner who could protect the capital employed; they did not formulate a limited set of achievable, commercial goals for enterprises; they did not provide sufficient autonomy to managers at the level of the firm, and they did not create mechanisms by which the representatives of the owner could monitor performance, reward success and punish failure. This, in essence, is what further reforms must do.

The achievement of these further reforms requires a number of interrelated steps:

- All state enterprises should immediately be transformed into joint stock companies. Their shares should be held by portfolio management agencies representing the owner of the enterprises.

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8 These portfolio management bodies might be called State or Republican Property Agencies, or that name might be reserved for the agencies in charge of the privatization process. Experience in other reforming socialist economies indicates that it is difficult to combine in a single agency the portfolio management and privatization responsibilities, regardless of how related the activities appear. The plural, agencies, is used because it is likely that both the political process and the overwhelming workload will necessitate a number of these bodies, probably at the republican level.
The owner's representatives should issue clear policy statements stipulating that enterprises will henceforth be run as profit-maximizing, commercial operations.

In conjunction with the introduction of price liberalization, a hard budget constraint should be imposed on all enterprises; that is, as prices start to represent scarcity values the transfer of government funds to the enterprises -- in the form of unjustified capital injections or credit at concessionary interest rates -- will end.

The notion of "noncommercial objectives" should be introduced. Most Soviet enterprises have long been burdened with noneconomic goals, including educating their workers and surrounding residents, providing health care for workers and surrounding residents, selling "socially desirable" products at less than cost, producing consumer items for which their technology and work-force are unsuited, and locating plants for regional equity rather than commercial concerns. In the future the assignment of such objectives to firms must be minimized. If the owner determines that there is both an acute need for such an objective to be filled, and that there is no superior, lower-cost alternative to the work being carried out by an enterprise, then such objectives may be assigned to an enterprise. However, their special nature must be noted in writing, the cost of carrying out these activities should be calculated, and the firm should be directly compensated for their fulfillment.

The performance of managers and workers should be evaluated on the basis of transparent commercial factors within their control. They should neither be rewarded for improvements in performance caused by shifts in exogenous variables, nor should they be punished for losses brought about by efforts to achieve the sociopolitical goals of the government/owner.

The owners' agents should guide and assess enterprises by naming the members and supervising the performance of the enterprise board of directors. Ideally, a majority of the board of directors should be drawn from the private sector; this is patently impossible in the present Soviet circumstances. Still, the boards could

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9 The type of board of directors suggested here may conflict with the composition of enterprise boards in the Law on Enterprises supposedly coming into force in January of 1991 (see above).
be composed of technical experts in the field of the enterprise's activity, of legal and banking experts, and of persons representing the firm's clientele, creditors, or suppliers.

- The board should have full power and capacity to appoint, evaluate, reward, and dismiss enterprise management. The owner has the same rights over the board, and in particular the chair of the board. The board deals with the enterprise; the owner deals with the board. The owner has no direct dealings with enterprise management.

- Enterprise management has the power to set output prices, hire and fire, and to determine product line and run, and plant location. Salaries and rewards for managers and board members should be commensurate with their talents and responsibilities. They should not be dictated by government pay scales.

- It is the board's responsibility, working with and through management, to establish and then monitor a formal system of annual statements of corporate intent, specifying the commercial objectives, clear targets against which performance shall be judged, a dividend policy, the noncommercial objectives imposed and their compensation, and details of the rewards or sanctions handed out if the objectives are -- or are not -- achieved.

- If managers fail to perform well -- in areas under their control-- they should be dismissed by the board. If boards prove incapable of eliciting good performance from managers, the boards should be dismissed by the owner. Conversely, good performance should be rewarded.

- In this schema, the role and powers of the branch ministries would be greatly reduced. Many of their responsibilities would be taken over by the portfolio management agencies, emerging commercial banks, and the revamped boards of directors. A possible organizational variation would be for the branch ministries to assume the portfolio management role; this is not the preferred solution.

This reform package has proven its capacity to effect substantial performance improvements in enterprise sectors to which it has been applied (for example, in New Zealand). There is much, however, in the above list of steps that the mass of Soviet bureaucrats and enterprise managers would find difficult to understand, much less enact. The very notion of an enterprise as a unit isolated from the larger "branch" in which it is situated, having a commercial life of its own separate from the interests of
the workers in the firm, succeeding or failing as its sales and prices fluctuate -- these are alien conceptions to many in the Soviet system. Even if one assumes that the lack of widespread understanding of these issues delays or complicates, but does not preclude a transition to this approach, there are many specific legal and policy preconditions that must be fulfilled, or issues that must be addressed, before the proposed enterprise reforms could take place. To list the most salient:

- Transformation of all enterprises to joint stock form assumes that the state is defined as the sole or controlling owner. This has not been easily accepted elsewhere in reforming socialist economies, and the issue is by no means resolved in Soviet law or thinking.

- Price liberalization has to precede the imposition of a hard budget constraint. If not, some good firms with output prices set below costs would disappear. The extent and pace of price liberalization has not yet been determined.

- Minimizing noncommercial objectives requires that legitimate social functions be undertaken by other bodies, either public or private. This issue is just beginning to be addressed.

- Turning management and supervision activities over to firm level bodies -- the board and the enterprise managers -- means finding a mass of people with the competence to take on these new and different roles. People with the requisite skills do not exist in the needed numbers.

The point in listing these issues is not to dwell on how difficult reform will be. Rather it is to show the interrelated nature of the reform process, and to shed light on the manner in which it might usefully be phased. For the matters under review then, step one is to specify ownership rights in law, step two is to liberalize prices, step three is to attend to the social safety net that will help those negatively affected by reform, and step four is to provide the enterprises with capable directors and managers. This paper addresses only the fourth issue.  

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10 For a consideration of the other steps, see the "Background Papers" to the Joint Study of the Soviet Economy, to be published in 1991 by the Organization for Economic Cooperation and Development.
ENTERPRISE MANAGERS: PERCEPTIONS AND REACTIONS

The bulk of higher-level enterprise personnel encountered were production engineers and technicians, not managers. They were more at home describing the design and quality of the items they produced than they were in discussing firm finances. Financial directors, both in the firms visited and in branch ministries had a better grasp of levels of profits, debt structure and types and amounts of government support. But even here there were several surprises: one financial director of a very large plant stated that annual average revenues of the enterprise were "a mystery" to him; while the financial director of another firm of 3,500 employees did not know the rate of interest the firm was paying on a 10 million ruble loan.

Every one of the managers met saw that the rules of the game had been altered. But rather than take steps to position themselves and their enterprises to deal with or take advantage of the changed set of rules, many were waiting to be told -- by the ministry, by other central authorities, by anybody -- what to do next. Management trainers interviewed said that a "wait to be told" attitude typified Soviet managers, who were previously not expected and are now generally not prepared to make decisions, to seize opportunities, and to be self-reliant. This assertion was backed by several ministerial officials, who said that the new system was fine for the bold and the brave, but made more difficult the life of the average manager.

Nonetheless, a number of managers and ministerial officials encountered perceived possibilities in the unsettled, flexible scene, and were taking positive steps to position themselves in order to survive, and perhaps even thrive, in the emerging environment. One manager, for example, was using a newfound latitude on paying workers to form "flexible production teams" in his assembly plant. This method allows core teams of workers to determine the pace of production and the number of supplementary workers to be brought into the team. The teams choose how many people to involve and how many hours to work, and they are rewarded financially for quantity and quality of production and cost-minimization measures. This, and several other incentive systems linking significantly higher pay with higher individual or small group output, is very new in Soviet firms. The initiating manager noted that workers in the teams earned 2.5 times the average wage, that there was keen competition to join the teams (the foremen are told to take only the best), and that by allowing him to start such teams he now had a way to compete with the cooperatives.
A number of other managers encountered are going further (without crossing the line and joining the quasi-private sector). There is a generalized and almost feverish effort on the part of innovative managers to involve a foreign partner or investor in their operations. There is considerable wishful thinking in this on the part of managers who hope to find market access and hard currency capital through foreign participation in their enterprises. But they generally have unrealistic estimates as to the interest and willingness of Western firms to invest in domestic operations, and most of the goods produced are not competitive in hard currency markets. In a few cases -- machine tools, for example, where firms attach Western-made controls to a Soviet chassis -- jointly produced items are selling well in the West.

The point is that the reaction to the unsettled but clearly altered rules of the game varies greatly from ministry to ministry, sector to sector, company to company. Several ministries visited announced intentions to turn themselves from allocative central planners and policemen of production quotas to sector policy analysts, facilitators of contacts with foreign firms, investors and buyers, and centers for sectoral research and development. A few ministries have already changed their names, from the All-Union Ministry to the All-Union Committee on Light Industry, for example. One innovative Minister announced his intention to turn his ministry into a joint stock company, owned by its constituent firms, obtaining its revenues purely by selling services to the enterprises, and competing with other providers of the same service, public and private -- no firm would be required to use the services.

Still on the positive side, some managers met were eagerly awaiting joint stock company status so as to sell shares (in the first instance to banks and other enterprises) and raise capital. One firm visited held shares in a foreign industrial firm, had sent several hundred of its workers abroad for training, and was paying for the training by having the trainees work part time in the very plant in which they held shares. Contacts with Western financial and business organizations are booming and intensely sought after. Many enterprises are tapping their flush social development funds and enrolling, at firm expense, their middle-level managers in one of the many new management training centers. In short, there is a great deal of positive activity taking place, as the more spirited managers and officials respond to the limited degree of autonomy they have been awarded, and try

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There reportedly exist more than 120 private management training institutes, schools, and centers in the USSR, ranging from very inexpensive and unstructured weekend courses, to 20,000 rubles-a-year Masters of Business Administration programs, complete with foreign teachers and internships in Western firms.
to envisage what the next openings will be so that they will be in a position to profit from them.

Some are not responding. Many officials met deplored the instability and chaotic nature of the present situation. They said they would not attempt to convert their enterprises to joint stock form until there was complete clarification on the legal front. They defended the need for certain sectors to continue to receive allocations from the planning system. They insisted that private owners have only a short-term view which must be balanced by the long-term view of the planners. A few were hostile to any notion of privatization, and a number said that limits on enterprise freedom and behavior were desirable and necessary. One official went so far as to characterize the changes of the last few years as the result of a "temporary euphoria" which would soon dissolve. These attitudes constitute a considerable obstacle to a transition to the market.

RECOMMENDATIONS

In these circumstances, what can be done to improve the quantity and quality of managers and board members? First, with regard to the training of managers: the highest management levels are already relatively well served. They have increasing access to a number of courses that expose them to the practices and approach of Western private business firms. This is all well and good; design, marketing, advertising, cost-effective production techniques, and issues of quality control are basic themes in Western business, and they have been largely ignored in Soviet industry. The efforts underway aimed at highest managers and their closest deputies thus deserve support and expansion.

However, the main areas requiring improvement are at less than general director level. The installation of a business orientation in firms cannot be the task of one chief executive officer or a few leaders. Large numbers of middle and lower level managers must understand what is at stake in the changed environment. They will need training, not so much in an academic, MBA-type approach, but more in the manner of the internal training provided in Western firms. It can be seen at once that this is an enormous task; no matter how few people an enterprise picks for training, the total number will be very large, given that the multiplier is between 47 and 55 thousand.

To facilitate the management improvement process, the Soviet authorities, at all levels, should take advantage of the experience accumulated by other reforming socialist economies, and the technical assistance and training agencies that have been working in these countries. The Soviet authorities should inquire of the Polish and Hungarian governments as to the methods they have
devised or applied to turn civil servants who were receivers of orders into managers who seize opportunities. Particularly useful from the enterprise perspective is the Polish "company doctor" program. Working with a private management consulting firm, the Poles are training teams that make a rapid triage of enterprises, dividing them into the comparatively healthy, the hopeless -- and thus candidates for liquidation -- and those which, after restructuring, could be sold or perform efficiently. While the thought of launching a similar process in the massive number of Soviet firms is daunting in the extreme, first steps have to be taken.

The Soviets should also expand and deepen their contacts with the multilateral and bilateral funding and assistance agencies such as the Organization for Economic Cooperation and Development, the International Monetary Fund, the European Bank for Reconstruction and Development, the World Bank, and the British Know-How Fund, all of which can offer information, advice and -- either now or in the future -- grant or loan financing to undertake studies and hire consultants, technical assistants, and advisors.

The Soviets might consider the use, perhaps at first in a few pilot or experimental enterprises, of management contracts. These would entail hiring managers, or entire management systems, from abroad and turning over selected firms to their direction. If the authorities were able to grant the hired managers nearly complete latitude, and if the contract contained appropriate and sufficient incentives for good performance, then the Soviets might gain expanded production and more internal efficiency in the contracted firms, plus a substantial amount of practical information on what they had to do, and how to go about it, in other enterprises. One could go further: in the innovative New Zealand enterprise reform program, it was decided to abolish citizenship requirements for enterprise chief executive officers, and to recruit internationally for these posts. At present, several New Zealand public corporations are headed by noncitizens, who frequently come from the private sector (they are paid accordingly).

Finally, the Soviets should seek assistance for, and set about the creation of, a training program for members of boards of directors. This would be necessary if the approach suggested above is adopted, but it would also be needed to make effective the "enterprise boards" supposedly coming into being in January 1991. Indeed, all members of all supervisory boards, of whatever type, require instruction on the objectives of the owners, the functioning of the firm, the rights and duties of the board, and the information that has to be submitted to the board and how to interpret it.
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