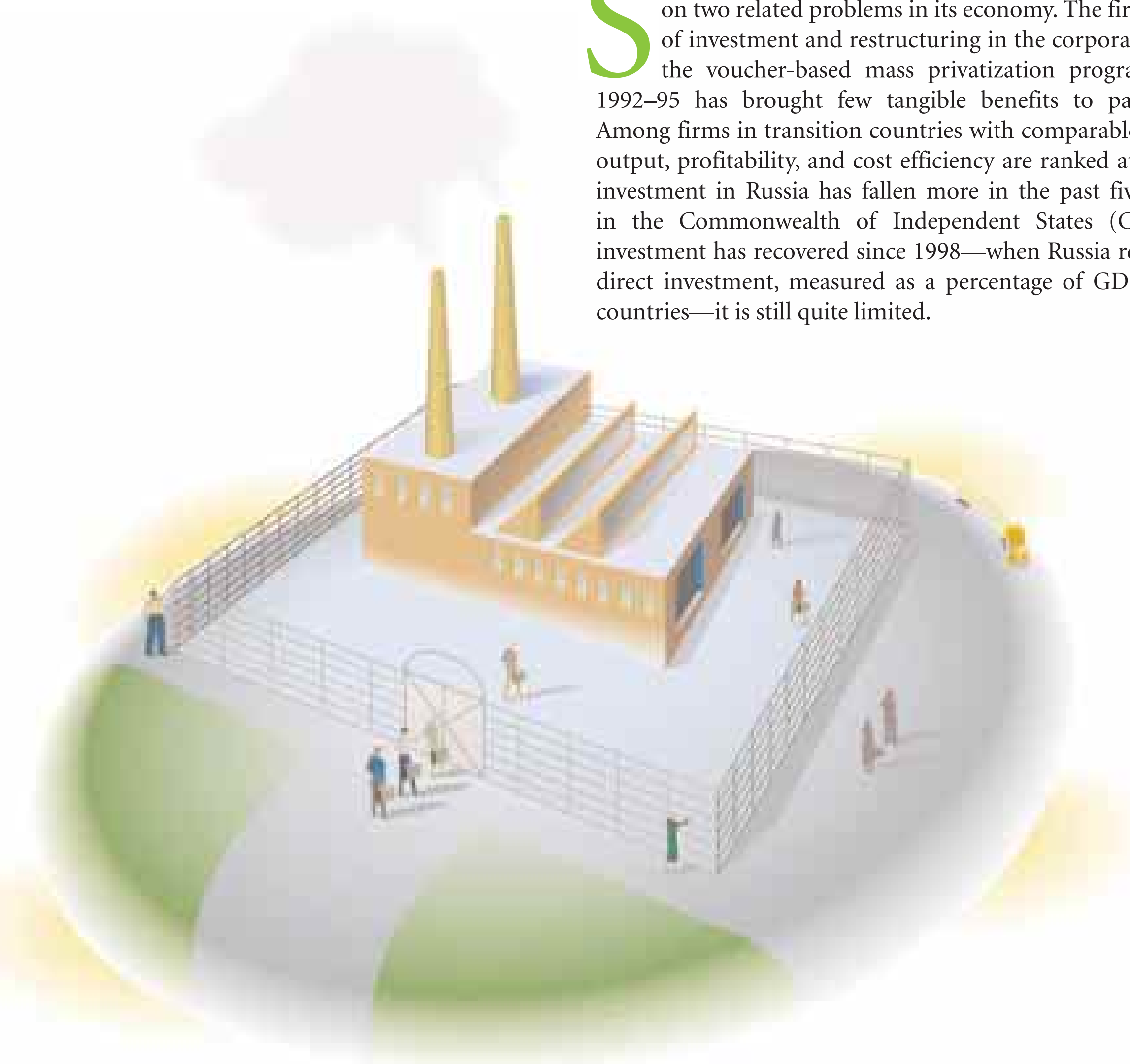
Stakeholders, Governance, and the Russian Enterprise Dilemma

Over the past decade, Russia's efforts to achieve economic growth and restructure its economy have been seriously hampered by a dearth of investment and the proliferation of barter and arrears. Given current conditions, how might Russian economic reform efforts best be supported?

Raj Desai and Itzhak Goldberg

SINCE Russia's August 1998 financial crisis, much attention has focused on two related problems in its economy. The first is the continuing lack of investment and restructuring in the corporate sector. In this regard, the voucher-based mass privatization program undertaken during 1992–95 has brought few tangible benefits to participating enterprises. Among firms in transition countries with comparable wealth, Russian firms' output, profitability, and cost efficiency are ranked at the bottom. Domestic investment in Russia has fallen more in the past five years than elsewhere in the Commonwealth of Independent States (CIS). Although foreign investment has recovered since 1998—when Russia received the *least* foreign direct investment, measured as a percentage of GDP, among *all* transition countries—it is still quite limited.



The second is the "virtual" economy (see Gaddy and Ickes, 1998). As enterprises have shifted en masse to barter, mutual nonpayment, and money surrogates, such as promissory notes (*veksel*), tax authorities have been forced to collect in-kind tax payments. Although nonpayments and barter declined during 1999, there remain large amounts of debts between firms, wages left unpaid, fiscal obligations unfulfilled, and barter-based transactions.

The epidemic of nonpayment and the absence of corporate restructuring have been blamed on the federal government's inability or unwillingness to enforce strict tax and bankruptcy policies. Nonpayments, according to this view, are the result of substantial forbearance by tax authorities toward enterprises' accumulation of arrears. Similarly, Russia's unfavorable investment climate is seen as a consequence of the lack of credible investor protection. Those who fault lax enforcement of payment obligations or weak shareholder protection, however, are only half right. Ultimately, one must ask *why* the construction of the institutional apparatus required to ensure payment discipline and investor protection in Russia has proved to be such an intractable problem for so long, despite the country's having received the best available advice and millions of dollars in foreign aid. To provide a complete answer to this question, one needs to address the issue of distorted incentives for two important stakeholders in the Russian economy—owner-managers and regional governments—and the system of enterprise property rights that has preserved firms as, above all, a source of rents.

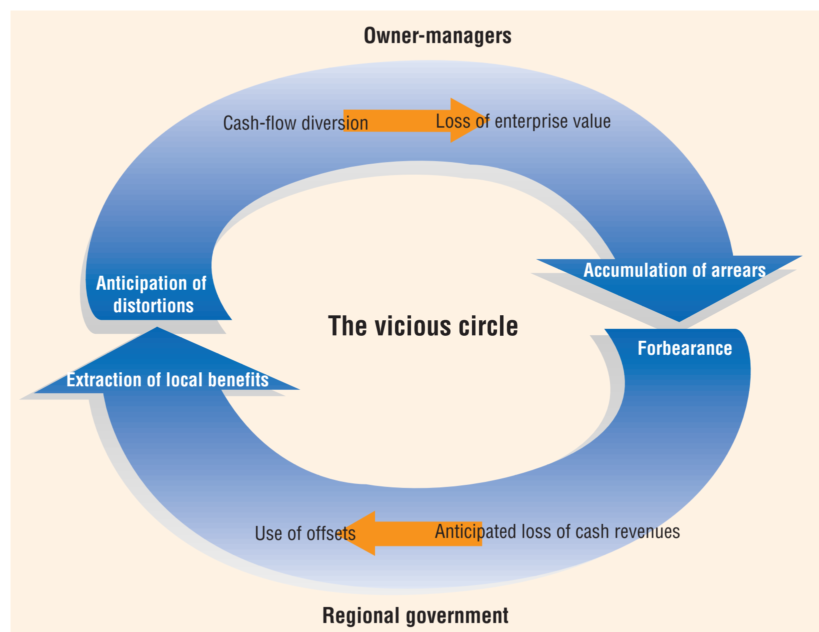
What happens when managers are owners

No external monitoring should be needed in an enterprise wholly owned by those who initiate and implement decisions, provide the financing, and bear the residual risks (and returns) associated with those decisions. How, then, can one account for the seemingly puzzling behavior of owner-managers in Russia who, in stripping assets from the firms they own, appear to be stealing from one pocket to fill the other?

The problem of corporate governance in Russia is not limited to protecting minority shareholders or other financiers. Rather, it involves the insufficient incentives owner-managers have to restructure firms and maximize their value over the long run. First, owner-managers perceive their titles to firms as uncertain, temporary, and subject to expropriation. With short time horizons, their expected gain from increasing firms' value and share appreciation is less than what they can obtain by stripping assets. Second, maximizing value is a reasonable long-term objective only if that value can be realized through the sale of the ownership rights in enterprises. Given the illiquidity of Russia's relatively undeveloped capital markets, both public and private, firms rarely change hands and managers therefore have little incentive to increase the firms' value.

Third, because dividends are taxable and have to be shared with other stockholders, mainly employees, owners have been more inclined to withdraw cash from their enterprises by requesting reimbursement for fictitious expenses or engaging in other types of theft. Even in those enterprises where only a minority of shares are held by management, managers use a variety of techniques to ensure that they have de facto control. They have often taken to (illegally) imposing bans on the selling of shares to outsiders, placing limits on share ownership, and using implicit threats against workers who violate these policies. Insider control is so entrenched that outside investors have little confidence that they will be able to take control of a firm even if they buy a significant portion of its shares.

While the original rationale for Russia's rapid privatization was to prevent asset stripping by managers in state-owned enterprises, owner-managers of privatized firms have significantly degraded their firms' assets. Efforts made to limit this asset degradation have, in recent years, been successfully blocked by a coalition of enterprise insiders and regional governments, together with their allies in the lower house of the Russian parliament, the Duma. They have subsequently been able to maintain the rents (and the opportunities for theft) generated by the mass privatization program and the subsequent "loans-for-shares" privatization scheme, which effectively gave away shares in major companies to a new class of oligarchs.



Regional governments exert influence

As the central institutions that govern the Russian economy have ceded their powers to the regions, regional administrations have seized these powers in a bid to maintain the operations of important local enterprises, as well as to protect the local workforce. Although the Russian federal government has long since given up attempts to intervene in company management, regional governments have continued to exert a strong influence over the actions of key enterprises, regardless of whether they have been formally privatized. Local authorities have the means to discipline disobedient managers by, for example, subjecting them to troublesome fire, safety, health, and other inspections. More directly, regional and municipal governments may effectively ban companies from laying off excess workers.

Anticipating such interference, managers have often engaged in a preemptive diversion of cash flows. The regional governments, knowing that the taxable revenues of firms will have been reduced by cash-flow diversion, respond by collecting revenues in kind from profitable enterprises while tolerating tax arrears from loss-making firms in order to maintain the latter's employment levels. These regional governments shield insiders from takeover attempts, obstruct the enforcement of outsiders' property rights, and perpetuate the system of using enterprises as sources of private benefits for managers and local officials, and sources of social and political benefits for the region (see chart on page 15).

Barter and arrears as tools of control

The system of nonpayments and noncash settlement, in the current environment, constitutes a useful instrument of enterprise control for both regional governments and insiders. Subsidies can be provided to favored firms in the form of preferential tax treatment, "discounts" on utility bills, and preferences in public procurement, all of which are intended to prevent companies from shutting down and laying off employees. These put potentially productive companies at a cost disadvantage, blocking their investment and growth.

While tax arrears constitute subsidies by regional governments to firms, there is reason to believe that barter is driven by insider control. The Russian system of taxation and payment (characterized, for example, by the freezing of bank accounts) has been frequently cited as a key rationale for barter. If this explanation were true, Russia would have been something of an anomaly. Excessive and arbitrary taxation in middle-income countries, while likely to promote financial disintermediation (cash is preferred to bank balances, because the former is less traceable than bank transfers and checks, and thus banks have less money to lend than they would if incentives for tax evasion were not as strong) does not necessarily prompt barter. In Russia, as the State Tax Service has taken to deducting tax payments directly from ruble bank accounts of debtor firms, the latter have used offshore bank accounts whenever they have needed to carry out cash transactions.

Barter is a consequence of failures in 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 also from minority shareholders (and, indeed, even passive shareholders such as employees). Noncash settlements enable owner-managers to degrade assets and divert cash flows in a less transparent way.

Ownership and control are the key source of Russia's problem with its corporate sector, and the solution *cannot* be simply to enforce hard budget constraints and antimonopoly rules; instead, it must be to change the system of property rights that *provides* the incentives to which the insider owners of firms respond. Those who argue that changes in enterprise ownership will have no effect until hard budget constraints and payment discipline are ensured have the sequence reversed (see World Bank, 1999). In the Russian economy, both nonpayment and barter are—in addition to allowing insolvent enterprises to remain in operation—used by enterprise insiders to preserve their power through opaqueness and fraud, and tolerated by regional governments that derive political benefits from firms. Payment discipline cannot be improved unless significant parallel changes are made in the incentives for owner-managers and regional governments.

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Need for selective ownership transformation

The last link in the property-rights-enforcement chain, of course, is bankruptcy, through which enterprise ownership is passed to creditors. Improved Russian bankruptcy procedures put in place since 1998 have greatly facilitated the reorganization of insolvent companies. In practice, however, there are three critical problems in relying upon bankruptcy procedures to initiate ownership transformation:

• ***Creditor coordination is difficult to sustain.*** Bankruptcy is usually a collective problem: all creditors must share the costs of the bankruptcy proceedings and agree on external management and other matters.

• ***The capacity of the judicial system is limited.*** Ownership transformation based on bankruptcies will ultimately rely on the country's courts—the resulting cases can place a significant burden on an already overloaded judicial system.

Investment-based ownership transformation: A pilot program for Russia's regions

The following proposal for transforming the ownership of Russian firms assumes the existence of a pool of privatized companies in which the managers and the employees combined typically own a plurality of voting shares, while the remainder is in the hands of the federal and/or the relevant regional government. The transformation would entail taking the following steps:

(1) A regional government receives a technical assistance/institution-building loan from a multilateral donor to hire an investment brokerage firm. The firm selects a pool of companies, each of which meets the following criteria: basic economic viability, accumulation of at least a specified minimum amount of tax arrears, and the existence of a prior agreement between the regional tax authorities and the firm's owner-managers 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 tax 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 firm to, in effect, "reprivatize" the selected pool of companies. The formula for compensating the investment brokerage firm is based on a fixed fee that covers the expenses of valuing the whole pool of companies plus an additional fee for each company successfully resold.

(3) The selected investment brokerage firm conducts a tender for the sale of the pool of companies. The tendered value of these companies would provide a benchmark rate for converting the tax debt into equity, and the bids received would, in effect, represent the market valuation of this rate.

(4) The investment brokerage firm, as part of the sale of the privatized firms' shares, would assist in converting their outstanding tax debts into equity. The conversion would take place only as part of the transaction.

(5) Given the layoffs that are likely to follow 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 could be financed by an international financial institution).

In this example, all debts converted into equity are held with the tax authorities; left out of such conversions are 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 sales of shares being divided pro rata among all the claimants. The control of local governments over suppliers—mainly the distribution companies—could help in coping with the creditors' coordination problem, referred to earlier in this article in the discussion of bankruptcy. It is advisable for all claims to be converted and sold simultaneously, in order to avoid the unintentional dilution of a buyer's expected ownership shares. We have also avoided distinguishing between levels of government. Although a large proportion of total tax arrears is currently held with the federal government, these debts are less likely to be collected than firms' debts to regional governments. The investment-based ownership transformation will have to include agreements between federal and regional creditors about offsetting these debts in the context of the continuing fiscal relationship between the two levels of government.

• ***Bankruptcy is disruptive.*** If creditors fail to reach an amicable agreement, regional authorities may be discouraged from liquidating firms in order to change their ownership.

Alongside a bankruptcy regime, however, a market for corporate takeovers constitutes a parallel mechanism for enforcing property rights. Given the entrenchment of insiders in Russian enterprises and the low probability that bankruptcy rules will encourage changes in ownership in the short term, ways to encourage the development of the takeover market should be seriously considered. 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 the residual holdings of governmental authorities, would constitute significant percentages of share capital in several cases.

There are two major pitfalls to such an approach: "investor capture" and "governmental capture." On the one hand, the risk of investor capture is simply that ownership transformation will, once again, open the door to rent seeking by current enterprise insiders eager to expand their control over productive domestic assets. As with the loans-for-shares program, ownership transformation will encourage investors whose connections to an enterprise are well hidden to submit inflated bids, thereby restricting competition for corporate control. On the other hand, governmental capture will occur if ownership transformation results in the renationalization of private enterprises. Piecemeal ownership transformation—by which a governmental body converts tax debts into shares, then awaits an acceptable investor—can also encourage governmental administrators to restrict bidding to favored parties or to otherwise bias the auction of shares.

Consideration of these risks—capture by venal investors or by governmental authorities—implies that any transaction aimed at restructuring ownership must comply with two requirements. First, newly acquired equity must be

simultaneously sold to external investors. Partial renationalizations have occurred where shares acquired by governmental agencies were not sold—either because the agencies were unwilling to relinquish control or because no suitable investor could be found. Second, resulting shareholdings (comprising converted debt and residual shares) must be sold in a way that involves some degree of competition among prospective investors.

These requirements therefore pose a central dilemma for an ownership transformation mechanism. On the one hand, simultaneous conversion of debt to shares and the sale of the resulting shares can be accomplished only if there is a priori investor interest in the share purchase. On the other hand, if investor interest is needed before a conversion can take place, this will preclude a competitive auction.

How, then, can these requirements be reconciled? The short answer is by delegation. By transferring tax debts in trust to an investment brokerage firm or other third party, which will then sell rights to purchase shares prior to the debts' conversion, investor interest can be solicited while ensuring the openness of the transaction. The box on page 17 details this possible solution—a pilot program proposed for selected Russian regions. Once completed, an ownership transformation along these lines would accomplish three necessary reforms:

- it would transfer a cash payment to the regional authorities, thus settling all outstanding tax arrears to regional governments, allowing firms to be sold free of these tax debts;
- it would allow coalitions of outside investors to dilute the ownership of insiders; and
- if followed up with a coherent program of supporting social reforms—safety net building, displaced worker programs, and the like—it would encourage regional authorities to resist treating local firms as a source of rents and demonstrate by example 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.

This approach to corporate takeovers may be objected to on the grounds that it would provide managers with additional incentives to accumulate tax arrears or that it would prevent creditors from fully exercising their rights under the existing bankruptcy law. The first objection presumes that ownership transformation is an easy exit for managers, but it is not. Tax arrears are to be converted, not forgiven, on a case-by-case basis in transactions where managers will lose ownership in proportion to the amount of their firms' unpaid taxes. Regarding the second objection, ownership transformation would be applied only to state debts—private creditors' rights would not be infringed upon.

Conclusion

Critical analyses have questioned whether the corporate-sector problems brought about by the Russian mass privatization program can be corrected. An authority on public sector reform and privatization has argued that reformers and multilateral lenders alike should abandon speed as a main priority in enterprise reforms and shift to slower, more carefully prepared transactions conducted on a case-by-case basis (Nellis, 1999). Toward that end, the proposed pilot aims to create, from the bottom up, a climate in which new investment is brought to firms trapped in a vicious cycle of decreasing capitalization, increasing arrears, and endemic corruption.

The proposition that conventional liberal reform will provide benefits in the long run will not be sufficient to persuade vested interests to change the status quo in Russia. Nor will pressuring the Russian authorities to enforce the "rules of the market" yield better results. Rather, the central challenge lies in building constituencies for reform by supporting new private firms and reform-oriented regional governments so that they can lobby, persuade, or circumvent the coalitions that support existing economic distortions. F&D

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Raj Desai is Assistant Professor of International Development at Georgetown University's Edmund A. Walsh School of Foreign Service.

Itzhak Goldberg is Lead Specialist in the Finance and Private Sector Development Unit of the World Bank's Europe and Central Asia Regional Office.

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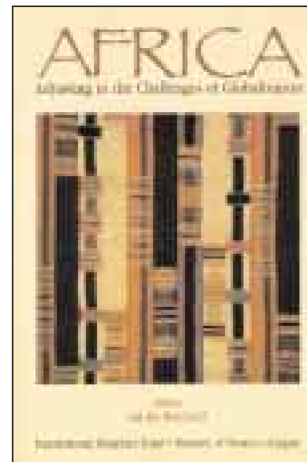

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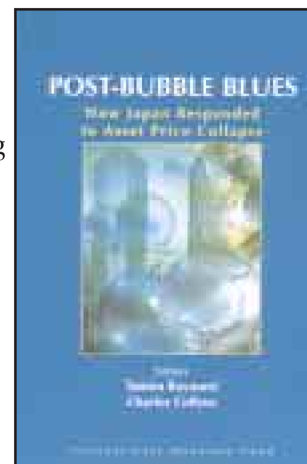

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