Russian Privatization and Corporate Governance: What Went Wrong?

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Abstract

In Russia and elsewhere, proponents of rapid, mass privatization of state-owned enterprises (ourselves among them) hoped that the profit incentives unleashed by privatization would revive faltering, centrally planned economies. Instead, the Russian economy has shrunk steadily since 1991 and suffered a major collapse in 1998, which exposed deep structural flaws in the privatization effort. We offer here some partial explanations. First, rapid mass privatization of medium and large firms is likely to lead to massive self-dealing by managers and controlling shareholders unless (implausibly in the initial transition from central planning to markets) a country has a good infrastructure for controlling self-dealing. Russia accelerated the self-dealing process by selling control of many of its largest enterprises cheaply to crooks, who got the funds to buy the enterprises by skimming from the government, and transferred their skimming talents to the enterprises they acquired. Second, profit incentives to restructure privatized businesses and create new ones can be swamped by the burden on business imposed by a combination of (among other things) a punitive tax system, official corruption, organized crime, and an unfriendly bureaucracy. Third, while self-dealing will still occur (though perhaps to a lesser extent) if state enterprises aren't privatized, since self-dealing accompanies privatization, it politically discredits privatization as a reform strategy and can undercut longer-term reform efforts. A principal lesson is that developing the infrastructure to control self-dealing is central to successful privatization of large firms -- as important, and in the early stages, perhaps more important than privatization itself.

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I. Introduction

Rapid mass privatization of state-owned enterprises in formerly centrally planned economies hasn't turned out nearly as well as its creators hoped, in Russia or elsewhere. When Russian mass privatization began in 1992-1993, its proponents (including ourselves) hoped that the Russian economy would soon bottom out and then turn upward, as the efficiency incentives unleashed by privatization took hold.[1] That didn't happen. Instead, the Russian economy stumbled along through mid-1998, continuing to shrink slowly by official indicators, then collapsed again, as it had in 1991-1992 prior to privatization. Russia's mass privatization "voucher auctions" were moderately honest, but gave control to managers. This permitted insiders (managers and controlling shareholders) to engage in extensive "self" or "inside" dealing (transactions by the company, not on arms-length terms, in which the insiders profit directly or indirectly at the company's expense), which the government did nothing to control. Later privatization "auctions" were a massive giveaway of Russia's most important companies at bargain prices to a handful of well-connected "kleptocrats," who continued to behave in the ways that earned them this nickname. Medium-term prospects are grim; the Russian ruble has plunged; the Russian government has defaulted on both its dollar-denominated and ruble-denominated debt; most banks are bankrupt; corruption is rampant; tax revenues have collapsed; capital flight is pervasive; and the government (whomever the Prime Minister happens to be at the moment) seems clueless about what to do next.

The Russian disappointment with mass privatization is mirrored by similar problems in other former Soviet Union countries and also, though less severely, by problems with Czech mass privatization, which in its early stages seemed to be a model of the transition from central planning to a market economy. This suggests that the failure of mass

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[1] The best statement of the optimists' view is **Maxim Boycko, Andrei Shleifer & Robert Vishny, Privatizing Russia** (MIT Press 1995). Boycko was one of the principal Russian architects of mass privatization. Shleifer and Vishny are American economists who helped to design the Russian mass privatization program. They and their collaborators recruited us (Tarassova beginning in 1992; Black and Kraakman beginning in 1993) to work on the legal infrastructure for Russia's capital markets. One outgrowth of that effort was the current Russian law on joint stock companies, which we have described elsewhere. See Bernard Black & Reinier Kraakman, *A Self-Enforcing Model of Corporate Law*, 109 **Harvard Law Review** 1911-1981 (1996); **Bernard Black, Reinier Kraakman & Anna Tarassova, A Guide to the Russian Law on Joint Stock Companies** (Kluwer Law International 1998). For a current statement of the related view that privatization was the right treatment, and that's Russia problems lie elsewhere, see Anders Aslund, *Russia's Collapse*, **Foreign Affairs**, Sept./Oct. 1999, at 64-77.

privatization to jumpstart the Russian economy may reflect structural flaws in mass privatization as a transitional mechanism, not just Russia's specific circumstances.

This paper joins an emerging literature that criticizes the prevailing wisdom that rapid privatization of large firms is an important element of the transition from central planning to a market economy.[2] We develop below a case study of what went wrong with large-firm privatization in Russia, using the Czech Republic as a comparison case study to assess the extent to which Russia's problems are generalizable. We bring to this task a reasonable mix of insiders' knowledge and outsiders' skepticism, gained through experience with privatization and capital markets reform in Russia and other countries.[3]

We leave to others analysis of the macroeconomic steps that Russia might have taken and focus here on microeconomic steps related to privatization and capital markets development. But the two are related -- Russia's macro effort to balance the budget, control inflation, and attract new investment was defeated, in large measure, by micro failures to rationalize the tax system, control corruption and organized crime, control insider self-dealing at privatized enterprises, and establish a tolerably friendly business climate.

We see three main failures in the Russian privatization effort. First, rapid, mass privatization of large enterprises is likely to lead to massive insider self-dealing unless (implausibly in the initial transition from central planning to markets) a country has a

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[2] Recent work includes Joseph E. Stiglitz, *Whither Reform?: Ten Years of the Transition* (keynote address at Annual World Bank Conference on Development Economics, April 1999); John Nellis, *Time to Rethink Privatization in Transition Economies?*, 36 **Finance & Development** 16-19 (International Monetary Fund June 1999); David Ellerman, *Voucher Privatization with Investment Funds: An Institutional Analysis* (World Bank Policy Research Paper No. 1924, 1998). Early writing expressing doubt about rapid privatization includes Peter Murrell & Yijiang Wang, *When Privatization Should be Delayed: The Effect of Communist Legacies on Organizational and Institutional Reforms*, 17 **Journal of Comparative Economics** 385-406 (1993); Peter Murrell, *What is Shock Therapy? What Did it Do in Poland and Russia?*, 9 **Post-Soviet Affairs** 111-140 (1993).

[3] Anna Tarassova was involved in the Russian privatization effort from 1992 through 1996, as a senior legal advisor to the Privatization Ministry during mass privatization, and later as a senior legal advisor to the Federal Securities Commission. She participated in drafting many of the basic laws and Presidential decrees that supported the development of Russia's capital markets. Bernard Black and Anna Tarassova worked together on several Russian capital markets laws and decrees, including joint stock company law, securities law, law on limited liability companies, and a decree on investment funds; Reinier Kraakman assisted in developing the theoretical structure for the Russian joint stock company law. Black has also been an advisor on privatization, corporate governance, and capital markets legislation to Armenia, the Czech Republic, Mongolia, Russia, South Korea, Ukraine, and Vietnam; Kraakman has advised on company law in Vietnam; Tarassova has advised on the Armenian Civil Code and on capital markets legislation in Armenia, Belarus, Kazakhstan, and Ukraine.

good infrastructure for controlling self-dealing. If control is given to the current managers (which was the political deal that underlay Russian mass privatization), they often won't know how to run a company in a market economy. Unless stopped (Russia made no effort to stop them), some managers will steal whatever assets the company still has, perhaps killing an otherwise viable company. If outsiders can acquire control in the stock market (as in the Czech Republic), they will often be worse owners than the managers that they replace. Indeed, bad owners will tend to drive out good ones. A controlling stake is worth more to a dishonest owner who will extract all of a firm's value than to an honest owner who will share the firm's value with minority shareholders.

To prevent this outcome, a decent legal and enforcement infrastructure capacity must precede or at least accompany privatization of large firms. If privatization comes first, massive theft is likely to occur before the infrastructure to control it can develop. Moreover, as a practical matter, important parts of this infrastructure can be built only on a base of existing private firms. For example, to develop skill in prosecuting fraud and self-dealing, regulators need some fraud and self-dealing to practice on. Thus, privatization must to some extent be staged, lest the crooks simply outrun the regulators.

The Russian government government accelerated the process of bad owners driving out good ones by selling control of major enterprises (cheaply) to crooks, who got the funds to buy them by skimming from the government. In most cases, these new owners transferred their skimming talents to the enterprises they had acquired, without improving the businesses and sometimes by starving them for funds.

In a mythical thick market for corporate control, honest entrepreneurs could buy companies from crooks if the company was worth more if run honestly than if run to maximize short-run skimming. But in fact, such entrepreneurs don't exist in Russia in significant numbers or with significant capital. If they existed, they wouldn't pay anything close to fair value when buying a company from a crook, because they couldn't verify what shape the enterprise was in. Moreover, the business might be worth more to the crook, who has a comparative advantage in the important tasks of self-dealing, evading taxes, obtaining favors from the government, not paying workers, enforcing contracts in effective albeit unofficial ways (instead of ineffective enforcement through the courts), and using these same unofficial means to enforce price-fixing or market division agreements or scare off competitors. In contrast, an honest owner risks having long-term investments them expropriated by the government.

Second, the profit incentives to restructure privatized enterprises and create new ones can be swamped by a generally hostile business environment created by (among other factors) a punitive tax system, official corruption, organized crime, an unfriendly bureaucracy, failure to privatize the urban land that businesses need to grow, and a

business culture in which skirting the law was seen as normal, even necessary behavior. A hostile business environment makes asset-stripping more attractive to insiders, compared to the alternative of improving the business. And fewer new businesses meant weaker market competition, which can create pressure on firms to restructure wholly apart from profit motives.

Third, too-rapid privatization of large firms can compromise future reform efforts. Inside dealing would occur to some degree even if large enterprises weren't privatized. But the reduced state control that accompanies privatization can make inside dealing easier. In a vicious circle, dirty privatization also reinforces corruption and organized crime, as the new owners (some already with Mafia ties) turn their new wealth to the task of bribing judges and government officials. Corruption and organized crime then reinforce a culture in which inside dealing is the norm. Corrupt officials and company insiders then join forces to resist future reforms, while the public comes to see privatization (and, by inference, other market reforms) as connected with inside dealing, corruption, and the growth of organized crime.

Our concerns here are with privatization of large enterprises, not with the other elements of the "shock therapy" prescription dispensed by Western advisors. There is much to be said, in the transition to a market economy, for the government rapidly selling or giving away small shops and businesses to the people who work there, and apartments and land to the people who live there. These steps don't entail the separation of ownership and control that makes self-dealing attractive for those who control large enterprises. But the Russian and Czech experience leads us to believe that a concerted effort to develop the infrastructure needed to control inside dealing is central to successful privatization of large firms -- as important, and in the early stages, perhaps more important than privatization itself.[4]

To be sure, Russia's problems could have arisen without privatization. Ukraine offers a sobering example. It hasn't privatized large firms, is as corrupt as Russia, and has done even worse economically. But the Ukrainian example only tells us that doing nothing isn't a viable strategy for the transition from Marx to markets either.

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[4] We do not assess in this paper where the line should be drawn between small enterprises, for which rapid privatization seems desirable, and large enterprises, for which it is problematic. Our tentative view is that for medium-sized enterprises, the success of privatization may depend on its form. Mass, "voucher" privatization separates ownership from control and is likely to produce the self-dealing problems that we discuss in text for large firms. Cash auctions of all of a company's shares may be preferable because they produce concentrated ownership. For medium-sized firms, as for large firms, there is much to be said for staged privatization, in which managers must earn the right to take their firm private by demonstrating that the firm is viable and they are honest.

A piece of the overall puzzle that seem important to us: The largest Russian companies were privatized in massively corrupt fashion, and ended up controlled by none-too-clean entrepreneurs, soon dubbed "kleptocrats" by the Russian press (*Russian:* **8: , BH@<">Z**) -- a handful of well-connected men who made their first millions -- and sometimes billions -- through sweetheart deals with or outright theft from the government, and then leveraged that initial wealth by buying major companies from the government for astonishingly low prices. The "reformers" who promoted privatization regretted the corrupt sales of major companies, but claimed that any private owner was better than continued state ownership. Even if the new owners got their ownership in regrettable ways, they would thereafter have incentives to increase company value. The extent to which the reformers believed this story themselves, or had been given financial inducements to put a good spin on a dirty process, remains unknown. But many foreign advisors bought this story. The "Washington consensus" supported dirty privatization as better than no privatization, and supported Russia's privatization czar, Anatoli Chubais, as he pursued privatization by any available means.[5]

Left unnoticed was that the new owners had two ways to make money -- increase the company's value, or steal what value already existed. The first was difficult, perhaps beyond their ability, and uncertain in outcome. The second was easy, they were expert at it, and it was sure to produce a handsome profit that could be tucked away overseas, beyond the reach of a future Russian government. Most of the kleptocrats chose the second, easy approach.

An example: Yukos, a major Russian oil holding company, was acquired in 1995 by Bank Menatep (controlled by kleptocrat Mikhail Khodorkovski) as part of the corrupt "loans-for-shares" privatization process. For 1996, Yukos' published financial statements show revenue of $8.60 per barrel of oil -- about $4 per barrel less than it should have been.[6] One surmises that most of the missing revenue ended up in offshore bank accounts controlled by Mr. Khodorkovski and his accomplices. Khodorkovski skimmed over 30 cents per dollar of revenue, while stiffing his workers on wages, defaulting on tax payments by claiming that Yukos couldn't afford them, destroying the value of minority shares in Yukos and its majority-owned production subsidiaries companies, and *not* reinvesting in Yukos' oil fields, which badly needed new investment.

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[5] *See* Stiglitz (1999), *supra* note 2 (describing the "Washington consensus" in favor of privatization by any means possible) (Stiglitz is Chief Economist of the World Bank).

[6] This assumes that Yukos exported roughly 25% of its production, at world prices of around $18/barrel, and sold the balance at domestic prices of around $10.50/barrel. Yukos revenue data is based on translated Yukos financial statements provided to us by Graham Houston of National Economic Research Associates in London. Houston's numbers are also reported in Jeanne Whalen, *Shareholder Rights, Round 2*, **Moscow Times**, Feb. 17, 1998.

It’s doubtful that running Yukos honestly could have earned Mr. Khodorkovski a fraction of what he earned by skimming revenue, let alone offshore and tax-free. He made a rational, privately value-maximizing choice. Even if running Yukos honestly was the best long-run strategy, Khodorkovski might have preferred a quickly skimmed bird in hand to two long-run birds in the bush. Besides, skimming was a business that he knew and was good at, while running an oil company was a tough business that he didn’t know and might fail in.

This example illustrates a general point: Privatization is not enough. It matters who the owners are. If it isn’t politically feasible to import foreign owners, who are more likely to run privatized businesses honestly (though hardly certain, as the Czechs learned), and to reinvest if profit opportunities exist, the second-best choice for large-firm privatization may be for the government to begin with case-by-case privatization of selected firms with strong profits and reputations for honest management, watch these firms carefully once they are privatized, and work hard to develop the legal and institutional infrastructure needed to limit insiders' ability to self-deal.

Even without immediate privatization, the promise of running a to-be-privatized company (with privatization conditioned on future performance), plus the need to compete in a world market, can motivate its managers to undertake some restructuring. If the company generates cash, the government will have a better chance of retaining enough revenues to maintain basic services. The government’s ability to detect and control theft will be higher if the enterprise is still state-owned. And the enterprise’s long-run sale price will be far higher if it is sold in a stronger legal environment, in a fairer auction, and perhaps with more foreign participation than was politically acceptable in the near term. Ironically, Russia and other former Soviet Union countries had such a "staged privatization" program in place in the early 1990s, through a program called "enterprise leasing." The privatizers killed enterprise leasing because they thought it wasn't fast enough and gave too much power to enterprise managers.

Proponents of fast privatization of large firms may respond that there is no assurance that the infrastructure to control self-dealing will develop on any relevant time frame. This is indeed a risk. But the right response may be staged privatization plus working hard to improve the business climate and develop the infrastructure to control self-dealing, rather than privatizing large firms anyway and hoping that the outcome will somehow be acceptable.

Several countries on the fringes of the former Soviet Union created a reasonably friendly climate for new businesses, and achieved corresponding economic success -- including Estonia, Hungary, Latvia, Poland, and the Czech Republic (which, in hindsight, may have succeeded despite, rather than because of, rapid privatization of its major

firms). Poland offers a nice contrast to Russia. It was slow to privatize either major businesses or the banks that were needed to finance new investment. It succeeded economically nonetheless because it quickly privatized small businesses and land, and created a climate in which new businesses could thrive and employ the workers that large enterprises needed to shed.

This article proceeds as follows. Part II provides a brief history of Russian privatization and the behavior of its major firms, including the sometimes astonishing corruption that accompanied the privatization effort. Part III discusses the factors that affect the level of self-dealing that controllers of privatized enterprises are likely to engage in, and the main structural flaws in Russia's privatization efforts. Part IV addresses the counterfactual question of what might have happened with slower, staged privatization and greater emphasis on building the institutions to control self-dealing. Part V evaluates the Czech experience, to assess the extent to which Russia's problems with privatization were rooted in large firm privatization as such (without the legal infrastructure to control inside dealing), and to what extent they reflect Russia's unique problems. Part VI offers some suggestions for structuring future privatization efforts. Part VII concludes by discussing what Russia and Western advisors can usefully do now to support Russia's transition to a market economy.

We seek to understand why a plausible reform program went wrong, what reforms might have worked better, and what can be done now. We part company with critics of mass privatization who espouse implausible alternatives, such as East-Asian style industrial policy (which Russia was wholly incapable of carrying out),[7] or seem mostly interested in assigning blame.[8]

II. A Cynic's Tour of Russian Privatization

This Part surveys Russia's privatization history, after the 1991 collapse of the Soviet Union. Some of the stories are well-known, others are newly reported here. Taken together, they paint a grim picture of a government that privatized small, mid-sized, and many large companies in semihonest fashion through mass privatization, but tolerated virtual giveaways of majority stakes in the largest companies, where most of the value lay, as well as insiders' subsequent theft of most of the value of the minority shares in

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[7] *See* **Alice H. Amsden, Jacek Kochanowicz & Lance Taylor, The Market Meets Its Match: Restructuring the Economies of Eastern Europe** (Harvard University Press 1994).

[8] For a blaming effort, largely devoid of useful discussion of what might have worked better, see **Janine R. Wedel, Collision and Collusion: The Strange Case of Western Aid to Eastern Europe, 1989-1998** (St. Martin's Press 1998).

both the largest companies and many companies whose shares were distributed through mass privatization.[9]

A warning. The stories about misdeeds that we tell in this article don't lend themselves to easy fact-checking. For some of the stories discussed below, we have personal knowledge; these are indicated in footnotes. For the others, we rely on news stories and sometimes, even less satisfactorily, on "general knowledge" – for example, the general belief that Gazprom CEO Rem Vyakhirev owns a substantial percentage of Gazprom's shares, even though the exact percentage is unknown. This means that we may inadvertently tell a story that isn't true or, more likely, provide only a partial picture. Still, we believe that our overall depiction of Russian business is accurate. The problem in recounting misdeeds by Russian insiders isn't finding true stories, but picking among the juicy stories that abound.

A. Mass Privatization: 1992-1994

Russia in 1992 was a huge country with a weak central government, that had neither will nor capacity to force privatization onto unwilling company managers. The prevailing Western advice called for "shock therapy" -- rapid decontrol of prices and freeing of markets, accompanied by rapid privatization of industry. Speed was thought critical – both to revive the economy and to reduce the state's role in running the economy before popular tolerance for the dislocations that accompanied the shock was exhausted and reform lost its political momentum.[10]

Privatization of state-owned enterprises in developed countries and some transition countries has proceeded primarily through one-company-at-a-time auctions, often organized by major investment banks, generally with reasonable transparency.[11] But

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[9] This Part primarily summarizes events that have been recounted elsewhere. Therefore, we provide only representative citations to academic sources and popular press articles.

[10] The best defense of shock therapy, by one of its principal proponents, is **Jeffrey Sachs, Poland's Jump to the Market Economy** (MIT Press 1994). But where Sachs sees Poland's slowness to privatize its large companies and major banks as a weakness, we wonder whether that hesitance might have been a strength instead. For an argument that Poland's economic success derived from building on existing institutions, not the shock of discarding them, see **Grzegorz W. Kolodko, From Shock to Therapy: The Political Economy of Postsocialist Transformation** (Oxford University Press forthcoming 1999). For other representative statements of the prevailing Western wisdom, see **Anders Aslund, How Russia Became a Market Economy** (Brookings Institution 1995); Joseph R. Blasi, Maya Kroumova & Douglas Kruse, Kremlin Capitalism: Privatizing the Russian Economy (ILR Press (imprint of Cornell University Press) 1997); **Boycko, Shleifer & Vishny** (1995), *supra* note 1.

[11] See, e.g., Steven L. Jones, William L. Megginson, Robert C. Nash & Jeffry M. Netter, *Share*

countries attempting the transition from centrally-planned to market economies had thousands of state-owned enterprises to dispose of, many of modest size, only some of which were economically viable. One-at-a-time cash auctions couldn't meet the timetable that shock therapy proponents, and raised the politically unacceptable risk that foreigners would buy major firms, and involved large transaction costs, relative to the value of most enterprises. Mass auctions were thought likely to exhaust the citizenry's modest funds and, ironically in view of later developments, to risk political backlash if companies were sold to wealthy crooks or ex-government officials.[12]

Mass privatization became the favored alternative. Citizens would be given vouchers, that they could use to bid for shares of privatized companies. The Czech Republic showed the way. Czech voucher privatization of all but a few large firms began in 1991, was well underway in 1992 when Russia started down the same road, and was largely complete by 1994. Czech industry was in private hands, and a new investment fund industry had sprung up to collect vouchers from citizens and invest in the privatization auctions. These "voucher investment funds" promised two things that citizens couldn't achieve on their own: diversification and the prospect of strong outside owners who could intervene to replace management when the old Communist managers couldn't make the transition to a market economy. Despite some doubts about whether voucher investment funds would be effective owners, the Czech Republic was widely viewed as a good model to follow.[13]

Russia followed in the Czech Republic's footsteps, but with some important differences. In the Czech Republic, most of a company's shares were distributed to citizens and voucher investment funds in voucher auctions; only a limited number were

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Issue Privatizations as Financial Means to Political and Economic Ends, 53 **Journal of Financial Economics** 217-253 (1999); Rafael La Porta & Florencio Lopez-de-Silanes, *The Benefits of Privatization: Evidence from Mexico* (Nat'l Bureau of Econ. Research working paper 6215, 1997).

[12] *See* Boycko, Shleifer & Vishny (1995), *supra* note 1, at 71-72 (discussing political opposition to cash sales). We are not persuaded that mass cash auctions were not a viable alternative to voucher privatization. Foreign participation in cash auctions could have been limited, much as it was for voucher auctions. Ex-government officials who invested large amounts to buy firms could have had the sources of their wealth traced. And Russian citizens were not that poor. They had upwards of $100 billion in savings in the state savings bank, Sberbank, which the government had frozen and was in the process of confiscating through inflation, plus large amounts outside the banking system. We think it fairer to say that the privatizers seized on voucher auctions because they were quick and their "giveaway" element made them initially popular, and never fully considered alternatives. While mass cash auctions seem less promising to us than the staged privatization that we discuss in Part IV.C, they would have produced less separation of cash flow rights from control rights, and hence potentially more restructuring and less asset-stripping.

[13] We discuss the Czech Republic's experience with mass privatization in Part V *infra*.

reserved for managers and employees. Privatization proceeded whether management liked it or not. A small number of voucher investment funds, some created by entrepreneurs but many associated with major banks (in turn still state controlled), accumulated most of the vouchers, and bought large stakes in most major firms. This gave most Czech firms major outside owners from the beginning.

In Russia, there wasn't political will or administrative capacity to force privatization on unwilling managers. The political solution was to bribe them with enough cheap shares so that they would pursue privatization voluntarily. Employees, too, were given large numbers of cheap shares, in a political bow to the Communist ideology of worker ownership. The result: most privatized firms were majority owned by workers and managers. A typical figure was 60-65% combined manager and employee ownership, perhaps 20% ownership by individuals and voucher investment funds, and the remainder by the state, which planned to sell its remaining stake for cash in the future. Given Russian labor's historic passivity and ignorance of free markets, this ownership structure led to virtually complete manager control of most enterprises.[14]

The managers' personal stake in their companies was often modest to begin with, but rose quickly. In Russia, unlike the Czech Republic, vouchers were publicly tradeable. This fostered a liquid voucher market, which let some citizens cash out, not for much money to be sure, but also made it easy for managers to buy vouchers that could be traded for shares in their own companies. Managers often got the funds to buy vouchers by illegally "privatizing" company funds. They continued to accumulate control after the voucher auctions were completed, by convincing or coercing employees to sell their shares.[15]

Some voucher auctions were marked by other irregularities, beyond the managers' illegal use of company funds to acquire vouchers. The auction design meant that the fewer vouchers were bid for a particular company's shares, the more shares would be distributed per voucher.[16] This gave insiders an incentive to discourage others from bidding at the voucher auctions. There were various ways to achieve this result. The

[14] The best source on the ownership structure that resulted from Russian voucher privatization is **Blasi, Kroumova & Kruse** (1997), *supra* note 10. Our discussion of the manner in which privatization was carried out relies on this book, **Boycko, Shleifer & Vishny** (1995), *supra* note 1, and the personal knowledge of Black and Tarassova.

[15] *See id.* at 193 (company surveys show top management ownership rose, on average, from 7% in 1994 to 10% in 1996, with the general director's personal stake rising from 2% to 4.5%).

[16] *See* **Boycko, Shleifer & Vishny** (1995), *supra* note 1, ch. 4 (describing the structure of Russian voucher privatization auctions).

auction location could be made hard to reach (Russia is a large country with a limited transportation infrastructure), or could be announced or changed at the last minute. In a few cases, phones and air flights into the city where the auction took place were conveniently disrupted shortly before the auction; in others, armed guards were hired to exclude unwanted bidders from the auction.[17] The larger the company, the more likely its managers (or less often, an outside investor) were to use tactics like these to discourage other bidders. Finally, perhaps 1,000 of the 15,000 mass-privatized firms were able to cut special deals with the government of various sorts.[18] Again, the larger the company, the more likely its managers were to have the political clout to obtain special treatment.

Finally, many of the largest enterprises were held out of voucher privatization, with the government disposing of at most a minority stake. In several important industries, the government then bundled its controlling stakes in a number of major companies into a smaller number of holding companies, and sold controlling stakes in the holding companies. The government created seven large oil holding companies: LUKoil, Sidanko, Sibneft, Rosneft, Tyumen Oil, Yukos, and VNK (Eastern Oil Company), which each held stakes in several producing companies, and together owned most of Russia's oil reserves. Privatization of electric power companies (with United Energy Systems as the principal holding company) and telephone companies (with Svyazinvest as the principal holding company) followed a similar pattern. Thus, the government created pyramid structures, distributed minority stakes in the bottom levels of the pyramids through voucher privatization, and then sold control of the whole structure.

Pyramid structures everywhere are an invitation for the controlling shareholder or family to siphon off wealth from companies that they control, but have a limited economic stake in.[19] This risk is (imperfectly) controlled in other countries because the pyramid commonly begins as a wholly-owned corporate group. The controlling family must develop a reputation for reasonable honesty, or no one will buy the noncontrolling shares that the family wants to sell. The risk from pyramid structures was magnified in Russia by weak enforcement capacity, plus the ability to acquire control of a pyramid without first developing a reputation for reasonable honesty. This risk soon came back

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[17] [news story cites to come].

[18] *See id.* at 37 (estimating that 8% of the 15,000 mass-privatized enterprises benefitted from special deals with the government).

[19] See Lucian Bebchuk, Reinier Kraakman & George Triantis, *Stock Pyramids, Cross-Ownership, and Dual Class Equity: The Creation and Agency Costs of Separating Control from Cash Flow Rights* (working paper Dec. 1998), available from the Social Science Research Network Electronic Library at <http://papers.ssrn.com/paper.taf?abstract_id=147590>.

to haunt the privatization effort.

The proponents of voucher privatization understood that some auctions wouldn't be perfectly clean, and that manager/worker control of privatized companies would limit shareholder oversight of managers. They saw this as an acceptable political price to pay for rapid privatization. They believed that while good private owners were better than bad ones, bad private owners were still far better than continued state ownership. As Andrei Shleifer, a principal Western advisor to the Russian privatizers, and Dmitry Vasiliev, a top Russian privatizer, explained:

> [Russian ownership] structures have been to a large extent determined by the political imperative of accommodating managerial preferences in the privatization program, since without manager support firms would have remained under political control. We believe that the ownership structures emerging from Russian privatization, while far superior to state ownership, still give managers too much control relative to what is needed to speed up efficient restructuring . . . . [20]

The privatizers ignored the special risks created by pyramid structures, perhaps because the manner in which the government would sell its remaining stake had not yet been determined. We recall no discussion of this issue at the time, and have found no mention of it in contemporaneous literature.

For our part, we don't doubt that privatization gave managers incentives to make profits. The harder question, to which we return in Part III, was how many managers would seek to profit by improving their business; versus how many would seek to steal the value that the business still had.

B. "Loans for Shares" and Other Rigged Auctions: 1995-present

A story. The U.S. Government owes $25 billion to Germany. To pay off the obligation, it gives $25 billion to the Bank of America with instructions to wire the funds to the German government. The money instead disappears. No one ever finds out where it went. No one at Bank of America goes to jail. No one asks Bank of America to pay the money back. The government continues to do business with Bank of America. Indeed, the President invites Bank of America's CEO to become a cabinet secretary, and

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[20] Andrei Shleifer & Dmitry Vasiliev, *Management Ownership and Russian Privatization,* in **Corporate Governance in Central Europe and Russia, vol. 2: Insiders and the State** 62, 76-77 (Roman Frydman, Cheryl W. Gray & Andrzej Rapaczynski eds., Central European Univ. Press 1996); *see also* Nellis (1999), *supra* note 2, at 18 (for the International Monetary Fund and the World Bank, "[t]he [perceived] immediate need was to create a basic constituency of property owners: to build capitalism, one needed capitalists -- lots of them, and fast").

for a time he agrees, before deciding that there is more profit to be made by dealing with the government than by helping to run it.

This story isn't remotely possible in the United States or many other developed countries. But change the bank to Oneksimbank (run by Vladimir Potanin, another of the new kleptocrats), run the money not through Oneksimbank but through two of its affiliated banks, and reduce the amount to $502 million, which is a rough Russian equivalent of $25 billion as a proportion of GNP, and it becomes a true Russian story, less widely known than it ought to be.[21] It's no longer hard to understand how Oneksimbank accumulated enough money to become a principal proponent and beneficiary of the rigged "loans-for-shares" auctions of major companies, through which Russia sold off many of its largest companies for a small fraction of fair value, beginning in 1995. It becomes easier to understand why the Russian government tolerated the obvious rigging of the loans-for-shares auctions, even though it was desperate for the revenue that honest auctions might have produced. And, to return to a major theme of this paper, if it's that easy for the well-connected to steal money, why go to the effort of earning it by running a business?[22]

Another popular way to instant wealth: Arrange to hold government funds, for a handsome fee, but where the real profit was paying little or no interest to the government when inflation was first in triple, then in double digits, real interest rates on government bonds and other money market instruments were 20-30% a year, and nominal rates were far higher). Vladimir Gusinski's MOST Bank, for example, got its start "managing" money in this manner for the Moscow City Government; Gusinski was soon rich enough to qualify as a first-tier kleptocrat. Potanin's Oneksimbank managed money for the Finance Ministry and the Foreign Trade Ministry; Mikhail Fridman's's Alfa Bank managed funds for the Customs Service and distributed agricultural subsidies.[23] Khodorkovski's Bank Menatep handled the funds that Russia spent on its military

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[21] See Matt Bivens & Jonas Bernstein, *The Russia You Never Met*, **Demokratizatziya** [exact cite to come] (1999); [get other cites].

[22] For more recent examples, see RFE/RL Newsline, May 21, 1999 (new Prime Minister Alexei Stepashin orders investigation into why a $100 million foreign loan, intended for the coal industry in Kemerovo Oblast, never arrived at its intended destination); Geoffrey York, *Kremlin Kills Corruption Probe of Highly Placed Officials*, **Globe & Mail**, June 27, 1999, at __ (Kremlin maneuvering to block prosecutor's probe into how the Kremlin spent $488 million to renovate the building that includes President Yeltsin's official residence); Celestine Bohlen, *Russian Says He Has Proof Bribes Were Paid to Kremlin*, **N.Y. Times**, Aug. 31, 1999 (Kremlin removes Russian prosecutors investigating corruption touching the Yeltsin family).

[23] See Bivens & Bernstein (1999), *supra* note 21; Craig Mellow, *The Oligarch Who Knew Better*, **Institutional Investor** 95-98 (June 1999).

operations in Chechnya and later promised to spend on rebuilding Chechnya. A Russian government audit later estimated that some $4.4 billion of these funds never arrived at their intended destination.[24]

As Pyotr Aven, then head of Alfa Bank (controlled by kleptocrat Mikhail Fridman), candidly explained:

> To become a millionaire in our country it is not at all necessary to have a good head or specialized knowledge. Often it is enough to have active support in the government, the parliament, local power structures and law enforcement agencies. One fine day your insignificant bank is authorized, for instance, to conduct operations with budgetary funds. Or quotas are generously allotted . . . for the export of oil, timber, and gas. In other words, you are appointed a millionaire.[25]

Loans-for-shares was an audacious scheme to leverage wealth acquired in these dubious ways, by using it to acquire Russia's biggest companies for a fraction of their value.[26] It began in 1995 with a proposal by Potanin, backed by most of the major new Russian banks, generally no cleaner than Potanin's Oneksimbank in how they had accumulated funds. The Russian Government wanted to raise revenue, but found it politically difficult to sell its stakes in Russia's largest enterprises, which had also been excluded from voucher privatization. The banks proposed to loan funds to the government for several years, with repayment secured by the government's majority stakes in these enterprises. Potanin (and everyone else) knew that the Government would never repay the loans, and would instead forfeit its shares to the banks that made the loans.

Under loans-for-shares, the Government auctioned its shares in a number of major oil, metals, and telephone companies in return for loans, giving the shares (and accompanying voting rights) as security to whomever would loan it the most money. But the auctions were peculiar indeed. The right to manage the auctions was parceled out among the major banks, who contrived to win the auctions that they had been appointed to manage, at astonishingly low prices. The bid rigging that was implicit in

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[24] See *The Abuses of Authorized Banking*, Radio Free Europe/Radio Liberty (Jan. 1998), available at <http://www.rferl.org/nca/special/rufinance/index.html>.

[25] Remarks by Pyotr Aven, founder of Alfa Bank, quoted in Igor Baranovsky, *Terror is a Fact of Russian Competition*, **Moscow News**, July 28, 1994, at 22.

[26] For discussion of the loans-for-shares auctions, see Ira W. Lieberman & Rogi Veimetra, *The Rush for State Shares in the "Klondyke" of Wild East Capitalism: The Loans-for-Shares Transactions in Russia*, 29 **George Washington Journal of International Law & Economics** 737-768 (1996). Ira Lieberman is a senior World Bank official who was in charge of the World Bank's efforts to support development of Russia's capital markets during the period of the loans-for-shares auctions.

divvying up the auction managing role became explicit in the actual bidding. The auction manager participated in two separate consortia (to meet the formal requirement for at least two bids), each of whom bid the government's reservation price or trivially above that. No one else bid at all. Foreigners were either excluded formally, or understood that it was pointless to try to bid.

In the couple of cases when someone bid in an auction intended to be won by someone else, the true nature of the "auctions" came to the fore, as pretexts were found to disqualify the high bidder. For example, Oneksimbank managed the Norilsk Nickel auction, with a reservation price of $170 million. It arranged three bids from affiliates, all at $170 or $170.1 million. Unexpectedly, Rossiiski Kredit Bank offered $355 million, over twice as much. Oneksimbank found patently spurious grounds to disqualify Rossiiski Kredit's bid; Oneksimbank's affiliate won the bidding at $170.1 million. Not that either bid was more than a small fraction of the value of a majority stake in Norilsk Nickel, which had annual profits of around $400 million.[27]

The loans-for-shares auctions were auctions that the world was watching, and sunshine is often a good disinfectant. One might have hoped that visibility, coupled with the government's desperate need for revenue, would instill some semblance of honesty. Those hopes were disappointed. Meanwhile, auctions that the world wasn't watching were often even worse.

For example, a company called Zarubezhtsvetmet (in Russian, this means foreign nonferrous metals) was formed to hold, among other things, the Russian government's 49% stake in a joint venture with the Mongolian government called Erdenet, which ran one of the world's major copper mines and produced 70% of Mongolia's hard-currency earnings. Zarubezhtsvetmet's market value was perhaps $200 million for 49% of Erdenet, plus another $50 million for other assets. It was sold in a cash "auction" to insiders with connections to the Russian Metallurgy Ministry, for around $150,000. No matter that Russia's agreement with Mongolia gave Mongolia the right to approve any transfer of Russia's interest in the joint venture, plus a right of first refusal to buy

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[27] See Lieberman & Veimetra (1996), *supra* note 26, at 749-50.

Russia's stake at the same price at which it was offered to someone else.[28] That right was simply ignored, despite Mongolia's official government-to-government complaint.[29]

Rather more of a nuisance was the Russian prosecutor who sued in 1997 to reverse the privatization of Zarubezhtsvetmet, on the grounds that Mongolia hadn't consented to Russia's transfer of its interest in Erdenet to private owners.[30] The Russian Government might have used this lawsuit, and the Mongolian complaint that preceded it, as an opportunity to placate the Mongolian government and recapture the $250 million of value that had been stolen when Zarubezhtsvetmet was privatized. But this was not to be. The prosecutor's error in filing the suit was soon corrected, and the suit has proceeded no further. In response to a second official complaint by Mongolia in 1998, First Deputy Prime Minister Yuri Maslyukov replied bluntly:

> **Q H@ 8"F", HF" %"T, &@ &@BD@F" @ D@FF46F8@< JR'FH>48, H@ B@*H&, DO *", < RH@ & F@@H&, HFH&44 F JB@<b>JHZ < <, 0 BD"&4H, : \FH&, >>Z < E @(: "T, >4, < 4< b&: b, HFb @H8DZ H@, "8P4@>, D>@, @$V , FH&@ %>, T>, ^8@>@<4R, F8@, @$X, *4>, >4, 1 "DJ$, 0 P&, H<, H** [With regard to your question about the Russian participant [in Erdenet], this is to verify that in accordance with the above-mentioned intergovernmental Agreement [on creation of Erdenet], it is open joint stock company "External-economic association Zarubezhtsvetmet."][31]

The fix was still in.

Another common tactic: Beginning in 1994, the government often required bidders in privatization auctions to promise specified levels of future investment when they purchased a controlling stake in a state-owned enterprise. Once the winning bidder acquired the shares were acquired, the promised investments were often quietly shelved,

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[28] See **E @(: "T, >4, <, 0 *J BD"&4H, : \FH&@< <@>(@: \F8@6 >"D@*>@6 D, FBJ$: 484 4 BD"&4H, : \FH&@< F@` 2' F@&, HF84N F@P4": 4FH4R, F84N D, FBJ$: 48 @ *, bH, : \>@FH4 <@>(@: @ F@&, HF8@(@F@&<, FH>@(@ (@D>@ @$@("HJH, : \>@(@BD, *BD4bH4b]C)] =]G** [Agreement Between the Government of the Mongolian Peoples' Republic and the Government of the Union of Soviet Socialist Republics on the Activity of the Mongol-Soviet Joint Mining-Concentrating Enterprise "ERDENET"] art. 21, para. 5 (June 5, 1991).

[29] Source: Various conversations from 1996 and 1998 between Bernard Black and Z. Enkhbold, Head of the State Property Committee of Mongolia.

[30] **3 F8@&@, 2'b&: , >4, @ BD42>">44 >, *, 6FH&4H, : \>Z < B: ">" BD4&"H42'P44 %? 1 "DJ$, 0 P&, H<, H** (Court complaint on deeming invalid the privatization plan for VO Zarubezhtsvetmet), filed by the General Prosecutor for the Russian Federation in the Arbitration Court for the City of Moscow (May 6, 1997).

[31] Letter from Yuri Maslyukov, First Deputy Prime Minister of the Russian Federation, to Prime Minister Elbegdorj of Mongolia (29 Oct. 1998).

or the shares were transferred to supposedly good faith purchasers, who were not bound by the original owner's investment promise. An honest purchaser couldn't use these dodges, so dishonest purchasers tended to win the auctions.[32]

Another provision of the privatization rules gave a firm's managers the right to acquire 30% of its shares cheaply if they first secured an agreement with the employees that would prevent the enterprise from going bankrupt for one year. Since proof that the enterprise would go bankrupt without the agreement, or wouldn't go bankrupt for a year with it, was in the eye of the beholder, this was an all-but-open gift of a controlling stake to the managers, in return for a phony agreement with the employees.[33]

C. The Outcome: A Kleptocracy

Taken as a whole, Russian privatization led to several distinct outcomes. First, a new kleptocracy emerged. A small number of individuals, who mostly achieved initial wealth through favorable deals with or outright theft from the government, ended up controlling most of Russia's major firms, especially the natural resources firms where most of the value lay. Some of these kleptocrats lost control of part of their empires in the 1998 economic collapse, or (at this writing) face some risk of losing that control. But it's too soon to count them out, and they all have ample wealth salted away in outside Russia.

Second, there is no evidence that mass privatization led to sharp improvements in firm productivity. We discuss the evidence on how privatization affected firm productivity in Part IV.B below.

Third, the Russian public came, for the most part, to detest privatization. They associate it with corruption, increased crime, and fabulous wealth for a chosen few while workers and pensioners go unpaid. This does not bode well for future reform efforts, or for the prospects for addressing the problems left by dirty privatization.[34]

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[32] *See* Basic Provisions of the State Program of Privatization after 1 July 1993, *approved by* Decree of the President of the Russian Federation No. 1535 (22 July 1994).

[33] *See* Regulations for the Procedure of Concluding an Agreement for Acquiring Shares with the Group of an Enterprise's Workers Who Have Undertaken to Implement the Privatization Plan and to Prevent the Bankruptcy of the Enterprise to be Privatized, *approved by* Order of the State Committee for State Property Management of the Russian Federation No. 862-r (23 Nov. 1992).

[34] By 1992, Russia had a new slang term to describe privatization that combined the word for privatization (Russian: BD4&"H42'P4b (privatizatziya)) with the verb BD4N&"H4H\ (to grab, to take improperly) to form BD4N&"H42'P4b (prikhvatizatziya), roughly translated as "grab-privatization." Top privatizer Anatoli Chubais was known as the (: "&>Z6 BD4N&"H42'H@D (the chief grab-privatizer). Stiglitz (1999), *supra* note 2, also notes the chilling effect that dirty privatization had on other market

As the kleptocrats' power grew, many of them found it convenient to use the press to promote their interests and to blunt public criticism of their activities. Many bought major newspapers and TV stations -- to the point where to understand a political debate in the Russian press, one must always keep in mind which kleptocrat owns which newspaper.[35] And they each formed alliances with powerful government officials -- to the point where to understand a turf battle within the government, one must understand which government official is an ally of which kleptocrat.

Those most often named as among the kleptocrats, their principal known or reputed investments, some of their present or recent past government connections, and their principal media outlets, are listed in the table below.[36] Each likely has amassed wealth well into the billions of dollars, largely at the government's expense, at a time when the Russian government can't (or won't) find a spare billion to stay current on payments to pensioners or its own employees.

Kleptocrat (political connection)	**Principal Companies**	**Media Outlets**

reforms. For elaboration on the possibility that a rule, even if efficient in the near term, may be inefficient in the long run because it produces political backlash, see Mark J. Roe, *Backlash*, 98 **Columbia Law Review** 217-241 (1998).

[35] *See, e.g.*, Laura Belin, *A Year of Discord*, in **Annual Survey of Eastern Europe and the Former Soviet Union: 1997 -- the Challenges of Integration**, at 276-284 (Peter Rutland ed., M.E. Sharpe Inc. 1998); Laura Belin, *Changes in Editorial Policy and Ownership at Izvestiya,* in *id.* at 291-295; Andrei Fadin, *Bankers and Oil Tycoons Use the Media as a Business Weapon*, **Transitions** ___-___ (Oct. 1997); Floriana Fossato & Anna Kachkaeva, *Russian Media Empires III,* **Radio Free Europe/Radio Liberty** (May 26, 1998), *available at* <http://www.refrl.org/nca/special/rumedia3/index.html>.

[36] Sources for this table include many of the articles cited above, personal knowledge, a chart made public by the U.S. State Department section on Intelligence and Review (presumably based on information gathered by the CIA), *Russia's Business Magnates: Their Empires and Interrelationships* (July 1998), and Donald N. Jensen, *Russia's Financial Empires*, **Radio Free Europe/Radio Liberty** (Jan. 1998), *available at* <http://www.refrl.org/nca/special/rufinance/index.html>. Different sources sometimes report conflicting information about who owns what. We used our best judgment in resolving these conflicts.

Vagit Alekperov (ties to Moscow Mayor Yuri Luzhkov)[37]	LUKOIL (largest Russian oil company); Bank Imperial (with Vyakhirev)	Izvestia newspaper (with Potanin); TV-6 (with Berezovski)
Boris Berezovski (ties to Boris Yeltsin, his daughter, Tatiana Dyachenko and former Prime Minister Viktor Chernomyrdin)[38]	Sibneft (oil and gas holding company), LogoVAZ (distributor for AvtoVAZ, Russia's largest car manufacturer), Aeroflot and Transaero airlines, Avtovazbank; Obedinenni Bank	ORT (with Fridman and Gusinski) and TV-6 (with Alekperov) TV stations; Vremya television program; Nezavisimaya gazeta, Novaya izvestiya and Kommersant newspapers, Ogonek magazine
Viktor Chernomyrdin (former Prime Minister)[39]	Gazprom (natural gas) (chairman; reputed share ownership) (Gazprom's ownership of other companies is listed below for Vyakhirev)	
Mikhail Fridman	Alfa Group holding company, Alfa Bank, Tyumen Oil (oil holding company), various construction companies, various oil export companies	Alfa TV, ORT television station (with Berezovski and Gusinski)
Vladimir Gusinski (ties to Moscow Mayor Yuri Luzhkov)	Media Most holding company, Most Bank	Sevodnya, Novaya gazeta (with Smolenski) and Obshchaya gazeta newspapers; Ekho Moskvuoy radio; ORT (with Berezovski and Fridman) and NTV(with Vyakhirev) tv stations, Itogi magazine
Mikhail Khodorkovski (ties to former Prime Minister Yevgeni Primakov)	Rosprom (holding company), Bank Menatep, Yukos (oil and gas holding company), various manufacturing, chemical, timber and retail companies	Moscow Times, St. Petersburg Times, and Literaturnaya gazeta newspapers

[37] On the LUKOIL-Luzhkov connection, see *"Party of Exporters" to be Victor in Upcoming Parliamentary Elections*, **Russia J.**, May 24-30, 1999, at 7.

[38] On Berezovski's media interests, see Andrew Higgins, *Russian Newspaper Finds Itself in a Tug of War Over Ownership*, **Wall St. J.**, Aug 9, 1999, at A15. Berezovski's partner, Roman Abramovich, may be emerging as a first-tier kleptocrat in his own right. See Eduard Gismatullin, *Sibneft Steps onto Kremlin Stage*, **Moscow Times**, June 1, 1999, at 1 (describing Abramovich's and Berezovski's joint control of Sibneft and related companies).

[39] On Gazprom, Chernomyrdin, and Vyakhirev, see *e.g.*, Aleksandras Budrys, *Ex-Russia PM Chernomyrdin returns to Gazprom*, **Reuters**, June 30, 1999; *Gazprom and Regions Cozy Up*, **Russia J.**, May 24-30, 1999, at 13; John Lloyd, *The Russian Devolution*, **N.Y. Times Magazine**, Aug. 15, 1999, at 34, 51 (discussing Chernomyrdin's reputed ownership of Gazprom shares). There was, as of mid-1999, a possible power struggle underway between Chernomyrdin (newly appointed as Chairman) and Vyakhirev (Chief Executive Officer) for control of Gazprom.

Yuri Luzhkov (mayor of Moscow)[40]	through City of Moscow: Guta Bank, Bank Moskvuoy, Bank for Reconstruction and Development, reputed to take a piece of every significant real estate deal in Moscow	Moskovski komsomolets newspaper; TV Center (TV station owned by City of Moscow)
Vladimir Potanin (ties to former Deputy Prime Minister Anatoli Chubais)	Interros holding company, Oneksimbank, RosBank, MFK Renaissance investment bank, various insurance companies, Norilski Nickel (nickel and other nonferrous metals), Sidanko (oil and gas holding company), Novolipetsk (steel), 25% of Svyazinvest (telephone holding company), various metallurgical, shipping and industrial companies	Izvestia (with Alekperov), Komsomolskaya Pravda (with Vyakhirev) and Russki telegraf newspapers, Ekspert magazine
Aleksander Smolenski[41]	SBS-Agro Bank, Agromprom Bank, possible co-owner with Berezovski of Sibneft	Novaya Gazeta (with Gusinski) and National News Service newspapers
Rem Vyakhirev (ties to former Prime Minister Viktor Chernomyrdin)	Gazprom (natural gas) (CEO, reputed share ownership), Bank Imperial (with Alekperov), Inkombank (minority stake), Gazprombank, National Reserve Bank, Promstroibank, Komitek oil company	Komsomolskaya pravda (with Potanin), NTV television station (with Gusinski); Rabochaya tribuna, Trud, and Profil magazines, numerous regional newspapers and TV stations

III. Structural Flaws in Russian Privatization

Russian privatization was dirty. On the whole, the bigger the stakes, the dirtier the deal. But that doesn't mean, without more, that rapid mass privatization was a mistake. Its advocates hoped that even if the manner of distributing the state's wealth was sometimes regrettable, the outcome would be salutary. New owners, motivated by profit, would improve the privatized companies' operations. The new owners would get rich, perhaps undeservedly, but the whole country would benefit from the gains from greater productivity.

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[40] See, e.g., Paul Klebnikov, *Who Will be the Next Ruler of Russia? The Slick City Boss or the Rough-Edged Populist General*, **Forbes**, Nov. 16, 1998, at 152 (describing businesses owned by the City of Moscow and controlled by Luzhkov); Mark Whitehouse, *Moscow Mayor Steals Political Spotlight*, **Wall St. J.**, May 20, 1999, at A14 (describing dealings between City of Moscow and Luzhkov's relatives and friends).

[41] Smolenski is often listed as one of the kleptocrats, but there is also evidence that he is partly or mostly a front man for Boris Berezovski, who rarely owns anything in his own name.

These hopes have mostly not been fulfilled. This Part seeks to understand why. Section A sketches an analytical framework for understanding why Russia's corporate owners and managers often chose self-dealing and asset stripping over company building. Section B reviews the legal and institutional context that facilitated corruption and asset stripping by the controllers of Russia's new private firms. Sections C and D discuss the outcomes from voucher privatization, which usually left managers in control of their own enterprises, and the kleptocrats' actions after they acquired control of Russia's biggest companies. Section E discusses the implications of Russia's unfriendly business climate. Part IV turn to the counterfactual: what might have happened with slower privatization and greater efforts to build a market-supporting infrastructure.

A. The Controller's Dilemma

Consider a stylized account of the dilemma facing a Russian manager or outside investor who acquires control of a privatized firm. The controller wishes to maximize his private return on investment. He enjoys nearly absolute power, at least in the short run, over his firm's operating decisions. And he operates in an institutional environment that imposes very few restrictions on self-dealing transactions. How can such a controller maximize his returns?

There are two basic ways for our hypothetical amoral controller to earn private returns from a potentially profitable privatized firm. The first is to increase the value of the firm, and thus the value of the controller's fractional stake in the firm. We call this the "value creating" strategy. The second is to expropriate value from other claimants on the firm's revenues. For example, by self dealing just enough to extract all of the firm's free cash flow, the controller can appropriate not only his own share of the firm's profits but also the distributions that would otherwise go to the government as taxes or to minority shareholders as dividends. By raising the level of self dealing beyond this point, the controller can skim revenues that would otherwise go to pay the firm's suppliers, employees, or creditors. We term such skimming the controller's "self dealing" strategy.

If the value creating and self dealing strategies were independent, an amoral controller would attempt to maximize returns along each dimension independently. He would create as much value as possible *and* steal as much of that value as possible. The two strategies are not independent, however. A controller who skims revenues owed to suppliers and employees risks forcing the firm into dissolution and destroying its going concern value. Suppliers and employees can be defrauded, but not indefinitely, even if they have no effective legal recourse. Sooner or later, they will refuse to do business with the firm.

Even for self-dealing that is limited to the firm's free cash flows, there are tradeoffs between self dealing and increasing value. For example, if the controller skims all of the firm's profits while continuing to pay its suppliers and employees, he expropriates the government's income tax revenues and the value of minority shares without jeopardizing the firm's survival. But there is almost certainly an opportunity cost to the firm, even under a rational income tax system. The firm will be unable to obtain external financing to pursue new business opportunities or support major investments. Nor can the controller use internal financing for these purposes without implicitly revealing the firm's profitability to the tax authorities and minority investors.

That opportunity cost increases under the confiscatory, discretion-laded Russian tax system. A company that pays its suppliers and employees on time and in cash reveals that it can afford to pay some taxes, which the tax authorities will then try to collect. A company that doesn't pay employees and suppliers has a better chance of pleading poverty to the tax inspectors, so that it can negotiate down the amount of tax (and bribes in lieu thereof) that it must pay. Thus, even modest self-dealing is likely to decrease a profitable firm's value. The controller cannot independently maximize returns from stealing and productivity increases; he must maximize them jointly.

A pure value creating strategy is unlikely. A controller can always find ways of grabbing some private returns from other corporate constituencies. Even in developed Western economies, there are well-known and often pursued opportunities for controllers to obtain private benefits. Thus, the critical question concerns the relative balance the controller establishes between extracting value and creating it.

This balance depends on the controller's expected gains and costs from a self-dealing strategy. The expected gains depend on the extent of self-dealing that is feasible. The costs are both direct and indirect. The direct cost of self-dealing is the present value of the expected official and unofficial sanctions imposed by regulators, courts, and market institutions. Corporate, securities, and insolvency laws that outlaw certain forms of self dealing raise the likelihood that these activities will be punished. More important, courts and regulators who are willing and able to enforce the law increase the expected costs of self dealing. Unofficial sanctions also increase with the sophistication of market institutions such as the financial press and reputational intermediaries such as accountants and investment banks. Finally, the costs of self dealing rise and fall with the general business culture's tolerance for cheating, and thus the reputational penalty attached to self dealing.

The indirect cost of self-dealing is the opportunity cost of foregoing profitable investments and decreasing the value of existing investments. Higher levels of self dealing imply greater losses of corporate value. At low levels, these costs are likely to

be the opportunity cost of foregoing expansion opportunities; at higher levels, they may include liquidation and loss of the firm's going concern value. The indirect cost of self dealing depends on a number of factors.

First, the firm's profitability. A profitable firm with significant growth opportunities suffers the most from self dealing. By contrast, for a firm that is unprofitable and has no realistic chance of earning profits in the future, self dealing will often maximize the firm's private value, including involuntary transfers from the government, creditors, suppliers, and employees, at the same time that it delivers that value to the controller. For these firms, an amoral controller's rational strategy is often to strip as much as possible and leave an empty shell behind.

Second, the overall business climate. Any factor that lowers the expected profitability of the firm also lowers the indirect cost of self dealing. The worse the overall business climate, the more self dealing we should expect. For example, a confiscatory tax that claimed all foreseeable corporate profit would eliminate value creation as a viable alternative to self dealing. A controlling shareholder could only earn a return by extracting cash flows from the firm before they are counted as profit and taxed accordingly.

Poor macroeconomic performance, which Russia had in abundance also depresses profitability and make asset-stripping more attractive. In a vicious circle, widespread asset-stripping then further degrades macroeconomic performance.[42]

Third, the separation between control and cash flow rights. The controller's percentage holdings of cash flow rights determine the extent to which he can externalize the costs of self dealing. As percentage cash flow rights shrink, so does the indirect cost to controllers of self-dealing, through future value foregone, while the benefits of self-dealing remain the same.

From this perspective, voucher privatization is an inherently dangerous strategy. It separates control from cash flow rights, not only for the largest firms for which this separation is hard to avoid, but for mid-sized firms that often have concentrated

[42] Simon Johnson, Peter Boone, Alasdai Breach & Eric Friedman, *Corporate Governance in the Asian Financial Crisis* (working paper 1999), *available from* the Social Science Research Network Electronic Library at <http://papers.ssrn.com/paper.taf?abstract_id=______>, argue that such a vicious circle can help to explain the 1997-98 financial collapses in a number of Asian countries. They report an inverse correlation between the strength of the country's corporate governance system and the extent of stock market decline. They hypothesize that as economic prospect dimmed, asset-stripping (and investor expectation of more of the same) grew, and contributed to stock market collapses.

ownership in developed economies. Allowing tradeable vouchers helps but only to a degree. Allowing voucher investment funds to aggregate the ownership stakes of individuals lets the funds provide a counterweight to managerial control of firms, but recreates the self-dealing problem at a different level -- the controllers of investment funds can strip assets from them. Indeed, as we argue in Part V.C, investment fund managers are *more* likely than company managers to find asset stripping an attractive strategy. Conversely, where feasible, privatizing a firm by selling a 100% stake for cash avoids the separation of control and cash flow rights, and thus reduces the likely extent of self-dealing.

Pyramid structures or lopsided distributions of voting rights that let controllers maintain control even though they hold only a tiny fraction of a firm's cash flow rights are especially likely to encourage asset stripping. Yet pyramid structures were built into the privatization plans for many of Russia's largest enterprises.

Fourth, the controller's effective time horizon (or implicit discount rate). A value-increasing strategy often requires investing capital in the near term, and generates additional cash flow only in the long run. Political uncertainty makes long-term profits less certain, and hence less valuable. So does the risk that a future government will prosecute the controller for current self-dealing. Even controllers who can strip assets today without fear of enforcement face a hard-to-estimate risk of future enforcement. This future risk doesn't affect the *firm's* remaining value, but reduces the *private* value of the controller's stake in the firm. The controller may rationally decide to strip as much as he can as fast as he can, before the regulators catch up to him. The Russian kleptocrats, having gotten the money to buy major firms in questionable ways, already faced future prosecution risk, which enhanced the attractiveness of asset stripping.

Fifth, inefficient capital markets. Efforts to increase long term corporate value will have less appeal if a controller cannot readily raise additional capital, or cannot expect to sell his stake at a fair price in the market. The more prevalent self-dealing is in the economy, the harder it is for an honest controller to persuade outside investors of his honesty, in order to obtain outside capital at all, let alone on decent terms. Moreover, a controller's self-dealing makes his representations about firm value suspect, and means that an outsider will pay less, not only for a minority stake, but for the controller's entire stake.

Sixth, managerial skill. Like taxes, poor management depreciates the value of corporate assets, and thus reduces the cost of self dealing. An incompetent controller earns less, and thus has a rational incentive to steal more. Here too, voucher privatization, which leaves the old managers in control, many incapable of adapting to a competitive market environment, is a dangerous strategy.

Seventh, the controller's morals: Our informal model of the asset-stripping decision assumed an amoral controller. But in the real world, morals matter. Some controllers will seek to create value rather than steal it, as long as they have decent prospects of doing so. Others will see skimming as a quick way to generate a handsome return on investment, and won't evaluate whether a value-creating strategy might create more value in the long term.

In Russia, these factors combined synergistically to make self dealing often the strategy of choice, not only for unprofitable firms, but for many otherwise viable firms as well. Self dealing was easy, running a business for profit was hard, separation of control from cash flow rights was inherent in voucher privatization, controllers' time horizons were short, capital markets were rudimentary, managerial skill was scarce, and too many businesses were sold to crooks who were predisposed to self-dealing.

B. Russia's Legal and Institutional Infrastructure

The Soviet Union, prior to 1991, had plenty of petty corruption, but limited opportunity for large-scale corruption. Workers in stores could appropriate and resell some of the best goods, but not too much, because there were others whose job was to control this sort of petty theft. Officials in charge of allocating apartments could give better apartments to their friends, but within limits, because frequent queue-jumping might get noticed and could lead to losing a moderately well-bribed job, as well as one's own nice apartment. Managers of state-owned firms couldn't set up transfer pricing schemes with other companies that the managers owned because private citizens couldn't own companies. A system of bureaucratic controls kept senior managers away from direct access to the money that a company received for selling its goods, and provided oversight of those who did have access to money.

Besides, the money from large scale corruption couldn't buy very much -- a new car (but senior managers and government officials already had a car), a vacation in the south of Russia (but senior managers and government officials already had nice government-paid vacations), but not a fancy house (they mostly didn't exist, and those that did weren't for sale), a fat bank account (which would be noticed), an overseas vacation (not possible), or an overseas bank account (not practically possible). And if you got caught being too greedy, there was the specter of a lengthy term in a miserable Russian jail or even a Siberian gulag (work camp), which you certainly wouldn't enjoy and might not survive.

At the same time, the legal and institutional infrastructure to control theft by insiders from private companies simply didn't exist. Prosecutors had no experience in untangling complex corporate transactions, and no understanding of the subtle and indirect ways in

which insiders can siphon off a company's profits. Concepts of fiduciary duty and proscriptions against self-dealing didn't exist. Indeed, the Russian language didn't contain words for these concepts.[43]

Basic commercial and capital markets laws didn't exist when voucher privatization was completed in 1994. Neither did basic institutions to enforce good behavior by company managers and controlling shareholders didn't exist either. A Securities Commission was created in 1994 but in name only. It still lacks a meaningful budget, can't pay its staff enough to keep qualified people for long, and doesn't have the political clout to launch a serious investigation of the kleptocrats' misdeeds. Russia had criminal lawyers, but few experienced business lawyers who could advise managers on how to behave with respect to their shareholders, nor an accounting profession that could ensure tolerably accurate financial disclosure. Its accounting rules date from the Soviet era and are designed to meet the needs of central planners, not the needs of private lenders and investors. Updating of the accounting rules is vested in the Finance Ministry, which has developed reporting requirements to help the Finance Ministry determine how much tax a company owes, not to help investors determine how much money it has earned.

Finally, the business culture was one of law avoidance. Under Communism, the parts and supplies needed to keep a factory running often couldn't be obtained through official channels. A good manager had to be skilled at obtaining parts and supplies in unofficial ways.[44] In a market economy, those skills were easily transferred to the new tasks of asset stripping and self-dealing.

The weak legal and institutional framework was no secret to the privatizers. But writing good laws can take years, and building good institutions takes decades. The privatizers weren't willing to wait. They chose to privatize immediately, and hope that the laws and institutions would follow later. The justifications for immediate privatization included the economic case for shock therapy as the best available transition from central planning to markets, the desire to seize a political window of opportunity that might close if they waited, and the belief that newly privatized companies and their shareholders

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[43] In drafting the Russian Law on Joint Stock Companies, we were forced to adapt an existing word that didn't quite fit (2'4>H, D, F@&">>Z6; zainteresovannuy) to express the concept of a person who had a conflict of interest with respect to a transaction entered into by a company. We had to carefully define this term, both explicitly and through the context in which it was used, for it to be understood at all. We were unable to employ the concept of a fiduciary duty to behave in the interests of the company, in preference to one's own interests, because we couldn't find an acceptable way to state this concept in Russian.

[44] *See, e.g.*, Rosalina V. Ryvkina, *What Kind of Capitalism is Being Created in Russia?*, 36 **Russian Law & Politics** 5, 21 (May-June 1998).

would create a constituency for good tax, commercial and capital markets laws, and for enforcement of those laws.

The laws did indeed follow, for the most part. A new Civil Code was adopted in three parts between 1995 and 1997. A weak law on securities (since strengthened somewhat) was adopted in 1995, a fairly strong law on joint stock companies was adopted in 1996; solid laws on bankruptcy and on limited liability companies in 1998. The major remaining gap is a law on investment funds. Russia's capital markets laws have weaknesses, but no more so than the laws in other privatizing countries.

But the privatizers hoped for more than just decent laws. They hoped that broad private ownership would create a constituency for enforcement of those laws. That emphatically didn't happen. Instead, company managers and kleptocrats became powerful opponents of efforts to strengthen the capital markets laws and opponents of better enforcement of those laws. They didn't want a strong Securities Commission, that might have been able to police some of the self-dealing abuses. They didn't want the rules on conflict-of-interest transactions to be tightened, as loopholes emerged. And what they didn't want, they didn't get. In hindsight, we can see how the early absence of a legal and institutional framework to control insider self-dealing contributed to a downward spiral into dishonesty and theft.

The tax system has gotten worse instead of better. Why isn't clear. Perhaps its very vagueness let most businesses escape with a modest payment to the tax inspectors (albeit very little to the government). Reform also faced opposition by the bureaucrats within the Finance Ministry and the tax police, because clearer rules and more reasonable rates would reduce their private income. And perhaps the system that evolved, in which company insiders bribed the tax inspectors and hid income from the government and shareholders alike, had some attractions to the insiders, who could then steal the hidden profits.

The kleptocrats were also able to coopt the Central Bank into opposing a stronger securities law or Securities Commission. The Central Bank's bureaucrats, for their part, didn't need much convincing that they, not the Securities Commission, ought to control Russia's capital markets. They were often none too honest themselves,[45] and for both

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[45] On the Central Bank's use of obscure offshore money management firm to manage some of the Bank's foreign currency reserves, including keeping two sets of books to hide what it was doing, see, *e.g.*, Celeste Bohlen, *Secrecy by Kremlin Financial Czars Raises Eyebrows*, **N.Y. Times**, July 30, 1999, at A_); Draft Report by PriceWaterhouseCoopers (report of independent auditor hired by the IMF to review the Central Bank's actions), available at <http//www.imf.org/external/country/rus/fimaco/russia.pdf>.

personal and bureaucratic reasons wanted the Central Bank to control Russia's capital markets, not the upstart Securities Commission. The Central Bank, aided by the Finance Ministry, did its best to limit the Commission's power, status, and budget. As a result, the company law was adopted with important loopholes, the securities law gave the Securities Commission highly limited powers, and the Securities Commission ended up in a protracted fight for political survival, which took most of what little resources it had. Nor did general prosecutors address the need for enforcement of rules against gross theft.

Company managers soon learned that they could plunder their firms with negligible risk of prosecution. For example, over a year after the 1998 ruble collapse exposed insider-dealing and asset-stripping at Russian banks, and prompted a race to strip the assets that remained, not a single bank official has been charged with anything.[46] Khodorkovski's Bank Menatep offers a concrete example of how the bankers have behaved. After Bank Menatep collapsed in mid-1998, Khodorkovski transferred its good assets to a new bank, Rosprom, leaving depositors and creditors to pick at the carcass of the old bank. To ensure that the transactions couldn't later be traced, Khodorkovski arranged for a truck containing most of Bank Menatep's records for the last several years to be driven off a bridge into the Dybna river. Where presumably they will remain.[47]

At the same time, the government's own behavior reinforced disrespect for rules. Managers had to cheat on their taxes, bribe customs inspectors, and avoid cash transactions to survive. The government didn't pay its own bills to companies that provided it with goods and services; hardly an incentive for those companies to pay their tax bills to the government. It became increasingly clear that the corruption went right to the top – to the extended Yeltsin "family."[48]

There's no way to know how much better laws and institutions would have helped, had they preceded instead of followed privatization. Good tax laws might have made a major difference. Even good capital markets laws wouldn't have been enforced, but they might have helped to establish baseline expectations about behavior. Conversely, their early absence contributed to a climate of lawlessness, in which managers could justify theft of corporate assets through self-dealing transactions by claiming (at least sometimes

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[46] *See Russian Banks: Stable Doors*, **Economist**, May 22, 1999, at 83.

[47] See ' : , $ A \b>ZN *7 @>PZ & %@*J) @8J<, >HZ ; + = ! G+A " A @8@bHFb >" *>,) J$>Z* **7 @<<, DF'>H**\ [Gleb Pyannuyx, *Endings in the Water: Menatep Documents Come to Rest at the Bottom of the Dybna*, **Kommersant]**, May 29, 1999, at **__.**

[48] *See, e.g.,* Michael Wines, *Yeltsin Son-in-Law at Center of Rich Network of Influence*, **N.Y. Times**, Oct. 7, 1999, at A1.

correctly) that they had done nothing illegal.

Our best guess is that the absence of stronger (but inevitably still mostly unenforced) capital markets laws made a modest difference in the behavior of managers and controlling shareholders; the absence of credible enforcement against gross theft made a large difference; the absence of good tax rules made a large difference, both in contributing to general lawlessness (because every company had to evade taxes to survive) and by forcing all companies to hide their true profits from public view (once profits were hidden from tax inspectors and shareholders alike, the temptation for managers to steal them was often irresistible); and that if official corruption is pervasive enough (it became increasingly so during the 1990s, other important steps aren't likely to be taken and it might not matter much if they were.

Better capital markets laws might become important in the future, if other impediments become smaller. At that time, the imperfections in these laws might loom larger, and perhaps would receive legislative attention. Still, the principal problem is not that the laws aren't strong enough, but that they aren't enforced. Even if Russia had world-class laws, enforcement is critical. The company law prohibits self-dealing by managers and large shareholders, but unhappy shareholders can rarely develop enough facts to prove the rampant self-dealing that occurs every day. The courts respect only documentary evidence, which is rarely available, given limited discovery and managers' skill in covering their tracks.

Moreover, a shareholder who sues a major company will usually lose at the trial court level, because of a combination of home-court bias and judicial corruption. A persistent shareholder with a strong case has a decent chance of getting a favorable judgment on appeal. But pursuing a case through three levels of appeal will take years, and when you're done, enforcing a judgment is problematic, because enforcement is by the same biased or corrupt lower court that the shareholder began at.

A recent example: The bankruptcy proceedings for Sidanko, an oil holding company owned by kleptocrat Vladimir Potanin, and Chernogoneft, a large oil producing company owned by Sidanko. Chernogoneft went bankrupt after selling its oil to Sidanko (without the shareholder approval for this related-party transaction that the company law requires), which then failed to pay for the oil and went bankrupt itself (why isn't clear). In the Chernogoneft bankruptcy proceedings, 98% of the creditors voted for a particular external manager, but the local judge instead appointed a different manager with ties to a competitor (Tyumen Oil, owned by kleptocrat Mikhail Fridman) that wants to acquire Chernogoneft (cheaply, one presumes). Sidanko's bankruptcy has been marked by similar irregularities, some reflecting a battle between Potanin and Fridman for control

of the Sidanko proceedings.[52] Other prominent bankruptcy proceedings have also been rigged by insiders, with the cooperation of the courts and (for bankrupt banks) the Central Bank.[53] In the face of behavior like this, law on the books simply isn't enough.

Perhaps enforcement of capital markets rules would have been equally minimal if the rules had come first. Or perhaps Russia would have found a different path-dependent equilibrium, with better capital markets laws, more vigorously enforced, had the laws preceded the privatization or had privatization been more honestly conducted. We cannot say. What we can say is that bad, politically powerful owners reinforce corruption and create pressure for weak rules and weak enforcement, and that this pressure has contributed to the non-enforcement of capital markets laws that is the norm today.

Having recounted Russia's many problems, we should mention a potential problem that Russia didn't have. Theorists have speculated that social "trust" – the willingness of people to deal fairly with each other and expect others to do likewise – is an important market-supporting institution.[54] We have no sense that Russia was an especially low-trust country at the beginning of the 1990s. Russians didn't trust their government, but enterprise managers were used to dealing with each other on an oral basis (often to circumvent formal regulations). Indeed, these informal contacts helped to make extensive barter chains a feasible substitute for cash-based transactions.[55] One of the tragedies of Russian misgovernment in the 1990s is that Russia is today a far more corrupt and lower-trust place than it was a decade ago, with all that implies for its future prospects.

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[52] For pieces of the Sidanko and Chernogoneft bankruptcy stories, see Igor Semenenko, *Siberian Oil Company Fights Hostile Takeover*, **Moscow Times**, May 29, 1999, at 12; Alan S. Cullison, *Russia's Tyumen Oil Seeks to Expand with Some Assets of Troubled Sidanko*, **Wall St. J.**, July 8, 1999, at A12; *Russian Court Overrules SIDANKO Creditors Claims*, **Reuters**, May __, 1999; Gary Peach, *Sidanko Squabbles Give Investment a Bad Name*, **Moscow Times**, June 1, 1999, at 14 (court rejects external manager proposed by 80% of creditors, including BP Amoco); Neela Banerjee, *From Russia, With Bankruptcy*, **N.Y. Times**, Aug. 13, 1999, at C1; *Oiling the Wheels*, **Economist**, Aug. 21, 1999, at 60; Neela Banerjee, *Creditors Accept Moscow's Terms in Oil Company Bankruptcy*, **N.Y. Times**, Sept. 8, 1999, at C4.

[53] *See, e.g.*, Andrew Higgins, *The Lion's Share: As One Bank Shows, Bankruptcy in Russia is a Real Cat Fight*, Wall St. J. April 5, 1999, at A1 (describing the election of the principal creditor committee in Tokobank's bankruptcy, in which Tokobank disallowed ballots filed by foreign creditors on flimsy grounds, while accepting massive fraudulent claims by offshore companies. This allowed the insiders who controlled these companies to control the creditor committee even though the claims were later judged fraudulent. All without objection from the Central Bank, which was overseeing the bankruptcy proceeding.).

[54] *See, e.g.,* **Francis Fukuyama, Trust: The Social Virtues and the Creation of Prosperity** (Free Press 1995).

[55] [to come - data on extent of contracts, with payment after delivery].

C. Loss of Corporate Value as a Constraint on Asset Stripping

The worse the business climate, the more likely it is that a privatized company's controllers will find asset stripping more attractive than value creation. Moreover, state-owned enterprises generally need to shed workers to improve productivity. Many will fail outright. New small businesses must take up the employment slack. If they don't emerge, the market pressure on large firms to restructure and reduce employment will be weaker; political pressure for firms to maintain employment and related social services will be stronger.

To begin with, many privatized enterprises had little hope of earning a profit in a competitive market environment. Liquidation was the value-maximizing strategy. For these firms, liquidation was inevitable, but mass privatization still had pernicious consequences.

Consider an unprofitable firm with assets worth $1000 in piecemeal liquidation, and $1500 if sold to a competitor, who will close the firm but still obtain some value from its customer relationships. If sold at auction, the firm will be sold for $1500. The sale delivers $1500 of value to its buyer, and $1500 in revenue to the government. If the firm is instead mass privatized, the controllers, who may directly own only 10% of the firm's shares, will strip its assets as best they can. They may realize $1000 from piecemeal liquidation, and another $1000 in wealth transfers from employees who work but don't receive wages, suppliers who deliver goods but don't get paid, and customers who receive defective merchandise during the liquidation process and have no recourse. The controllers get rich, employees and counterparties suffer, and the government receives no revenue. Moreover, the whole process encourages corruption (the controllers will pay bribes to avoid being prosecuted or paying taxes) and contributes to a business climate where parties to contracts can't trust their counterparties and asset-stripping is an accepted way of doing business.

For potentially profitable firms, Russia's business climate was lousy. We discuss the most important problems below.

Confiscatory taxation (if anyone paid their taxes) and arbitrary enforcement: Russian tax law is both amazingly complex and quite simple. The complex part is the vague and constantly changing rules and administrative interpretations. The nominal tax rates aren't that extreme, but they are applied to a measure of "income" that grossly overstates actual income. Actual taxes can easily exceed 100% of profits. In addition, tax inspectors have broad discretion to interpret the vague rules as they see fit and seize a company's bank accounts and other assets to pay whatever tax the inspector claims is owed. Companies have a theoretical right of appeal, but will be out of business long

before the appeal is heard.

The simple part is how businesses have to behave: The confiscatory rates produce derisory revenues, because almost no one pays them. Instead, everyone hides their income as best they can, and then bribes the tax inspectors to reduce whatever initial assessment the inspectors make. Russia's development of an extensive barter economy has been documented elsewhere. An important reason for the use of barter is that cash in a bank account invites the tax inspectors to seize it.[56]

Falsified books, however rational in response to the arbitrary enforcement of an irrational tax code, preclude development of strong public capital markets. Companies that can't report income honestly to the tax inspectors can't report honestly to investors either. Investors therefore can't use published financial statements to check on management honesty and skill. They have to hope (usually in vain) that managers will reinvest some of the hidden income that the company generates, instead of simply stealing it. Capital markets without honest financial reporting are inevitably weak, no matter how good the background laws on companies, securities, and the like, and the tax system precludes honest reporting.

The transition to barter made matters still worse. In a barter transaction that often involves multiple intermediaries, and is intentionally designed to hide true profits from the tax inspectors, the opportunities for insiders to skim profits are endless, and the prospects of catching them remote. Hidden transactions and complex multiparty barter transactions also preclude companies from using the courts to enforce contracts. If the true oral contract between two companies calls for delivery of a large quantity of goods at a handsome price, while the written contract, prepared for the edification of the tax police, calls for delivery of a small quantity at a much lower price, and one party defaults, the other can hardly go to court to enforce the oral deal. This severely undercut whatever benefit might have come from the adoption in the mid-1990s of a reasonably good Civil Code and other commercial laws.

If a company stays small, it has a better chance of staying out of sight, and away from the tax inspectors (and the Mafia). Russia is the only country we know of where businesses routinely avoid publicity, and obtain customers only by word of mouth.

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[56] See, e.g., Kathryn Hendley, Barry Ickes & Randi Ryterman, *Remonetizing the Russian Economy*, in Harry G. Broadman, ed., *Russian Enterprise Reform: Policies to Further the Transition* 101-120 (World Bank Discussion Paper No. 400, 1999); Alan Reynolds, *Russia and Japan in the Shadow of Tax Policy*, **Jobs and Capital** 50 (Milken Inst. Summer/Fall 1998). For a non-tax-related explanation for barter, see Clifford G. Gaddy & Barry W. Ickes, *Russia's Virtual Economy*, 77 **Foreign Affairs** 53-67 (Sept./Oct. 1998).

Business cards routinely contain no telltale address, and often not even a local phone number (the prefix would let the tax inspectors and the Mafia learn the business's approximate location). A cell phone number or satellite number is safer. Businesses, sometimes even retail businesses, operate from behind unlabeled doors. That privately rational behavior, though, depresses economic performance.

The International Monetary Fund (IMF)'s intervention exacerbated the problems with Russia's tax system. A core IMF condition for Russia to receive new loans was controlling the budget deficit by raising taxes. But the IMF devoted far less attention to the tax reform that was needed before tax revenue could be raised in sensible ways. Controlling the budget deficit was a prerequisite for new loans; reforming the tax system was a soft condition that the IMF asked for but never insisted on. But Russia's drive to collect more tax revenue was counterproductive. The revenue-raising effort didn't raise more revenue. Tax revenue as a percentage of GDP declined steadily throughout the 1990s). It did, however, intensify official corruption, as businesses responded to higher tax demands with larger bribes, destroy any hope of a more honest business climate, and increase government resistance to desperately needed systemic tax reforms (which threatened the flow of bribe income).

Official corruption. The need to pay multiple bribes -- to tax inspectors, to customs officials, to the police not to harass you, to anyone from whom you need a permit to operate (and there are many such persons) -- has landed Russia at or near the bottom of most lists of official corruption.[57] Russia may be better than Nigeria, but not by much, and has been getting worse instead of better.

Moreover, while payoffs to organized crime at least provide protection against similar demands by competing Mafia groups, payoffs to government officials offer little or no protection against demands by other officials. Most are sole practitioners -- which means that the combined bribe demanded by multiple officials can be far larger than a "monopoly" official, seeking to maximize long-term income, would demand. A monopoly official won't charge so much that businesses are likely to fail; sole-practitioner officials face no such constraint.[58]

Organized crime. If there is a retail establishment in a major city in Russia that

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[57] See Transparency International, *The Transparency International 1998 Corruption Perceptions Index*, available at <http://www.transparency.de/documents/cpi/index.html> (Ranking Russia 76th of 85 ranked countries, with a corruption rating of 2.4 on a 1-10 scale, with lower ratings indicating higher corruption).

[58] *See* Andrei Shleifer & Robert Vishny, *Corruption*, 108 **Quarterly Journal of Economics** 599-617 (1993).

doesn’t pay a healthy share of revenue for “protection”, we haven’t heard of it. Arguing too strongly over how much to pay can adversely affect one’s life expectancy, as can complaining to the police, who are likely to be in the pay of the mafia. This leaves businesses to make their best case to their protectors to leave them enough profit so they can stay in business. Sometimes this happens, sometimes it doesn’t.

Many large businesses also pay for protection. Some (also or instead) engage large private security forces (which are a necessity in any event, the only question being their size). But private security is expensive, offers imperfect protection when goods are transported to market, and can easily be turned to pernicious use – including enforcing price-fixing and market-division agreements with competitors or scaring off new entrants into a market.

Urban land. Start a new business or growing an existing one requires land. In most Russian regions, urban land hasn't been privatized. Land is still available. But obtaining it requires bribing government officials, who will tell their Mafia buddies about you, will know who you are for the purpose of levying taxes, and can revoke your nonfirm land rights if you don’t pay enough taxes or bribes. Moreover, if land rights aren’t secure, businesspeople won’t invest much in buildings or equipment that could be confiscated. So businesses won’t grow very large and won’t employ many people.

An irony: Land privatization, while critical to new businesses, would have been a mixed blessing if coupled (as it would have been) with rapid privatization and inability to control insider self-dealing. For many businesses, land was their most valuable asset. If it had been salable, it often would have been sold cheaply to insiders, robbing shareholders of some of the value that their enterprises would otherwise retain.

These five problems -- confiscatory taxation, organized crime, corruption, unfriendly bureaucrats, and difficulty in obtaining urban land -- seem to us to be the most important components of a generally unfriendly business environment. But other factors matter too.

Lack of capital. Russians don’t trust banks, for good reason. A recent reason: In 1991, the supposedly reform-oriented government froze private savings, held in the state savings bank, Sberbank, and then confiscated the vast bulk of those savings by paying interest rates far below inflation and not releasing the funds until 1993. Savings that might have formed the initial capital for new businesses were wiped out. And future savings, instead of being placed in banks, where they might be productively lent to businesses, were often kept in hard currency, in or outside Russia, because no one trusted the banks. Moreover, huge numbers of elderly people, who held the bulk of the savings, came to equate “reform” with theft of their savings, and turned against reform, which helped to give the Communists the political strength to block many of the legal reforms

that the privatizers had hoped would privatization.

Those citizens who put savings into the new private banks, often run by the kleptocrats, soon regretted that choice. During and after the ruble crash in mid-1998, a bank run ensued, the banks refused to honor depositor demands for their funds. The Central Bank was in no hurry to straighten out the mess, and failed to prevent their owners from stripping the banks of their remaining good assets, leaving depositors and other creditors with an empty shell. This episode surely reinforced Russian citizens' tendency to put money offshore if possible, but in any event not where it they could be reinvested in Russian businesses.[59] The end result is that new and growing businesses have few sources of capital to turn to.

Restrictive labor laws. As part of its Communist heritage, Russia has highly restrictive labor laws, that often prevent layoffs altogether, and at a minimum make them very expensive. Standard advice is to plan to pay about 6 months severance to employees to get them to leave voluntarily. Of course, many Russian businesses don't pay their employees on time or in full, but honestly run or foreign-owned businesses can't escape so easily. As one Western law firm bluntly warned its clients, when "Russian employees sue foreign companies in Russian courts for wrongful termination, they usually win."[60]

Unfriendliness to foreign investment. Foreign businesses face additional problems, including ever-changing currency regulations, that make it difficult to withdraw money once invested, and ensure that the Central Bank, which writes the regulations, takes a cut of every dollar that is withdrawn. The regulations have little effect on capital flight, because the kleptocrats and other major players exploit loopholes or bribe their way out of compliance. Instead, they discourage capital from entering.

Some evidence of the overall chill on business: At a time when business opportunities should have been abundant and workers readily available, the number of small Russian businesses dropped from 877,000 in 1995 (many started in an initial burst of enthusiasm in the early 1990s) to 829,000 in 1997.[61] On a per capita, this is about

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[59] *See, e.g.*, Mark Whitehouse, *Frustration Soars for Russian Bank Depositors: Moscow Does Little to Resolve Crisis*, **Wall St. J.**, Apr. 8, 1999, at A14. For an asset-stripping, example, see text accompanying note 47 *supra*. On capital flight, see Mark Whitehouse, *In Russia, Capital Flight Continues Unabated,* **Wall St J.**, Apr. 19, 1999, at A__.

[60] See Mary Holland & Olga Kozyr, *Downsizing Russian-Style*, **CIS LawNotes** 6, 7 (Patterson Belknap Webb & Tyler, Mar. 1999).

[61] See Robert Orttung, *Newly Elected Regional Governors Grapple with Moscow*, in _______________: **Annual Survey 1997**, at 285-290 (1998).

1/4th of the number of small American businesses.[62] The Russian pattern of major firms not paying workers for months on end is possible only because workers have no alternative. In the more successful post-Communist countries, even state-owned firms have shrunk payrolls and improved productivity. In Russia, it is common for a privatized firm to have cut production by 50% since 1991, but cut employment by only 10%. Productivity has declined instead of increased.

Meanwhile, stories abound of businesses abandoned under the combined burdens that Russia imposed on them. Some could tolerate the payoffs to the Mafia, whose bosses sometimes understood that new businesses should be milked, not slaughtered. But few could tolerate the payoffs to government officials, who were often unconcerned with whether the business survived as long as they got their cut in the near term, and couldn't protect firms against payoff demands by other officials.

Taken together, the problems discussed above encouraged the managers of privatized businesses to choose asset stripping over value creation. We turn in the next two sections to a review of what happened to Russia's privatized firms. Section D discusses the mass privatized firms; Section E discusses the largest firms that were held back during mass privatization and sold later in corrupt cash auctions.

D. Mass-Privatized Enterprises: Manager Theft and Incompetence

Voucher privatization left the old Communist-appointed managers in control of the newly privatized enterprises. Many didn't know how to earn a profit in a competitive market environment, which enhanced the attractiveness of asset stripping.

At many firms, privatization was followed by consolidation of control. Privatization proponents hoped that outside investors would invest in salvageable firms and profit by installing better management. That happened in a few cases. Sometimes the outsiders reached an accord with the company's managers to buy a stake directly from the company; sometimes they bought controlling stakes in the market or by hiring agents to stand at the company's gates and make offers directly to employees. Occasionally, managers sought outside investors, and accepted oversight in return for cash.

But more often, enterprise managers acted in dubious ways to acquire more shares and thereby cement their control. Managers had the easiest access to employees' shares, and often bought them at derisory prices, sometimes by threatening retribution or shutdown if the employees' didn't sell. The managers had no money with which to buy

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[62] [US data & citation to come].

shares, but that was a solvable problem. Sometimes shares were bought with the company's own funds, but the managers ended up with the shares. Other times, managers siphoned off funds by causing the company to engage in self-dealing transactions with a front company set up by the managers. The funds could be used both to improve the managers' standard of living and to buy enough employee shares to lock up control. Employees may not have understood the value of their shares, or may have accepted for a time the managers' promises of a bright future for the enterprise, or simply found it too difficult to organize to stop the theft.

In Russia's coal industry for example, many firms were doomed to fail in the long run. But even potentially profitable firms sometimes ran out of cash after mismanagement by crooked top managers. A typical pattern: Managers earned worker support by promising high wages, which they then didn't pay, claiming that the company had no cash.

This was true enough -- whatever profits the coal companies might have earned were skimmed instead. Common skimming techniques include: selling the coal to an intermediary at below-market prices, which could resell it at market prices, with the difference pocketed by the managers, who controlled the intermediary; buying mining equipment at inflated prices, with the difference between market price and the price paid pocketed by the managers through kickbacks (if the inflated price was actually paid, that is); and paying workers with vouchers redeemable for food and supplies at the company store, which then sold goods to this captive market at far above market prices, with the difference pocketed by a supply company controlled by the company's managers. The workers, instead of asking where the cash went, periodically go on strike against the Government seeking unpaid back wages, sometimes shutting down railways to dramatize their claims the Trans-Siberian Railway was shut for two weeks in May 1998 by a coal miners' strike).

We make no claim that every privatized enterprise was run by crooks. But many were. We also suspect that many managers who started out honest changed their minds along the way, partly because they saw how their fellow managers behaved and what they were able to get away with, partly because they were embedded in a system which demanded that profits be hidden (which then made them temptingly easy to steal), partly because they saw the Mafia and dishonest managers becoming wealthy while they struggled to survive, and partly out of disgust because the authorities were too corrupt to do anything about even obvious theft. Honest and dishonest behavior alike can be contagious, and Russia fell into a dishonesty equilibrium.[63]

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[63] See Paul J. Zak & Stephen Knack, *Trust and Growth* (working paper 1998), available from the Social Science Research Network electronic library at

E. Major Enterprises: Kleptocrat Looting

The small and medium enterprises that were privatized through voucher privatization were large in number, but often small in value. Many, perhaps most, were nonviable. But Russia is a big country, blessed with natural resources, and there was enormous value in its natural resources companies, in related companies (steel and aluminum mills), as well as power and telephone companies. The government either didn't sell shares in these major companies at all during voucher privatization, or sold only minority stakes. Estimates of these companies' value, if run to maximize profit and permitted to sell their products at market value, and valued at developed country multiples, are often staggering. The table below gives some rough values (precise estimates aren't possible).

<http://papers.ssrn.com/paper.taf?abstract_id=136961> (modeling a separating equilibrium, in which countries can be characterized as either high or low trust).

September 1999 Value Estimates for Major Russian Companies

The estimates below are rough estimates of the value of selected major Russian companies, if run to maximize profit, taxed on that profit at conventional marginal rates (say 33%), permitted to sell their products at world prices, and valued at developed market multiples. The estimates were provided to us by James Fenkner of Troika Dialog. Value estimates for oil and gas companies are based on $13 per barrel of oil (or gas equivalent); for electric companies on $795,000 per megawatt of generating capacity; for steel companies at $148 per ton of capacity; for aluminum companies at $2793 per ton of capacity; for Norilsk Nickel at .085 x value of reserves at current commodity prices; for Rostelecom at 3.3 times book value of property, plant and equipment; for Sberbank at __ x book value of assets; for Aeroflot at $16.5 million per plane.[64]

Company	Industry	Value at Western Multiples ($ billions)	Market Capitalization ($ billions)
Gazprom	natural gas	1960	4
Lukoil	oil	195	5.5
Yukos	oil	170	0.3
United Energy Systems	electricity	110	3.1
Surgutneftegaz (producing co.)	oil	91	4.4
Tatneft	oil	75	0.4
Sberbank	bank	60	0.4
Tyumen Oil	oil	47	not traded
Mosenergo	electricity	12	0.8
Irkutskenergo	electricity	10	0.4
Norilsk Nickel	nickel	9	0.5
Rostelecom	telephone	5	0.9
Bratsk Aluminum	aluminum	2.3	0.03
Krasnoyarsk	aluminum	2.2	0.08
Aeroflot	airline	2	0.09
Magnitogorsk	steel	1.8	0.04
Seversal	steel	1.7	0.08
Total		**2754**	**20.8**

Conservatively valued by Western standards, Gazprom alone is likely worth $600 billion. Some estimates of its value, including the one above, approach $2 trillion. Russia's oil industry could be worth $500 billion or more. How then, can Russia be

[64] For other estimates for selected companies, see Bivens & Bernstein (1999), *supra* note 21 (Gazprom); Alan S. Cullison, *Vanishing Act: How Oil Giant Yukos Came to Resemble an Empty Cupboard*, **Wall St. J. Eur.**, July 15, 1999, at 1 (Yukos).

bankrupt, with total market capitalization at September 1999 of around $20 billion, unable to collect taxes, unable to pay the $1.7 billion it owes to the IMF in 1999, unable to pay its own pensioners and workers the modest amounts they are owed?

An inescapable answer is theft of these companies' value on a massive scale by the kleptocrats who acquired them in loans-for-shares "auctions" and other transactions. Theft at the time of sale, by buying controlling interests for a tiny fraction of fair market value. And then continued theft through self-dealing transactions that left many of Russia's biggest, most valuable companies unable (or unwilling) to pay taxes, pay their workers, or reinvest.

Privatization proponents argued that, despite the corruption of loans-for-shares and other major company selloffs, privatization put control of Russia's major companies in the hands of competent businessmen, who had an incentive to restructure these enterprises, to replace management that couldn't make the transition to a market economy, and to make the investments needed to improve productivity.

What happened was almost exactly the opposite. We haven't had the opportunity to learn whether the kleptocrats were competent to run a large business. They devoted themselves, instead, to activities at which their skill is unquestioned: Skimming profits from their companies; starving them of funds (to the point where many were unable even to pay their workers or a fraction of their tax bills, let alone invest in new equipment); replacing managers who resisted the skimming (or threatening/bribing them into submission), shooting managers and local government officials who resisted too strongly.

This story can only be told through anecdotes. We offer five below -- hopefully enough to give the reader a feel for the transactions that take place, and convince the reader that our strong words are justified. For the first four, we have firsthand knowledge of the shenanigans; the fifth, Gazprom, is simply too big to be left out.

Khodorkovski/Yukos: We recounted above the example of Yukos, whose 1996 oil revenues were reported at $8.60 per barrel, about $4 below what they should have been. with most of the rest presumably ending up in the offshore bank accounts of Khodorkovski and his collaborators. But this was only part of Yukos' activity. Yukos owned several operating subsidiaries, each of whom had with large minority interests thanks to voucher privatization. Yukos purchased oil from these subsidiaries at even lower prices, averaging around $7.50 per barrel -- low enough so that these subsidiaries, with combined pretax profits of around $1 billion before Yukos acquired control, were soon reporting minimal profits or outright losses, and defaulting on their tax payments.

Yukos had bled them of whatever cash they had.[65] The subsidiaries' sale of oil to Yukos, without approval by the subsidiaries' minority shareholders, was a flagrant violation of the joint stock company law, but no matter. No one sued, and if they had, well, judges could be bought or their decisions ignored. The transactions were flagrant enough to prompt the Russian Securities Commission to launch an investigation into dealings between Yukos and its subsidiaries. But this investigation went nowhere, perhaps because the Commission didn't have the staff to pursue the investigation, or because it was warned off by Khodorkovski's government allies.[66]

Khodorkovski's ambition exceeded his reach, however. In 1997 and 1998, he borrowed heavily from Western banks, using Yukos shares and (illegally obtained, under the Russian Company Law) guarantees from Yukos' subsidiaries as collateral. When the Russian ruble collapsed in mid-1998, Khodorkovski's Bank Menatep, like most major banks, was heavily exposed because of investments in ruble-denominated Russian government bonds. If one counts his offshore wealth, Khodorkovski surely could have weathered this storm, but he chose instead to let Menatep and Yukos sink. Yukos defaulted on its loan payments. This meant that 30% of its shares were seized by Western lenders. Khodorkovski still controlled Yukos, though, at least for the moment, and used that control to strip it of its real value -- ownership of its oil producing subsidiaries.

At each major subsidiary -- including Tomskneft, Yuganskneftegaz, and Samaraneftegaz -- each themselves huge companies potentially worth $billions based on their oil reserves -- Yukos proposed for shareholder approval the following package of proposals, with only minor variations:

> (i) A massive new share issuance to obscure offshore companies, at dirt-cheap prices (valuing the companies at 1% or less of their true value, and perhaps 10% of their depressed trading prices), with even that modest amount to be paid not in cash but in promissory notes issued by other Yukos subsidiaries, which were of dubious legality and even more dubious value. Enough shares were to be issued (between 194% and 243% of the previously outstanding shares) to transfer control from Yukos (which Khodorkovski expected to soon lose control of) to the offshore companies.

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[65] See Joseph Kahn & Timothy L. O'Brien, *For Russia and Its U.S. Bankers, Match Wasn't Made in Heaven*, **N.Y. Times**, Oct. 18, 1998, at A1 (reporting on Yukos' dealings with subsidiaries).

[66] See Federal Commission for the Securities Market, Press Release (Feb. 17, 1998), available at <http://www.fedcom.ru/enews/pr0217-1.html>; Geoff Winestock, *The Quixotic Technocrat*, **Moscow Times**, Mar. 31, 1998 (Securities Commission head Dmitri Vasilyev says that he was dissatisfied with Yukos' response, but had no power to do any more himself).

(ii) A multiyear agreement obligating the subsidiary to sell its output to one or more of the offshore companies at the laughable price of 250 rubles per ton (around $1.30 per barrel at mid-1999 exchange rates, and headed lower over time as the ruble depreciates against the dollar).

(iii) Shareholder approval of large asset transfers to still other obscure companies, including both past and unidentified future transactions.

Shareholders who opposed these proposals were given the opportunity to sell their shares back to the company at prices that valued the three companies, with proven oil and gas reserves of around 13 billion barrels of oil equivalent, at a total of $33 million -- $.0025 per barrel of proven reserves. No, this is not a misprint.[67]

To be sure, Yukos had a problem implementing this scheme -- it needed shareholder approval for this raw theft. Yukos typically owned only 51% of the shares in the subsidiaries, and needed 75% of the votes of the shareholders who participate in a shareholder meeting to authorize the share issuance (plus a majority of the votes of noninterested shareholders). Khodorkovski's solution was bold, if not exactly legal: The day before the date of the subsidiaries' shareholder meetings, Yukos arranged for a compliant judge to declare that the minority shareholders hade been acting in concert, in violation of the Antimonopoly Law. The judge issued an order disqualifying everyone but Yukos and its affiliated shareholders from voting. When minority shareholders arrived at the meetings, they were greeted by armed guards and most were barred from voting or attending the meeting on the basis of this court order. Yukos' shares were voted and were counted as noninterested; the proposals all passed. Having used Yukos's voting power to ram through these proposals, Khodorkovski proceeded to transfer essentially all of Yukos's remaining shares in two of the three oil-producing subsidiaries to offshore companies.

Maybe, in a few years, an appellate court will rule that all this was illegal. But

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[67] For pieces of this story, see *Selected Documents in Regard to Minority Shareholders Rights Abuses in YUKOS's Production Subsidiaries* (May, 31, 1999) (materials presented by Michael Hunter, President of Dart Management Inc., a major investor in the Yukos subsidiaries, at OECD Conference on Corporate Governance in Russia (Moscow, Russia, June 1, 1999); see Alan Cullison, *Russian Firm Bars Minor Holders, Passes Contentious Share Increase*, **Wall St. J.**, Mar. 24, 1999, at A21; David Hoffman, *Out of Step With Russia? Outsider's Battle over Stake in Oil Giant Offers a Glimpse of Nation's Uncertain Capitalist Ways*, **Wash. Post**, Apr. 18, 1999, at H1; *See* Alan S. Cullison, *Yukos Transfers Two Oil Units to Offshore Firms*, **Wall St. J.**, June 4, 1999, at A12; Alan S. Cullison, *Vanishing Act: How Oil Giant Yukos Came to Resemble an Empty Cupboard*, **Wall St. J. Eur.**, July 15, 1999, at 1; Alan S. Cullison, *Russian Share Shuffle Maddens Investors*, **Wall St. J.**, July 23, 1999, at A12.

there's no guarantee of that, or that such an order can be effectively enforced. In the meantime, Khodorkovski will have stolen billions more through below-market sales of the subsidiaries' oil, while running these companies (which all desperately need new investment) even further into the ground than they already are.

Besides, opposing Yukos can be bad for one's health. The mayor of Nefteyugansk was murdered in June 1998, several weeks after publicly demanding that Yuganksneftegaz (one of Yukos' main subsidiaries) pay its taxes and back wages.[68] In March 1999, the head of another oil company, who had won a high profile lawsuit against Yukos, had his car blown up near his home, with armed attackers waiting to finish off anyone who survived the bomb. By chance, he wasn't inside, but his bodyguards were less fortunate.[69]

Khodorkovski's behavior didn't seem to trouble senior Russian officials. In the middle of the scandal, he accompanied then Prime Minister Yevgeni Primakov on Primakov's spring 1999 trip to meet with President Clinton (aborted in midair when NATO began bombing Serbia). It did trouble the Securities Commission, which has the power to defer registering the share issuance while it investigates whether the shares were validly issued, though minority shareholders are still waiting for it do so (or not).[70]

Berezovski/Sibneft: Sibneft is another major Russian oil holding company. So far as anyone can tell, it is controlled by Boris Berezovski and his partner Roman Abramovich (and perhaps also by Aleksandr Smolenski). But no one knows for sure, because Berezovski rarely owns shares in his own name, and operates instead through obscure intermediary companies. Sibneft's main production subsidiary is Noyabrskneftegaz, of which Sibneft owned about 61%. In round numbers, Noyabrskneftegaz earned $600 million in 1996, the last year before Berezovski acquired

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[68] See, e.g., E , D(, 6 G@B@& & _ D46 7 @>"R@8@&, 7 @>L: 48H 42 2' >, LH, ` (">F8@(@DZ >8" 2'8@>R4: Fb J$46FH&@< < ^D" [Sergei Topov & Yuri Konachokov, *Conflict Over Nefteyugansk Market Ends in Mayor's Assassination*], **Kommersant Daily**, June 27, 1998 (reporting the murder and the mayor's conflicts with Yukos); %: "*4<4D 9 "*>46, 7 D@& 4 = , LH\ [Vladimir Ladni, *Blood and Oil]*, **Komsomolskaya Pravda**, July 8, 1998, at 2 (speculating that Khodorkovski and Yukos were the parties most likely to be behind the attack).

[69] *See* Grigori Mkrtchyan & Oleg Luriye, *Holiday Contract*, E @&, DT, >>@ E , 8D, H>@ **[Top Secret]**, Mar. 1999 (interview with the intended victim, Yevgeni Rubin, about the attack, a prior attack on his life 3 months earlier, and his conflicts with Yukos).

[70] The Securities Commission did refer the matter to the general prosecutor for investigation. See Alan S. Cullison, *Russian Watchdog Sues Oil Giant, Seeks Probe of Share Shufflings*, **Wall St. J.**, July 22, 1999, at A22.

control of Sibneft, and $0 in 1997. Meanwhile, most of the missing $600 million showed up as profit earned by Sibneft, even though under Russia's joint stock company law, transactions between parent and subsidiary require consent by the subsidiary's minority shareholders, which was never obtained.

Simply appropriating Noyabrsk's profits wasn't enough to satisfy Berezovski. In 1998, at a Noyabrsk annual general meeting, shareholders were presented with a draft new charter to approve, which was supposed to bring the charter in line with the new Russian joint stock company law, and with a proposal to increase the number of "announced" common shares, that could be issued by decision of the board of directors. The notice to shareholders did not mention by what number the announced shares would be increased. Management announced at the shareholder meeting that it proposed to authorize announced shares equal to an astounding 196,300% of the current number of issued shares. Virtually no shareholder other than Sibneft voted to authorize these shares, but the authorization to squeaked through with the necessary support from 75% of the shareholders who showed up and voted, perhaps because Sibneft had hidden how many additional shares it proposed to authorize and some minority shareholders did not attend the meeting.

At the meeting, Noyabrsk management promised to follow the charter in issuing the shares; the charter provided for preemptive rights, which ensured that all shareholders could buy newly issued shares in proportion to their current holdings. Thereafter, Noyabrsk's management ignored its charter and their own promise to shareholders and issued shares at roughly half of Noyabrsk's trading price (already severely depressed by Sibneft's expropriation of Noyabrsk's profits) to four purchasers with close relationships to Sibneft, also ignoring along the way the requirements in the joint stock company law that shares be issued at "market value" and that any transaction with a 20% shareholder or its affiliated persons be approved by noninterested shareholders.

This action, and the likelihood of more of the same, enhanced Sibneft's trading price at the same time that it severely depressed Noyabrsk's trading price. Sibneft then announced an exchange offer -- it would swap 4 Sibneft shares for each Noyabrskneftegaz share held by Noyabrsk's minority shareholders. This was around 1% of the relative value of Noyabrsk and Sibneft, before this sorry saga started. Most minority shareholders accepted the offer -- the alternative was no more attractive. One shareholder who sued found the local courts unreceptive, and decided to settle rather than fight a years-long battle in the upper appellate courts.[71]

[71] Bernard Black was an advisor to a minority shareholder in Noyabrskneftegaz in the matters described in text, including unsuccessful litigation (marked by lower court decisions explainable, in at least one case, only by judicial corruption) to overturn the results of Noyabrsk's shareholder meeting.

Potanin/Sidanko: Sidanko is yet another major Russian oil holding company, 96% controlled by Vladimir Potanin through Oneksimbank and its affiliates, especially MFK (Mezhdunarodnaya Finansovaya Kompaniya). Oneksimbank, MFK, and other affiliates also held significant stakes in Sidanko's subsidiaries. One might think that, given that Potanin already controlled 96% of Sidanko, and had acquired control of MFK, which was trying to establish a reputation as the first major league, Russian-owned investment bank, he wouldn't think it worth the bother to try to further dilute the ownership interest of Sidanko's minority shareholders. This expectation, like so many Western expectations about how rational businessmen, concerned about their future reputation, ought to behave, turned out to be unjustified.[72]

In early 1998, Potanin decided to kill two birds with one stone -- simplify the share ownership structure within the Oneksimbank financial-industrial group, and severely dilute the 4% minority in Sidanko. The chosen means was a share swap, in which Sidanko issued convertible bonds to Oneksimbank affiliates in exchange for their shares in other group companies. With the twist that Sidanko issued a huge number of bonds, with a conversion price that was a tiny fraction of Sidanko's current market price. The effect was to more than triple Sidanko's outstanding shares (once the bonds were converted), while adding only modestly to Sidanko's value. The 4% minority would be diluted down to 1.3%.

This story, unlike the others told here, had a (temporarily) not-too-unhappy ending, at least for shareholders in Sidanko itself, though not shareholders in Sidanko's subsidiaries, which Sidanko was looting by buying their output at below-market prices. Sidanko's minority shareholders screamed, the Securities Commission launched an investigation into Sidanko's violations of the Company Law, and Potanin backed down. Sidanko agreed to issue enough shares to minority shareholders at the same low price to compensate for the dilution caused by the convertible bond offering. This satisfied the minority shareholders and apparently the Securities Commission as well, even though issuing shares at below market value to Sidanko's minority shareholders didn't cure Sidanko's prior violations of the Company Law, and was itself a further violation of the

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A fuller account of the litigation can be found in Bernard Black, *Shareholder Robbery, Russian Style*, in Institutional Shareholder Services, **ISSue Alert**, Oct. 1998, at 3. [cite needed on exchange offer and prior market price ratios -- Economist has some of this].

[72] Bernard Black and Reinier Kraakman acted as advisors to a minority shareholder in Sidanko in connected with the dilution effort described in the text. For pieces of the Sidanko story, see Jeanne Whalen, *Sidanko Bond Issue Tests Legal Water*, **Moscow Times**, Feb. 10, 1998; Jeanne Whalen, *Sidanko Talks Tackle Bond Dispute*, **Moscow Times**, Feb. 12, 998; Jeanne Whalen, *Shareholder Rights, Round 2*, **Moscow Times**, Feb. 17, 1998; Jeanne Whalen, *Sidanko President, Top Managers Quit*, **Moscow Times**, Mar. 17, 1998.

law.

But investor satisfaction didn't last long. After the ruble crash in mid-1998, Potanin found himself in financial trouble (not counting his offshore assets, anyway), and decided to take Sidanko through bankruptcy proceedings. A possible outcome is that Potanin or other insiders will emerge with control of Sidanko, while outside investors (including BP Amoco, which paid $571 million for 10% of Sidanko in 1997) are frozen out.[73]

Zarubezhtsvetmet/Erdenet: We described above Russia's sale of its $200 million stake in Erdenet for $150,000 by contributing the stake to Zarubezhtsvetmet and then privatizing Zarubezhtsvetmet, despite Russia's agreement with Mongolia barring transfer of Russia's shares in Erdenet without Mongolia's consent. But now that Zarubezhtsvetmet's (unknown) owners held 49% of Erdenet, what would they do with it? Would they improve Erdenet's operations or invest in the new copper refining capacity that Erdenet wanted to build?

The answer was not long in coming. In early 1998, it was discovered that Erdenet was bankrupt, unable to pay either its taxes or its overdue bills for electric power. Some $30 million had disappeared, surely with the connivance of Erdenet's general director, Mr. Elbegdorj. The unpaid electric bills meant the utilities couldn't pay Russia for fuel, leaving Mongolia's capital city, Ulaanbaatar, mostly without heat for several months of a (typically) bitterly cold Mongolian winter. The Mongolian government sought to fire Elbegdorj and trace the funds; the Russian members of Erdenet's board of directors refused to cooperate, presumably because they were in cahoots with Elbegdorj. Their resistance deadlocked the company (which has 3 Mongolian and 3 Russian board members) for the better part of a year. Mongolia finally used emergency legislation to wrest control of Erdenet away from Elbegdorj and his Russian accomplices.[74]

Gazprom: Gazprom's wealth is Even a conservative $600 billion estimate of its market value, based on Western multiples, implies that mass privatization this one company, on the basis of one citizen, one share, could have delivered $4,000 in value to each citizen. That, coupled with honest management that delivered that value to shareholders, would without more have redeemed the promise of mass privatization -- that the state was returning ownership of its property to the people. Continued state

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[73] *See* sources cited in note 52 *supra*.

[74] Small pieces of this story can be found in [cite to come]; the remainder comes from conversations between Bernard Black and Z. Enkhbold, head of Mongolia's State Property Committee and the person in charge of Mongolia's efforts to regain control of Erdenet. Bernard Black was an advisor to Mongolia in connection with its actions related to Erdenet, and prepared a legal opinion on Mongolia's behalf concerning the legality of its actions in replacing Mr. Elbegdorj.

ownership would, without more, have given the government the ability to finance its payments to pensioners and workers, while leaving open the possibility of future privatization.[75]

This was not to be. Who owns how much of Gazprom is a secret, but the managers received a huge cut. In mid 1999, the government still owned 38%, while the managers' official stake was around 35%, most of which went to a small group of people who reportedly received stakes of 1% to 5% -- potential wealth of $1.2 to $6 billion each. That left another 25% in other hands. Some of that can be traced to individual owners but much of the ownership is hidden. Former Prime Minister Chernomyrdin, a former CEO and current chairman of Gazprom, is widely rumored to be a major owner. No accident, then, that Gazprom didn't pay much in taxes, despite its wealth and repeated IMF urging that Gazprom was grossly undertaxed and an important target of opportunity for a government desperate for revenue. Gazprom's managers have likely found ways to accumulate shares beyond what is publicly known, but how many is anyone's guess.

How honestly Gazprom has been run is impossible to know from the outside. In 1997, for example, it reported modest profits of around [$1 billion] on revenues of around [$30 billion]. Gazprom's true revenues are hard to determine, because it faces political constraints on cutting off some nonpaying customers (the countries of Ukraine and Belarus, for example). Still, it is possible that revenue measured in billions of dollars per year is simply not appearing in Gazprom's financial accounts, and is getting skimmed instead.[76] We do know that Gazprom spends lavishly on executive perquisites -- a glitzy new Moscow headquarters complex, top-of-the-line corporate jets, and so on.

Given the anecdotes we have recounted, and many others that we could have told instead (the better known ones include Berezovski's looting of AvtoVAZ and Aeroflot, Trans World Metals' tolling agreements with the Novolipetsk steel mill and all three of Russia's major aluminum refineries, and Primorski Krai governor Yevgeni Nazdratenko's takeover of Far Eastern Shipping Co.),[77] one might ask: Are there any honest major

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[75] See Bivens & Bernstein (1999), *supra* note 21.

[76] *See, e.g.*, Adell Karian, *Russia's Dirtiest Secret: Where the Money Goes*, **Russia J.**, Aug. 23, 1999 ("Where [Gazprom's] cash flow winds up is anybody's guess, and whether the company's numbers even remotely reflect reality is a question that securities analysts would far prefer to avoid."); Radio Free Europe/Radio Liberty, *RFE/RL Newsline*, Aug. 30, 1999 (First Deputy Prime Minister Nikolai Aksenenko complains that Gazprom is selling its gas too cheaply to middlemen, who are making "enormous profits").

[77] On AvtoVAZ see [author], *Godfather of the Kremlin?,* Forbes, Dec. 30, 1996, at __. On Aeroflot, see Paul Klebnikov, *The Day They Raided Aeroflot* , Forbes, Mar. 22, 1999, at 106; John Tagliabue, *Swiss Ask Whether Russian Used Aeroflot to Siphon Millions*, **N.Y. Times**, Sept. 15, 1999,

companies left in Russia? Well, yes. Some behave tolerably well. LUKOIL is better respected than the other major Russian oil companies. As a result, its shares trade at around five times the price per barrel of reserves of its competitors, albeit still at a fraction of Western prices.[78]

But gross misbehavior was more the norm than the exception. The reinvestment that the privatizers had hoped for rarely occurred. The kleptocrats often reneged on promises of new investment that they made in the loans-for-shares auctions, or that their companies had made before the kleptocrats acquired them. Yukos again provides an example. Yukos had entered into a long-term contract with Amoco to jointly develop a major Siberian oil field, the Priobskoye field in West Siberia. Soon after acquiring control of Yukos, Khodorkovski renounced Yukos' contract with Amoco, ostensibly because it was too favorable to Amoco. One surmises that his true reasons likely included unwillingness to pony up Yukos' share of the planned investment (a dollar invested was a dollar left unskimmed) or to subject Yukos' operations to the scrutiny that Amoco would have insisted on.[79]

The underlying question must be: If privatization of large firms was this bad, can the alternative have been worse? We turn to that question next.

IV. The Counterfactual: What Might Have Happened With Staged Privatization of Large Firms and Greater Emphasis on Institution Building

Defenders of rapid privatization of large firms would likely respond to our recounting of scandals with two principal assertions. First, they would contend that theft would likely have occurred even if large firms had not been privatized.[80] Second, they would contend that privatization produced productivity gains at some firms. We consider

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at A8. On Trans World Metals, see, e.g., Erin Arvedlund, *Investors, Factory Face Off Over Board*, **Moscow Times**, Feb. 11, 1997; Tom Warner, *The Supply Wars of Ukrainian Aluminum*, **N.Y. Times**, Aug. 23, 1999, at C2; [additional cites r/e aluminum to come]. On Nazdratenko and Far Eastern Shipping Co., see Bruce Ramsey, *Red Faces Here Over Visit by a Russian Official*, **Seattle Post-Intelligencer**, July 24, 1999.

[78] [citation to come].

[79] *See* Jeanne Whalen, *Pena: Russia Should Respect Its Oil Deals*, **Moscow Times**, Sept. 24, 1997; Jeanne Whalen, *Amoco Eyes Sale of Stake in Far North Oil Project*, **Moscow Times**, Nov. 14, 1998.

[80] This was the principal defense of mass privatization by Dmitri Vasiliev, Deputy Minister in the Russian Privatization Ministry during mass privatization and currently head of the Russian Securities Commission, in commenting on this paper at a June 1999 Moscow conference on Corporate Governance in Russia. But Vasiliev limited his defense to Russia's 1993-1994 mass privatization. He opposed loans-for-shares and similar "auctions" of Russia's largest companies.

both of these arguments to be only partial responses, for several reasons.

The first step in assessing what might have happened is to define a counterfactual. For us, the counterfactual is not *just* slower privatization of large firms. That might have reduced political backlash against market reforms, but probably wouldn't have helped the Russian economy much. A more aggressive counterfactual, but one that we believe was attainable in the early reform period of 1991-1993, would have comprised a number of interrelated steps:

- rapid privatization of small firms, much as actually occurred
- slower, staged privatization of large firms, with a promise to managers that their firms will be privatized if the managers perform well enough to justify privatization
- taking the political energy that went into privatizing large firms, and devoting it instead to building the institutions to control self-dealing, corruption, and organized crime
- creating a friendlier business climate, especially a friendlier tax regime

The first step needs no explanation; we provide more detail below on the other three steps and why we believe they were attainable.

A. Did Large-Firm Privatization Make Insider Dealing Worse?

In Russia and other former Soviet Union countries, much theft occurred prior to privatization, and would have continued if the enterprises hadn't been privatized. Theft of the assets of state-owned companies was even given a polite name -- "spontaneous privatization." The counterfactual question is whether the theft would have been greater or less if large-firm privatization had proceeded more slowly, and higher priority had been given to building the legal infrastructure to control insider self-dealing.

We think the theft was likely worse in fact than in our counterfactual. To begin with, our counterfactual includes taking the political energy that was devoted to overcoming the practical and political obstacles to privatization, and devoting that energy to a full-scale effort to build the institutions that are needed to control self-dealing. Part of that effort would be an attack on spontaneous privatization, through the criminal process, and through developing the enforcement institutions and understanding of complex self-dealing transactions needed to attack spontaneous privatization that is less crude than simply walking off with the assets.

An attack on spontaneous privatization was politically feasible. There was ample public support for criminal prosecution of managers who were lining their own pockets with the assets of state-owned enterprises. Given the awful state of Russian prisons, it might not have taken that many exemplar cases to turn many managers' risk-reward

calculus toward more honest conduct. At the same time, the exemplar cases could have helped to nourish a business culture that frowns on self-dealing, which would then underlay successful large-firm privatization. Such a program would likely have reduced the scope of spontaneous privatization, even if there is no way to know by how much.

Second, even without this redirection of political energy, there are cases where theft increased as a result of privatization. The market price of Tomskneft, for example, plummeted in 1996 when Yukos acquired a controlling stake from the government, evidence that investors expected worse treatment from Khodorkovski than from the former managers. By mid-1999, the shares of Tomskneft and other Yukos subsidiaries had all lost 98-99% if their former value. The market price of Yukos itself also plummeted once Khodorkovski decided to bail out and transfer ownership to offshore companies; Yukos was quoted in mid-1999 at 6 cents per share, a 99% drop from its market price of $6.00 per share a couple of years earlier.[81] The market price of Noyabrskneftegaz moved steadily downward after Sibneft acquired control, at a time when the overall Russian stock market was climbing, as minority investors incorporated lower and lower expectations about how much value would be left for them, dropping from $__ per share in [date] to $__ per share in [date], the latter price reflecting a coercive exchange offer by Sibneft of [4] Sibneft shares for each Noyabrskneftegaz share. Sidanko also looted its subsidiaries, and then was looted itself, with both Sidanko and some of its subsidiaries ending up in bankruptcy.[82] Reported earnings tell the same story. Tomskneft, Noyabrskneftegaz, and other major enterprises reported large profits under government ownership, which turned to breakeven or outright losses after a kleptocrat acquired control.

Second, if major natural resources enterprises remained under government ownership, the current profits, but substantial value would remain to be recovered if an honest government emerged. With privatization at knock-down prices, there is nothing left in government hands to be distributed. Not only the short-term value, but the full long-term value, was stolen.

Third, control mechanisms were likely stronger under government ownership. Company managers had lots of discretion, but there was still a chain of command to whom they reported. Petty theft was common, but gross theft might upset one's superiors. There was also the prospect of political embarrassment, and even a possible jail term, if theft became too obvious and was publicly reported.

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[81] See the discussion of Yukos in Part III.C *supra*.

[82] On Sidanko's bankruptcy, see Part III.A *supra*.

The theoretical case for privatization rests in part on the value of separating enterprises from political oversight, so that managers' decisions are motivated by profit, not by whatever motivates politicians (politicians might, for example, favor higher employment, even at the cost of lower profits). As Shleifer & Vishny argue, "privatization widens the separation between the manager and the politician, and in this way stimulates restructuring."[83] But the same freedom from state control that facilitates restructuring, if the manager wants to restructure, also facilitates theft, if the manager wants to steal.

Indeed, it is difficult to see how one could construct a theoretical model in which privatization promotes restructuring by freeing firms from state control, in which that same diminished control does not, other things equal, also permit increased theft through inside dealing. To prevent increased theft, the state would have to retain controls over inside dealing, while relinquishing control over other managerial decisions. That would require the state to devote specialized resources (prosecutors, a strong Securities Commission) to controlling inside dealing. Russia didn't take these steps initially, and once managers and kleptocrats became strong, they became powerful opponents of controls on self-dealing. efforts. The kleptocracy became self-reinforcing.

For us, it is inconceivable that the Russian government would be as financially crippled as it is today if it still owned Russia's major natural resources companies. Oil and gas revenues alone would be ample to pay the government's foreign debt service and pension and salary obligations. And political pressure to capture at least some of those revenues for these purposes would be strong.

B. The Efficiency Consequences of Large-Firm Privatization

Dirty privatization might be justified if it accelerated the restructuring of inefficient state-owned enterprises. Unfortunately, there is little evidence of this.

In much of the world, case-by-case privatization of state-owned firms, often monopolies like railroads, telephone, and electric utilities, or natural resources firms, has led to increased productivity.[84] But the evidence on post-privatization efficiency gains from Russia and other former Soviet Union countries is much more mixed. As John

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[83] **Andrei Shleifer & Robert W. Vishny, The Grabbing Hand: Government Pathologies and Their Cures** 147 (Harvard University Press 1998).

[84] *See* Juliet D'Souza & William L. Megginson, *The Financial and Operating Performance of Privatized Firms During the 1990s*, 54 **Journal of Finance** 1397-1438 (1999); William L. Megginson, Robert C. Nash & Matthias van Randenborgh, *The Financial and Operating Performance of Newly Privatized Firms: An International Empirical Analysis*, 49 **Journal of Finance** 403-452 (1994).

Nellis concludes in a recent survey:

> Evidence – early and fragmentary, but impossible to ignore – from . . . Armenia, Georgia, Kazakhstan, the Kyrgyz Republic, Moldova, Mongolia, Russia, and Ukraine – shows less promising results:
> - Private ownership often does not lead to restructuring . . .
> - Some partially state-owned firms perform better than privatized firms.
> - In some countries, there are few differences in performance between (wholly) state-owned and privately owned firms.
> - In other countries, there are clear performance improvements only in those very few firms sold to foreign investors.[85]

If the choice on privatization is not all or none (and there is no reason why it must be all or none), our own judgment is that small-scale privatization of small shops (basically given to their employees) was an important positive step, mass privatization of medium and larger enterprises was neither a clearly good nor a clearly bad step, and the rigged sales of the largest enterprises were a major error.

It isn't clear, in the end, whether slower privatization of large Russian enterprises would have produced better or worse economic results than the actual rapid but dirty privatization. Ukraine didn't privatize, and ended up as corrupt as Russia and in even worse economic shape. The initial stage of mass privatization was, on the whole, less corrupt than the subsequent rigged sales of major companies. It produced many viable companies, especially smaller companies. But the sales of the largest enterprises seem a failure both economically and politically.

The nature of the privatization process, and the institutional environment in which it takes place, matters more than the Russians or their Western advisors expected. Voucher privatization separates control from cash flow rights, and encourages asset stripping. Mass privatization produced some decent owners and some bad ones, though with a regrettable tendency for bad owners to drive out good ones, often by buying control at low market prices that reflected the expectation of substantial insider theft. Loans-for-shares produced bad owners who chose asset-stripping over value creation, almost without exception.[86]

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[85] Nellis (1999), *supra* note 2, at __.

[86] [cite to come – perhaps to **Harry Broadman, ed., Russian Enterprise Reform: Policies to Further the Transition** (World Bank 1998)] If not, cite to Harry G. Broadman, *Comments on Ownership and Control of Russian Industry* (OECD Conference on Corporate Governance in Russia, Moscow, Russia, June 1999)].

Moreover, we often measure efficiency in terms of the size of the social pie, without regard to who owns which slice. That simplifying assumption fails miserably in the Russian environment. One tragedy of Russian privatization is that wealth differences soared while the overall social pie was shrinking. The standard measure of inequality, the Gini coefficient, increased from around [22] in 1989 to [50] in 1996 (compared to a U.S. level of [ ] in 1999). The percentage of Russians living in absolute poverty (by standard measures) grew from a small fraction of the population in 1989 to an estimated 55 million (37% of the population) in 1999.[87] There is a huge difference in social utility between $25 billion held offshore by a handful of kleptocrats, of no use to anyone else in Russia, and a similar amount distributed broadly among the Russian population.

C. Staged Privatization: Enterprise Leasing and Alternatives

Section B addressed whether large-firm privatization produced productivity gains compared to continued state ownership, holding constant the (bad) institutional environment. However, our counterfactual does not hold constant the institutional environment. Instead, it assumes that (i) the political energy devoted to privatization was devoted instead to building the institutions needed to support large firm privatization; and (ii) the government makes a promise to managers of future privatization, if their results justify it. This promise won't be fully credible, because the government can always renege, but semi-credible promises could have been indeed were being made, prior to mass privatization.

Greater emphasis on institution building might have controlled insider theft and thus improved productivity, both before and after privatization took place. As it was, too many mangers chose to run their business to maximize short-term skimming rather than long-term value. Stronger institutional controls on skimming would have reduced the expected return to skimming, while improving the firm's expected long-term value (because the same government that was building stronger institutions was less likely to expropriate the value the managers created). That would have changed the managers' choice to skim instead of build in at least some cases – how many is impossible to know.

Moreover, a promise of future privatization could have provided incentives for productivity improvement similar to those created by immediate privatization, without the loss of state control over insider dealing that resulted from full privatization. Such a promise could take many forms. But we need not speculate on its exact form because such promises *were being made*, throughout the former Soviet Union, through a program

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[87] [cites to come for data, and definition of Gini coefficient. Rough Gini values are taken from Stiglitz (1999), *supra* note 2, fig. 2. On poverty rates, see Michael R. Gordon, *Hardened to Hardships, Russians Simply Stretch the Rubles Further*, **N.Y. Times**, Aug. 22, 1999, at A1.

called enterprise leasing that began in 1989, during the perestroika era. The privatizers killed enterprise leasing in 1992, so we don't know how it would have turned out. But we know how it started, and the start was quite promising.[88]

Enterprise leasing involved a contract between the state, as enterprise owner, and either the enterprise or its labor collective, that promised the enterprise greater freedom in making investment and operating decisions, the ability to pay higher wages, the ability to retain its own profits, and the potential to eventually buy ownership of the enterprise from the state, all conditioned on the enterprise producing profits that could be reinvested, devoted to paying the higher wages, or saved toward an eventual buyout.

This scheme created complex but on the whole quite promising incentives and information-revelation mechanisms. Saved profits were the *only* funds that could be used for an eventual buyout, so there was a powerful incentive to run the firm efficiently and not to squander profits through higher wages. Conversely, managers that didn't generate (and then save) enough profits to buy their own firm faced the risk that the state would sell the firm to outside owners, who would then likely replace the managers.

The firm's accounts were open to its workers, who could therefore watch the managers. The workers had strong incentives to monitor the managers, lest the managers pay high salaries to themselves or skim profits. Critically, the workers also had the ability to police self-dealing by complaining through the existing administrative chain of command. Managers, in turn, knew that they could be fired or even jailed, or privatization could be withheld, if they ran the enterprise crookedly.

Privatization, then, would be available to those managers who proved their skill by earning profits, and proved their honesty by not self-dealing. Honesty, not self-dealing, would become the way to eventual wealth. A managerial culture of honesty would be reinforced, instead of degraded (as happened with actual mass privatization).

The state, meanwhile, could maintain a tax base by collecting a fraction of the reported profits as taxes. Managers couldn't hide profits without depriving themselves of

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[88] The discussion below of enterprise leasing relies primarily on Anna Tarassova's personal knowledge of how enterprise leasing worked in practice in the Moscow region during 1991-1992. For discussions that convey the reformers' antipathy to a program that they saw as half-a-loaf, see in **Roman Frydman, Andrzej Rapaczynski & John S. Earle, The Privatization Process in Russia, Ukraine and the Baltic States** 20-22, 63-64 (Central European University Press 1993); **Aslund** (1995), *supra* note 10, at 225. The initial decrees permitting enterprise leasing were Decree of the Presidium of the Supreme Soviet of the USSR on Lease and Lease Relations in the USSR (April 1989) and Decree of the President of the USSR, Fundamentals of Legislation of the USSR and the Union Republics on Lease (Nov. 1989).

the opportunity for a future buyout. And the state would have a strong incentive to honor the privatization promise when the time came. Privatization would raise revenue while still promising tax revenue down the road. With a respectable tax base in place, and privatization revenue also flowing in, the government would have been less inclined to turn (as it instead did) to draconian tax rules in a desperate but futile attempt to raise revenue.

Slower privatization of large enterprises would also have made it possible for Russia to develop a better legal and institutional infrastructure to police the behavior of managers and controlling shareholders, when full privatization occurred. This doesn't mean that this infrastructure would have developed. But the possibility existed. The energy that the privatizers devoted to mass privatization, devoted instead to controlling inside dealing, certainly *could* have produced stronger institutions to control the managers and owners of to-be-privatized firms.

The early returns from enterprise leasing were quite positive. It began in 1990, based on decrees issued in April and November 1989, and soon proved highly popular with managers and workers. And enterprises that entered the leasing program – self-selected to be sure – were often doing well. By early 1992, about 9,500 leased enterprises accounted for 8% of total employment and 13% of industrial production. This success made leasing a threat to the privatizers' preferred strategy of mass privatization. The privatizers shut down the leasing programs, lest too many profitable firms choose the leasing route and be unavailable to be privatized.

Some caveats are appropriate. First, some firms could become profitable only under new management. Enterprise leasing wouldn't directly lead to replacement of the old managers. But mass privatization as actually carried out, with control given to workers and managers, also didn't produce rapid managerial turnover. And with leasing, the state retained the power to sell unsuccessful enterprises – easily identified by their failure to complete a buyout – to new owners, or install new managers.

Second, enterprise leasing won't work for enterprises that have no profit potential. For these enterprises, the managers' best option will be to skim what they can while they can. But for these enterprises, privatization is no better -- it will accelerate the plunder by loosening the bureaucratic controls that might have limited theft from state-owned enterprises.

Third, enterprise leasing was most promising for the small, mid-sized, and larger enterprises that went through mass privatization. For Russia's huge natural resources and utility companies, which were mostly withheld from mass privatization and corruptly sold afterwards, leasing would have conveyed too much wealth to a few lucky managers to

be optimal. Honest case-by-case privatization auctions might have been preferable. But even for these enterprises, leasing would still have likely been better than the dirty privatization that actually took place.

Stepping back from the details of the enterprise leasing program, it is one, but surely not the only, example of an approach that can be called *staged privatization*. For us, staged privatization, exemplified by enterprise leasing, has several key features: (i) bureaucratic controls are loosened as the infrastructure to control self-dealing within fully private enterprises is created; (ii) bureaucratic controls are loosened first on operating decisions, and only later on self-dealing, as the infrastructure to control self-dealing is created; (iii) the promise of future privatization, contingent on performance, can create profit incentives *today* comparable to those created by immediate privatization; and (iv) if only successful, honestly run enterprises are eligible to be privatized, a virtuous spiral that encourages good managerial behavior can emerge, instead of the downward spiral that resulted from rapid mass privatization without controls on self-dealing.

It is ironic that the Russian Communists of a decade ago, knowing that central planning was a dead end but not fully trusting markets either, likely built through enterprise leasing a better means for enterprises to manage the transition to privatization and a market economy than the privatize-now approach that Western advisors later promoted and Russian reformers enthusiastically seized on. The Russians who blame Western advice for destroying their economy are not entirely wrong.

D. The Political Consequences of Dirty Privatization

Russians themselves are generally satisfied with small-scale privatization, but do not distinguish sharply between voucher privatization of medium-sized and large firms (in which most received worthless shares or had whatever value the shares might have had stolen) and the corrupt sales of the largest enterprises. Both have left a residue of popular distrust of privatization and a market economy, that will adversely affect future market reforms for decades to come. That is a heavy price to pay for the uncertain economic benefits of fast large-firm privatization.

We have argued in Section A that insider theft was likely worse after large firms were privatized than before. But even if not, the political consequences of massive theft of enterprise value are very different if the theft occurs within government ownership, rather than after privatization. In the former case, the political case for a move to a market economy becomes stronger, and is coupled with political pressure for controls on insider self-dealing. In the latter case, the political case for market reforms is undermined, as people come to associate privatization with theft of government assets, and the inside dealers form a more potent opposition to political efforts to control them.

In addition, one hoped-for consequence of privatization was faster restructuring of major enterprises. Restructuring -- in the sense of new management or new investment -- was the exception. But restructuring through layoffs – both actual and de facto (by not paying wages) -- and shedding of social obligations to maintain housing, kindergartens, medical clinics and the like) was common.

This shedding of excess costs was inevitable in the medium to long term. It might have been politically acceptable in the short term, if the government had stepped into the breach, by providing the social services that enterprises were shedding, plus some unemployment, retraining, and relocation benefits, especially in company towns where new jobs were scarce. The social consequences would have been milder if the business climate for new firms had been friendlier, so that more laid off workers could land at other jobs. Absent either of these ameliorating factors, these layoffs and shedding of social obligations led to real misery, reflected in the form of a large increase in the number of seriously poor people, a sharp increase in death rates, as well as political unhappiness with the market reforms that had led to layoffs and poverty.

E. Toward A Friendlier Climate for Small Business

The most challenging part of our counterfactual involves greater effort to create a friendly business climate for small business. A friendly climate depends on a complex set of interrelated government actions. But here are two key steps that the reformers could have pushed for, by using political capital redirected away from immediate privatization.

One step would have been to waive all enterprise-level income-based taxes on new businesses, at least businesses below a certain size, such as 500 employees. This would have seemed more feasible if tax revenue was continuing to flow in from other sources, such as enterprise leasing of larger enterprises. The actual confiscatory taxes that Russia levied have been hugely counterproductive. They raise negligible revenue, promote corruption, drive small businesses underground and sometimes out of business, and drive larger businesses to hide their profits (which then promotes skimming).

Even far more sophisticated countries have had little success collecting enterprise-level income taxes from small businesses. The United States, for example, recently gave up, and now allows all non-publicly-traded businesses to choose to have all profits and losses are passed through to the enterprise owners. If the U.S. can't collect these taxes, Russia had no hope of doing so, and should have been counseled not to try. Such a waiver has an obvious constituency and would have been politically feasible, had it been tried with serious support from the reformers and their Western advisors.

A second critical step would have been to attack the corruption and organized crime

that placed such a heavy tax on small businesses. Some of this attack would have happened automatically, as part of an overall effort at institution building. It also could have been explicitly made part of the institution-building program. If an aggressive attack on corruption had been a top priority for the internal reformers, and been a key condition for outside financial assistance, the attack might have been launched, and would likely have been at least partly successful. Such an effort is far harder today, because corruption is more deeply entrenched.

The political viability of an attack on corruption and the Mafia is not in doubt, only the political will to carry it out. But the (hypothetical) attack had a greater chance of success if pursued immediately, and accompanied by building strong enforcement institutions, before the privatized businesses could become supporters of the corrupt status quo.

We could continue in this vein, to discuss privatization of urban land as a further important step. Our central point is not the precise steps that could have been taken, but that steps to improve the business climate were politically viable. Some of those steps could have been taken if they were given the priority that was accorded instead to rapid large-firm privatization. Political attention is a scarce resource. The reformers chose to focus on immediate privatization, and thus foreclosed the opportunity to accomplish much along other lines.

V. Insider Self-Dealing in the Czech Republic

The Czech Republic offers an interesting comparison to Russia, that can help us isolate which aspects of the Russian experience with rapid mass privatization were unique to Russia, and which may reflect deeper problems that arise when privatization precedes development of legal and institutional controls on self-dealing.

The Czech Republic was the first country of the former Soviet Union to take the plunge into mass privatization, through voucher auctions that took place in two stages, in [1991-1992], and in [1993-1994]. By 1994, most of Czech industry was in private hands, competing stock markets had emerged, and the Czech economy was growing briskly, with rapid formation of new businesses and minimal unemployment. The Czech Republic seemed to be a model of how to manage the transition from a centrally planned to a market economy. Indeed, as late as 1996, the Czech Republic seemed to be "the success story of Eastern European mass privatization."[89]

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[89] John C. Coffee, Jr., *Institutional Investors in Transitional Economies: Lessons from the Czech Experience*, in **Corporate Governance in Central Europe and Russia, vol. 1: Banks, Funds, and Foreign Investors** 111, 111 (Roman Frydman, Cheryl W. Gray & Andrzej Rapaczynski eds., Central

Today, no one is so sanguine. The early Czech stock market success has disappeared, to be replaced by a scramble for control of the privatized enterprises; by stock prices that collapse once control is attained; and by widespread looting of privatized companies by their controlling shareholders (which explains the collapse in stock prices) and of many voucher investment funds. The Czechs have invented their own term for the widespread practice of selling a company's products at below-market prices to an intermediary owned by the company's managers, then to be resold at market price -- "tunneling." As a result, the Czech Republic plunged into recession in 1997 and 1998, while neighboring Poland and Hungary, which were slower to privatize large firms, but better at building controls on self-dealing, continued to expand briskly.

As John Nellis concludes in his survey of experience with privatization:

> "[t]he lack of prudential regulation and enforcement mechanisms in the [Czech] capital markets opened the door to a variety of highly dubious and some overtly illegal actions that enriched fund managers at the expense of minority shareholders and harmed firms' financial health.[90]

A. The Czech Experience with Tunneling

Czech mass privatization was accompanied by the spontaneous emergence of lightly regulated voucher investment funds, which collected vouchers from citizens and used them to invest in the companies that were being privatized. The voucher investment funds often took sizeable stakes in a limited number of firms, enough to give them influence and sometimes control over firm management. This seemed at first to be a good way to encourage restructuring. When holdover management couldn't make the transition to a market economy, the funds could step in and install new managers. There was, to be sure, concern that some large funds were run by banks. These funds tended to own smaller stakes in a larger number of companies. This raised the concern that the banks would use their stakes to cement lending relationships, and not to promote restructuring.[91]

European University Press 1996).

[90] Nellis (1999), *supra* note 2, at 17.

[91] The discussion below draws heavily on a series of articles by John Coffee. *See* John C. Coffee, Jr., *Inventing a Corporate Monitor for Transitional Economies: The Uncertain Lessons from the Czech and Polish Experiences*, in Klaus Hopt, Hideki Kanda, Mark Roe, Eddy Wymeersch & Stefan Prigge, eds., **Comparative Corporate Governance: The State of the Art and Emerging Research** 68-138 (Oxford Univ. Press 1998); Coffee (1996), *supra* note 89; John C. Coffee, Jr., *The Lessons from Securities Market Failure: Privatization and Minority Protection* (working paper 1999), *available from* the Social Science Research Network electronic library at

Exactly the opposite happened. The bank-run investment funds indeed didn't generate much restructuring. But that was the *good* news. A retrospective analysis by the Czech Ministry of Finance found a *negative* correlation between post-privatization firm performance and the percentage of shares held by non-bank voucher investment funds.[92] The principal reason was that the voucher investment funds often used their influence not to restructure firms, but to tunnel away their profits. As scandals proliferated, foreign investors also withdrew – foreign direct and portfolio investment dropped from $103 million in 1995 to $57 million in 1996 and turned negative in early 1997, as the continuing small direct investments were more than offset by withdrawals by portfolio investors.[93]

The minimal regulation of investment funds, companies, and securities markets more generally, was by design. The Czech government was dominated by fervent free-marketeers who believed that market participants would largely regulate themselves. They were simply wrong. The scams that quickly developed offer a tutorial in the many ways that fraudsters can extract value from both companies and the investment funds themselves. A 1997 report by the Czech Ministry of Finance identified 15 common techniques:[94]

> • <u>the interconnection of several companies</u> -- especially investment companies, investment funds and securities dealers, pension funds, banks and other companies. These interconnections are informal, hard to identify, and utilize puppets.
>
> • <u>large conventional fines</u> -- conventional fines are agreed on in agreements on securities transfer, the amount often being a multiple of the value of the agreed deal; in case of failure to comply with the conditions of the agreement, one contracting party . . . is obliged to pay this considerable sum. Simultaneously, failure to comply with conditions is ensured by the above interconnection of persons in the contracting parties.
>
> • <u>purchases of worthless shares</u> -- persons controlling investment companies or investment funds found a normal joint-stock company, whose shares are based on

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<http://papers.ssrn.com/paper.taf?abstract_id=______. See also Andrew Weiss & Georgiy Nikitin, *Performance of Czech Companies by Ownership Structure* (working paper 1998); **Organization for Economic Cooperation and Development, OECD Economic Surveys 1997-1998: Czech Republic** (1998); [other cites to come]; Czech Ministry of Finance, *Current Aspects of the Czech Capital Market* (informally circulated report, 1997).

[92] Czech Ministry of Finance (1997), *supra* note ?, at 1.

[93] *Id.*

[94] *id.* at 4-9.

worthless property (e.g. receivables, know-how) and then these shares are purchased [by the] investment fund or unit trust.

• concluding unfavourable options and futures contracts -- such agreements do not cover the risks associated with unfavourable developments in the prices of securities held by the investment fund or unit trust [that are subject to the option or futures contract] . . . .

• transfer of advances for the purchase of securities -- the investment company or investment fund transfers a considerable amount of money . . . [to] a securities dealer; this cash is not subject to payment of interest by the dealer and thus does not yield any income for the fund holders; the dealer makes use of this money for dealing in his own name; and the money is transferred without any guarantees . . . to a securities dealer with negligible assets, a securities dealer who is a natural person, [or] to unreliable dealers.

• long settlement periods for securities sold -- an investment company sells securities from the assets of a unit trust or investment fund and sets a long settlement period. Cases are known where the settlement period is several years, or where settlement is made in installments spread over a period of up to 30 years. In the meantime the company owing the money declares bankruptcy and is liquidated.

• loans of securities -- [Czech law] permits the loaning of securities to other persons for a maximum period of 30 days under conditions of perfect security. In practice, neither condition is met and the securities are loaned from the assets of an investment fund or a unit trust without any guarantees and even without any payment for the loan.

• poorly drawn-up agreements on the transfer of securities -- the agreements do not cover basic obligations, such as the date of supply of the security, date of settlement of advances for the purchase of the securities, poor designation of the contracting parties (e.g. an investment company acts in the name of and at the expense of a unit trust, which is not a legal entity, [when under Czech law] the investment company [should act] in its own name and on its own account).

• irrational movements of securities -- there are entire chains of trades in a single type of security; over a few days or weeks or even months, the respective security is owned by a whole series of companies and then returns to the fund at an entirely different price than that when it left. These practices have a great many modifications and are very difficult to uncover. In the light of the known deformations of prices on the stock exchange where negligible quantities of securities are traded so that it is very easy to manipulate their prices, the stock exchange price has no indicative value. It is difficult to demonstrate dishonest intentions and damage to shareholders or fund participants, especially when a considerable period of time has passed between the sale and purchase of the security owned by the fund. . . .

• trading in securities at ridiculous prices -- such operations can be carried out especially because there is no objectively determinable price for most securities as the price-creating function of the public market fails to operate. . . . [Czech law] prohibits funds from loaning money from their assets to other (i.e. third) parties. Funds evade this restriction by concluding an agreement on the sale of securities from their assets to some other legal entity, usually an associated one, at a very low price. A verbal agreement is then made that this associated person will sell the securities back to the fund after a certain period of time, again at a very low price. The low price is agreed so that the associated companies need not pay large sums, which they do not usually have.

The person who purchased the securities from the fund can use them for a certain period of time, trade them, realize profit from such trading or brokerage fees and, after a certain period of time, returns the securities back to the fund. These operations are based on friendly agreements only . . . and the entire agreed operation need not be completed; i.e. the fund need not regain ownership of the securities. . . .

• disadvantageous purchases and sales of securities -- this is only a slight modification of the above practices, e.g. [purchasing new issues of a company's shares] for large sums while these shares can be purchased on the market at much lower prices. . . .

• trading by management on its own account -- these practices . . . [are] associated with the misuse of confidential information, obtained on Boards or Directors of joint-stock companies, whose shares are part of the assets of the fund; this information is supplied to the management, employees, or relatives, or the [company's] shares are sold to such persons at low prices. Investment funds or unit trusts may own up to 20% of the shares of joint-stock companies. On the basis of a relatively large ownership share, the representatives of the fund or investment company demand a seat on the Board of Directors of such a joint-stock company and at Board meetings or in some other way they learn [and can then trade on] confidential information . . . .

• concentration of considerable amounts of cash in the accounts of investment funds or unit trusts in banks. This method formed the basis for subsequent "tunneling" into unit trusts managed by the CS Fund, an investment company. The method was based on the fact that the investment company gradually sold securities from the assets of the unit trust and when the entire assets were transferred in the form of deposits to a bank, the deposits were withdrawn and transferred to an account abroad. . . .

The retention of a large share of the assets of a fund in the form of deposits with a bank can have other reasons. Especially small banks, which are informally connected with the management of an investment company or an investment fund, can solve the problem of insufficient liquidity by retaining part of fund assets in [cash] with such a bank. In this way, the bank hides its own difficulties from bank supervision and postpones its decline: when the bank does finally fail, the assets of the fund are also

> affected . . . .
>
> • <u>failure to comply with limits for restricting and spreading risks</u> -- Czech law sets forth limits for holding securities [of a single issuer] in relation to the total volume of assets owned by an investment fund or unit trust . . . . Cases have been registered in which investment funds . . . exceeded the limits for restricting and spreading risks . . . . Simultaneously, the banks whose shares were owned by the funds encountered difficulties, were subjected to compulsory administration or entered liquidation, their shares fell to zero value and the investment funds often suffered considerable losses. . . .
>
> • <u>"tunneling" into companies is a frequent phenomenon.</u> Current "corporate raiders" have discovered a risk-free method of removing money from companies. This method consists of holding a general meeting of shareholders, in which the "raiders" have a voting majority; this meeting passes a decision on a transaction involving company property . . . and the Board of Directors of the company then carries out this operation, with consequent damage to the company. No (minority) shareholder can blame the Board of Directors of the company for this operation as it is bound by the decision of the general meeting . . . .
>
> These ways of "handling" the assets of investment funds and unit trusts are combined in practice and are very difficult to demonstrate and penalize.

The scandals led to a collapse in the Czech stock market. Share prices and the number of listed companies. By 1999, only a dozen or so companies had real liquidity. Roughly a quarter of the Czech investment funds were looted so thoroughly that they went bankrupt; another quarter were converted into unregulated holding companies, with likely adverse consequences for their minority investors.

The Czech Republic, unlike Russia, has responded to the scandals with strong efforts to tighten its legal controls across a variety of dimensions -- company regulation, securities regulation, investment fund regulation, creating a strong securities commission, and so on. Those efforts give hope of improved performance in the long term, but for now, the government is shutting the proverbial barn door after many of the most valuable horses have already been removed, and much harm has been done to the public's faith in a market economy.

B. Comparing Russia and the Czech Republic

Russia privatized without enforcement against self-dealing, and with an environment that was actively hostile to forming new businesses or honestly reporting of profits. The Czech Republic also privatized without enforcement against self-dealing, but otherwise had an environment that was reasonable friendly to new businesses. It didn't impose

obstacles to honest financial reporting or honest management of privatized enterprises. It had been Communist only for 40-or-so years, not 75 like Russia, and had never been as thoroughly Communist. Memories of how to run a private business survived. It was closer to major export markets in Western Europe.

That not-so-bad environment was sufficient to nourish self-dealing. One central reason involves a simple exercise in comparative economics: The shares of a mass-privatized company were worth more to crooks, who would use 50% control to extract 100% of value, than to honest owners who would run the company for the benefit of all shareholders. So bad owners could and did drive out good ones.

At the same time, the Czech Republic's friendlier business climate surely meant that there were cases where for insiders, the strategy of stealing all the value they could was dominated by the strategy of running the business to maximize long-term value, or selling to someone else who would do so. In Russia, theft of company assets became the norm; in the Czech Republic, it merely became distressingly common.

In neither country did entrepreneurs succeed at doing both -- running the business to maximize long-term profit and skim what they could in the near term. That inability may reflect institutional competence – the same people simply aren't good at these very different tasks. It may reflect the practical reality that maximizing long-term value often requires new investment, which won't be available because investors won't trust the skimmers (for good reason). Finally, it may reflect the insiders' judgment that once they steal what they can, the prospect of keeping their share of what's left over the long-term, given the risk that a future government will investigate the near-term theft, isn't high enough to devote much effort to.

Whatever the reason, insiders either skim or restructure and reinvest, but rarely do both. The many Czech cases where insiders skimmed from viable enterprises, instead of restructuring them, demonstrate -- as the Russia example alone cannot -- that strong controls on insider self-dealing are a necessary precondition for successful large-firm privatization.

C. The Special Case of Voucher Investment Funds

In both Russia and the Czech Republic, the privatizers hoped that the voucher investment funds would become strong outside owners, who could replace bad managers and force restructuring of enterprises. That sometimes happened, but more often, the voucher investment funds were part of the problem, not the solution. Too often, they looted the companies they invested in and were looted themselves.

The theoretical analysis in Part III.A of an amoral controller's choice between value creation and self-dealing can help to explain why. A value creating strategy is most likely to maximize the controller's private value for an operating company with strong growth prospects. For voucher investment funds, growth prospects are limited. They receive a one-shot infusion of capital at the time of voucher privatization, that won't be replicated through private investment for a long time, if ever. This virtually ensures that if self-dealing isn't policed, an amoral controller is better off stealing all of the fund's value than keeping a partial claim on that value through management fees. Thus, we disagree with those who argue that Russia's problems with privatized firms reflect manager control of the privatized firms, to which voucher investment funds are an antidote, rather than flaws in mass privatization *per se*, absent controls on self-dealing.[95]

VI. Implications for Future Privatization Efforts

Russian mass privatization was motivated, in important respects, by faith. As Andrei Shleifer and Robert Vishny, key Western advisers on Russian privatization, wrote as recently as 1998:

> We believe that managerial discretion problems are usually minor relative to political discretion problems. Privatization works because it controls political discretion.[96]

For Russia, we once shared that belief. So did most of the Western advisors who pushed the Czech Republic, Russia, and many other countries to plunge ahead with mass privatization. But they and we were wrong. As with many religious beliefs, the faith that any private owner was better than the state as owner rested on an unexamined premise – that a country has the will and infrastructure to control managerial discretion manifested through overt self-dealing. If the state can carry out that basic function, then the belief becomes tenable. If the state cannot control this form of white-collar crime, then the balance between the problems of managerial discretion and political discretion is far more uncertain.

We are learning, through experience, that Western-style capitalism is more fragile than we thought. It will not emerge -- certainly not quickly, perhaps not at all -- if seeds are simply scattered widely through mass privatization, to grow in the thin soil of an institutionally impoverished country. Instead, the institutions that control theft in its

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[95] *See* Raj M. Desai & Itzhak Goldberg, *The Vicious Circle of Insider Control in Russian Enterprises* (working paper 1999).

[96] **Shleifer & Vishny**(1998), *supra* note 51, at 150 (emphasis added).

myriad forms, especially inside dealing by managers and controlling shareholders of large firms, are an essential fertilizer.

This article is not the place for full discussion of the complex legal, institutional, and cultural ingredients that must be combined to create fertile soil in which privatized companies can take root.[97] The task is not a simple one. One problem is that we don't yet know how strong the infrastructure must be before large-firm privatization is likely to promote, rather than hinder, economic development. A second is that many of the necessary institutions can develop only as the market develops. A securities commission needs fraud to practice on, if it is to become skilled at combating fraud. So do criminal prosecutors. Accountants investment bankers, and other reputational intermediaries also learn from their mistakes – from the frauds they didn't catch.

What we do know is discouraging. The necessary tasks cannot be completed quickly. Ironically, the countries that -- like Russia -- have made the worst hash of managing their state-owned enterprises are least likely to possess or soon develop the institutions that would let them achieve economic gains from rapidly privatizing large firms.

We sketch below -- a full treatment is beyond this article's scope -- some tentative answers to two policy questions. First (section A), how should countries with weak institutions behave, with regard to not-yet-privatized firms? Second (section B), what should Russia and other countries that have already -- perhaps prematurely -- privatized most of their major enterprises do now?

A. Steps Toward Successful Large-Firm Privatization

At a high level of generality, the central steps toward successful privatization seem to us to include a reasonably honest government, a reasonably friendly climate for businesses new and old (for which an honest government is one component), and a reasonable effective infrastructure. The creation of this infrastructure can take place in parallel with staged privatization. The promise of future privatization can create efficiency incentives *today* comparable to immediate full privatization, without premature loosening of existing bureaucratic controls on insider dealing, and ideally (as with

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[97] For discussion of the legal and institutional prerequisites for strong public capital markets, see Bernard S. Black, *Creating Strong Stock Markets by Protecting Outside Shareholders: The Nontriviality of Securities Law*, Stanford Law School, John M. Olin Program in Law and Economics Working Paper No. ___ (1999), available from the Social Science Research Network electronic library at <http://papers.ssrn.com/paper.taf?abstract_id=______>.

enterprise leasing), with future privatization offered only to firms that are competently and honestly run.

The government's promise to reward managers through future privatization can also be made explicit, if need be. The government can reserve a percentage of the company's shares for its managers. If the promise is credible, the expectation of receiving shares in the future looks, from a manager's perspective, not very different in its incentive properties from restricted stock or stock options that vest over time, Both of these devices are commonly used as incentive compensation in developed economies. In some ways, restricted stock and unvested stock options are superior to full ownership of shares as a management incentive device, because managers can sell shares that they fully own, and many sell to diversify their personal financial portfolio, thus weakening the incentive effects that stock ownership was intended to provide.

It can help to invite in well-functioning foreign firms, to buy controlling stakes in local firms. But foreign ownership is no panacea. Foreigners can strip assets as well as locals, if not well-chosen. An honest government could create an auction process that screened foreign investors for quality, but such a government wouldn't need the screening, because it could control insider dealing fairly well anyway. A corrupt government that couldn't control insider dealing isn't likely to do a good job of choosing investors – witness Russia's disastrous effort, through loans-for-shares, to pick winners of the auctions of major firms.

A further essential step: Competition policy should make it easy for new firms to challenge existing monopolists; trade policy should make it possible for imports to challenge domestic products. Distribution monopolies, often connected with organized crime, are especially pernicious because they limit competition across a broad range of products, not just in a single product market, especially severely the ability of imports to compete with domestic products. The more competitive product markets are, the greater the pressure to improve operational efficiency, the fewer the rents to be skimmed, and the shorter the time period in which skimming can be sustained.[98]

Just as the enforcement infrastructure to control self-dealing by managers of large firms must be largely in place before full privatization, lest the managers of privatized firms defeat efforts at further tightening, so competition and trade policy needs to be put

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[98] On the empirical correlation between good competition policy and good outcomes from privatization, see Pankaj Tandon, *The Efficiency of Privatized Firms: Evidence and Implications* (updated cite to come, Boston Univ. working paper 1994); John Nellis, *Competition and Privatization: Ownership Should Not Matter -- But It Does*, 4 **Revista do Instituto Brasileiro de Estudos Das Relacoes de Concorrencia e de Consumo** 211-216 (1997).

in place before or together with privatization, lest the new private owners defeat later efforts to reduce their rents.

B. What Should Russia Do with Its Already Privatized Firms?

1. A Crash Effort to Control Inside Dealing and Corruption

Russia is some distance away from having a normal capitalist economy, where capitalists mostly act to increase the value of the companies that they run, instead of mostly lining their own pockets at the company's expense. The core steps include: a rational tax system; a serious top-down attack on organized crime, on corruption at all levels and the broad administrative discretion that invites corruption; strong civil and criminal enforcement of the existing rules that constrain inside dealing; strengthening those rules by removing the more obvious loopholes; and improving financial reporting by major firms (which isn't feasible until the tax system is reformed to permit firms to report their results honestly). No one of these is sufficient by itself, but each will help, and progress on any one will likely reinforce progress on other fronts.

These changes are all "on the agenda" – no sensible person could be against them, and many Russians understand their importance. But none are at the top of the agenda, either for the Russian government or its Western advisors. They need to be. Otherwise, Russia risks going the way of Nigeria – another oil-rich country whose government is thoroughly corrupt and its population impoverished, while a favored few skim billions into offshore accounts. Sadly, we can't expect improvement during Yeltsin's presidency, and none of the leading candidates for the Presidential election in 2000 is likely to offer much improvement.

2. The Case for Selective Renationalization and Reprivatization

Western advisors understand that loans-for-shares and similar privatization sales were thoroughly corrupt, but remain highly reluctant to propose renationalization as a strategy. In contrast, we see possible merit in selective renationalization, followed promptly by reprivatization. Once the government has the will and ability to renationalize with reasonable honesty (not today's government, and probably not for some years), renationalizing and then promptly reprivatizing some major companies could be the best available strategy.

The case for renationalization and reprivatization will be case specific, and can be illustrated better with examples than in the abstract. Here are two. Suppose that Mikhail Khodorkovski succeeds in stripping all value from the minority shares in Yukos and its production subsidiaries and transferring essentially all ownership and profits to shadowy

offshore companies. Renationalization would then harm no one but Khodorkovski and his accomplices, and would give the Russian government a second chance to privatize these companies properly, Reprivatization could raise serious revenue for the government. A tolerably honest government that earned from reprivatization even 20% of the value of a comparably sized Western firm would raise around $35 billion in privatization revenue, which exceeds the government's total 1998 tax take of around $25 billion. And the new owners, unlike the current ones, will presumably pay workers, pay taxes, and reinvest where appropriate.

Similarly, renationalization of Zarubezhtsvetmet would harm no one but its current crooked owners, would benefit the Erdenet copper mine and the entire country of Mongolia, and would permit Russia to find better private owners and to earn the revenue from reprivatization that it should have earned the first time. Moreover, for the current owners, "harm" is a peculiar term. They would most likely keep the profits they skimmed while they owned the company, which far exceed their investment.

The appropriate analogy is to a thief who steals government property. Few would doubt that the appropriate response is for the government to take back the ill-gotten property and then resell it. That Khodorkovski also stole the property of the minority shareholders in Yukos and its subsidiaries, might give rise to an argument that the government, when it reprivatizes, should pay something to the former minority shareholders, if they can be found. But whether compensation is paid to minority shareholders is a secondary matter. The central task is to recover and resell the stolen property, in the cases where "theft" is the proper descriptive word.

Indeed, the anti-renationalization advice now proffered by the multilateral institutions is internally inconsistent. The IMF and the World Bank are encouraging governments to seize insolvent financial institutions -- often brought down by lending to insiders -- and sell their assets. They withhold aid from governments that are slow to do so.[99] The multilateral agencies have failed to see the analogy between seizing a financial institution that has been stripped by insiders and seizing a nonfinancial institution that has been stripped by insiders.

We stress that what we propose, in appropriate cases, is renationalization *plus* prompt reprivatization, *when and only when* the government can do a better job both in privatization itself and in controlling self-dealing by private firm controllers.[100] We have

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[99] [cites to come. Recent example -- IMF conditioned Indonesia bailout funds on Indonesia's willingness to seize insolvent banks].

[100] For a similar proposal, involving the government swapping tax obligations for additional

no opinion on whether renationalization without privatization could make sense. That depends on whether a Russian government that can't semi-honestly sell its major companies can do a better job of running them than their current owners. That is a choice between two bad owners. It's hard to tell which is worse. Moreover, the reprivatization strategy makes sense only if the reprivatization will be more honest than the initial privatization and the new controllers will be more likely than the old ones to create value instead of strip assets. In Russia today, there is no basis for either of those beliefs.

We recognize that the risk of renationalization may cause managers to accelerate the plundering of the enterprises that they control. If renationalization extends beyond clear cases of theft, it can lead managers who might otherwise manage firms with at least one eye toward long-term value to plunder instead. But if limited to clear cases of theft (of which Russia has no shortage), and especially accompanied by criminal prosecution of some of the crooks, renationalization can also convey a important message to managers about acceptable and unacceptable behavior, and the long-term downside risk from plundering. In the end, the appropriate deterrent to continued theft cannot be to turn a blind eye to all crooks, for fear that prosecuting some will cause others to steal even faster before their turn comes.

3. Strengthening Product Market Discipline

We suggested in Part VI.A that open competition and trade policy are essential accompaniments to privatization. Russia has a long way to go along these dimensions. A review of Russia's competition policy and trade policy is beyond the scope of this article. For competition policy, suffice it to say that the European Bank for Reconstruction and Development, in its 1998 Transition Report, rated Russia as 2+ on a 1-5 scale for its competition policy, indicating ample room for improvement.[101] And Russia's trade policy has been moving in the wrong direction – for example toward higher customs duties and tighter restrictions on oil exports, the better to subsidize domestic oil consumers and the owners of the favored few firms that win export rights.

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company shares, which it then promptly sells to investors, see Desai & Goldberg (1999), *supra* note 95. In our judgment, Goldberg & Desai pay insufficient attention to whether there is reason, without both reform within the government and strengthening of the government's enforcement capacity, to expect auctions of shares that are newly issued in payment of tax obligations to produce honest auctions or better new investors than the owners the government has found in the recent past.

[101] **European Bank for Reconstruction and Development, Transition Report 1998** (1999), at 26.

A further essential step: Competition policy should make it easy for new firms to challenge existing monopolists; trade policy should make it possible for imports to challenge domestic products. The more competitive the market, the greater the pressure to improve operational efficiency, the fewer the rents to be skimmed, and the shorter the time period in which skimming can be sustained.[102]

Just as the enforcement infrastructure to control self-dealing by managers of large firms must be largely in place before full privatization, lest the managers of privatized firms defeat efforts at further tightening, so competition and trade policy needs to be put in place before or together with privatization, lest the new private owners defeat later efforts to reduce their rents.

VII. Conclusion: How Can the Outside World Help Russia?

What the world outside Russia can do now to help isn't clear. There is ample evidence, from decades of foreign aid to corrupt governments, that shoveling money at them doesn't help economic development, and might hurt by financing the corrupt elements of the society and imposing a repayment burden (assuming that most aid is in the form of loans).[103] Efforts at legal reform are worthwhile, as a way to develop background conditions that will become important when and if more important factors fall into place. IMF aid was supposed to buy time for Russia to reform its tax system so it could collect the revenues it needed to balance its budget; instead, aid may have merely permitted the existing system to survive a bit longer, by substituting for revenues that weren't collected, while tax reform promises went unkept. Most of the proceeds were apparently siphoned off by the kleptocrats and government officials, while the country faces the burden of either eventual repayment or official default (the road Russia has thus far chosen for most of its obligations).

It might help to promise aid, to be delivered only after promises were kept, not merely made. A government that first adopted simple, enforceable tax rules, put corrupt officials in jail, and solved a few of the many murders of politicians and businessmen might be worth trusting to use aid funds to support development, or to assist the losers

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[102] On the empirical correlation between good competition policy and good outcomes from privatization, see Pankaj Tandon, *The Efficiency of Privatized Firms: Evidence and Implications* (updated cite to come, Boston Univ. working paper 1994); John Nellis, *Competition and Privatization: Ownership Should Not Matter -- But It Does*, 4 **Revista do Instituto Brasileiro de Estudos Das Relacoes de Concorrencia e de Consumo**211-216 (199_).

[103] *See, e.g.,* **The World Bank, Assessing Aid: What Works, What Doesn't, and Why** (Oxford Univ. Press 1998); Jonathan Isham & Daniel Kaufman, *The Forgotten Rationale for Policy Reform: The Productivity of Investment Projects*, __ **Quarterly Journal of Economics** 149-184 (1999).

from the switch to a market economy. It could help to fund an extensive training program that brought the best and brightest Russians to Western countries for training. Many would stay (benefitting their new home country but not Russia), but some would return. And more would return in a decade or two, by then highly skilled, if opportunities improve. The return of foreign-trained professionals, mostly from the United States, has aided development of other countries, including China, Taiwan, India, and Ireland. It could help Russia too, but over a time period measured in decades.

A small example: Funding 500 top Russian law students to get American LLM degrees would cost perhaps $20,000,000 per year initially, and much less over time if students who took law firm jobs (as most will) had to repay their tuition loans. A significant fraction of these lawyers would return to Russia, either immediately or when business conditions improved. In a decade, Russia would have a pool of 5,000 American-trained lawyers to draw on, who would understand how a system of market-supporting laws is supposed to work. Many of them would become bar leaders. Some would become senior government officials or political leaders who could help to bring such a system about. This kind of bottom-up support of people who can develop future reforms is rarely popular with aid donors, though, except on a token scale, because it has a payoff measured in decades.

A related but even longer-run project would be to develop new private law and business schools. Russia's current law schools are far too small to meet Russia's need for lawyers trained in business law. Moreover, the current law schools will be dominated for some time to come by Communist holdovers who don't understand business themselves, so can hardly be good teachers. Business schools rarely exist at all -- Communist Russia didn't need them.

Aid that supports development of enforcement capacity could be highly useful. For example, judges and prosecutors need training to be able to handle complex corporate cases, and the Securities Commission needs all the enforcement resources it can get. This won't help for cases where prosecutors are called off by politicians, but not every corporate crook has as much political clout as the first-tier kleptocrats.

Foreign pressure aimed at opening Russia's markets to competition could be useful, because strong product market competition can police much self-dealing, at least in the medium-to-long term. But to be politically palatable, the advice to open markets to imports and foreign investment must be coupled with the advisors' willingness to open

their own markets to Russian exports – willingness that has sometimes been notably absent.[104]

Quick strategies are not apparent. With corruption so deep that most of the value inherent in state enterprises was and is being stolen, with the government either actively cooperating or looking the other way, we shouldn't be surprised that dollars loaned to the government from abroad -- whether privately or by multilateral organizations like the World Bank and the IMF -- receive similar treatment. World Bank and IMF aid, with promises of future aid conditioned on basic economic reforms that might facilitate the growth of new businesses, have produced little actual reform.

A central economic lesson of the 20th century is the huge difference between well-run, mostly market-centered economies and badly-run, often government-centered economies. Explicitly communist countries like Russia were by no means the worst of the badly run countries. Many African countries did still worse. That experience demonstrates both the boost that good government can give to economic performance, and the difficulty of escaping from a long legacy of bad government.

A central lesson from the past decade is that mass privatization offers no escape from that general lesson. Mass privatization of large firms in an otherwise badly run country is no panacea. In Russia, and perhaps more generally, it isn't clearly better than no privatization at all. Russia, like many other transition economies, desperately needs an unremitting focus on building the infrastructure to support a complex market economy, whether or not accompanied by rapid privatization of the assets that remain in government hands. Once the infrastructure is in place, privatization will likely succeed. Until then, privatization will likely fail to boost economic performance.

More generally, mass privatization was part of a conscious effort by the shock therapists to destroy the existing structure of state control, quickly and irrevocably. In the political sphere, Edmund Burke taught us two centuries ago that destructive revolutions often come to bad ends; a lesson that has been relearned many times since (not least in Russia under the Communists).[105] Economic revolutions that destroy existing institutions before new ones can be built are similarly likely to founder, as those without scruples take advantage of the resulting institutional vacuum.

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[104] *See, e.g.,* William Roberts, *Curbs Sought on Steel Imports*, **J. Commerce**, Oct. 1, 1998 (antidumping actions by U.S. steel producers against Russian steel imports).

[105] *See* **Edmund Burke, Reflections on the Revolution in France** (1790) (Liberal Arts Press 1955).