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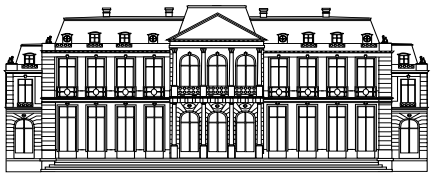

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Introduction

In this brief presentation, I would like to make some comments on the progress of reforming the business climate in Russia, including how it compares to that of other countries in transition. I would then like to discuss some of the current policy measures dealing with corporate governance reform that are presently under discussion by the Government, especially those that are part of the World Bank-supported structural adjustment program. I will conclude with some ideas about how to deepen the policy agenda for further inquiry in the area of Russian competition, corporate governance and shareholders' rights.

Reforming the Russian Business Environment

For many of us who have toiled hard to understand enterprise reform in Russia, a central issue in evaluating how privatized Russian firms (or those of any other transition country) are performing, is to focus on the *nature* of the privatization that firms underwent (or are still undergoing), since in my view that is in large part determinative. This conclusion may sound trivial or axiomatic to many who are experts in this field today. But in the earlier years of Russia's (and other countries') transition, there was a sense in the policy community that ownership change from public to private—however it comes about—is necessarily welfare improving, even in the short run.

We know better today. Indeed, it can be said that, although in the past seven years Russian firms have experienced change in ownership, there has been remarkably little change in corporate performance or restructuring.[1] The fact is that the *process* of privatization is absolutely critical in shaping *ex post* firm performance. That is why it has been so important that the Russian authorities in recent years have tried to build a third-generation privatization program—following the mass privatization and loans-for-shares efforts—called the Case-by-Case (CBC) approach. This approach, which is essentially international best practice carried out in the more advanced countries worldwide, is fundamentally predicated on a rules-based framework of transparency and competitiveness and the use of independent financial advisors, who operate at arms length from both the seller (the state) and prospective investors. This is a program that we at the World Bank have been supporting in Russia the past few years.

[1] See Broadman, Harry G., ed., *Russian Enterprise Reform: Policies to Further the Transition.* The World Bank. Washington, D.C. January 1999.

But even if privatization is done according to international best practice, what really matters in terms of engendering sound corporate governance incentive structures is the state of development of market institutions at the time of privatization—especially institutions pertaining to definition, credibility and enforcement of property rights, and those pertaining to the competitiveness of product, factor and capital markets, including entry, exit and the market for corporate control. To be sure, there is abundant empirical evidence showing that, controlling for other factors, privatized firms on average perform better than those remaining in state hands.[2] So in some sense the answer to the counterfactual question of: "what would have happened had we not privatized?" is known. But what is less known, is the nature of the interaction between the institutional factors I just mentioned and the impact of privatization on firm performance.

What in fact do we know? We know that, despite an increase in participation by "outsiders" in recent years, many Russian privatized firms suffer from "insider control", where firm ownership is dominated by managers and employees. As has been widely documented in Russia and elsewhere, absent (external) checks and balances, insider control engenders many pernicious effects. Among other things, unchecked insider control leads to:

- Inability for firms to attract investment
- Asset stripping
- De-capitalization
- Wage manipulation
- Retardation of enterprise restructuring
- Insider blockage of investor protections and other corporate governance reforms
- Fraud and corruption

It is very clear that Russia, like some other transition economies are in a "zone of property rights uncertainty" in that the earlier system of property rights under central planning has eroded or disappeared, but that a new market-based system of well-defined property rights is still largely non-existent.

What is important about this finding, is that it is more widespread and more applicable to a broad array of transition economies than might be suggested at first glance.

Indeed, even in transition countries where privatization has not yet been systematically implemented, but where, against the backdrop of an absence of robust development of market institutions there is (i) decentralization and erosion of state owned enterprises' property rights and (ii) spontaneous privatization, we do see these problems.

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[2] Nellis John., "Time to Rethink Privatization" *Finance and Development*. International Monetary Fund. June 1999.

In particular, China—a transition country I have come to know well in an earlier World Bank incarnation—is a good case in point, and perhaps one that is instructive to highlight, as the debate over reform of Russian governance intensifies and people begin to draw comparisons with and lessons from other transition countries—especially those that have exhibited strong growth and are looked to as potential role models.

In the World Bank's work on state asset management and corporate governance in China, we have found that in many large existing state owned enterprises (SOEs) where there is not sufficiently market-oriented corporate governance incentives—whether internal or external to the firm—there is pronounced unchecked insider control.[3] We called it a "corporate governance vacuum." The negative results of this invitation for Chinese SOE managers to enjoy insider opportunism without well-defined property rights are basically those pernicious effects that I have just listed. Everybody gravitates to the good assets, but no-one wants the bad ones. But these are state owned enterprises that are not being formally privatized. The result is an asymmetry where there is, in effect, the privatization of assets but the socialization of the liabilities, since the state is left holding what no-one else wants to assume – the liabilities; in particular, the liabilities arising from redundant workers, housing obligations, pension, health and other social insurance functions, education and so on.

There is another important comparison between Russia and China that is important to highlight. That is the question of financial industrial groups (FIGs) and holding companies. As is the case in Russia, the Chinese are actively establishing these entities, based on the (earlier) Korean and Japanese models. Yet even before the East Asian crisis hit—which exposed the frailties and weak governance incentives embodied in Korean *chaebols* and neighboring countries' similarly configured enterprise group structures—signals had been sent to the Chinese authorities about the limited benefits, if any, of such enterprises. In the wake of Russia's financial crisis, which as Radygin points out is causing some of the country's FIGs to be pulled apart, the Russian authorities would do well to focus on the lessons of the East Asian experience, just as the Chinese are now doing. The implications are similar for the recently created (yet still not financed) Russian Development Bank, modeled in large part on the Japanese Development Bank.

[3] Harry G. Broadman, "The Chinese State as Corporate Shareholder'" *Finance and Development*. International Monetary Fund. September 1999; also *China's Management of Enterprise Assets.* The World Bank. August 1997.

Of course, the parallels between China and Russia are not exact, especially in terms of initial conditions before their respective reform periods began. But the evidence indicates the generic importance of how corporate governance is affected when we are faced with a business environment characterized by weak fundamental market institutions and poorly defined property rights.

Corporate Governance Reforms in Russia

I would be remiss if I did not describe what the World Bank is doing to promote more effective corporate governance in Russia under our structural adjustment loan (SAL) program. As I am sure many of you know, the World Bank's SAL program provides support to the Russian authorities' for their *medium-term* structural reform program. As the manager of the Russia SAL program over the past few years I can tell you first-hand it has been quite a challenge; never a dull moment! These SALs are the "structural sisters" to the IMF's macro program in Russia, although our focus is necessarily more long term than the Fund's. We are now in the process of re-negotiating the third structural adjustment loan—"SAL3"—which is a $1.5 billion operation. Importantly, achieving success in the structural reform effort in Russia requires our working not only with the Government, but also establishing a policy dialogue with the Duma as well as Russian businesses, NGOs and civil society.

Four important measures dealing with corporate governance *per se* are included in the latest SAL3 program. These measures are the product of our close working relationship with Dimitry Vasiliev and his colleagues at the Federal Securities Commission. But before I describe them, I want to emphasize, in line with my earlier remarks, that the SALs focus on other equally important policy measures to foster business development in Russia beyond those that would narrowly be labeled as corporate governance reform. In particular the program contains key economy-wide, cross-sectoral measures dealing with (i) competition policy and regulatory reform, (ii) reducing barriers to entry, (iii) bankruptcy, (iv) accounting and auditing reform, (v) FDI and trade reform, (vi) labor mobility, (vii) financial sector and capital market reform, (viii) land reform, (ix) fiscal management, among others. The Government's *Letter of Development Policy*, which describes in detail the overall SAL3 undertakings by the Russian authorities with the Bank, has been made public by our counterparts and is on the Government's website.[4] In fact, the publication of the LDP is itself an innovation of our work in Russia.

[4] The website address is: http://www.economy.gov.ru/le4/LDP0719e.htm

With respect to corporate governance reform: First, we are working with the authorities to enact amendments to the law "On Joint Stock Companies" as well as legislation "On Protection of the Rights and Legitimate Interests of Investors in the Securities Market" to enhance protection of minority shareholders' rights, including protection from transfer of assets between parent and affiliate companies, and increasing substantially the penalties for violating investors' rights.

Second, we are seeking to introduce into legislation criminal liability for repeated failure for information disclosure and for issuance of illegal securities as well as put in place court of law actions for liquidation of financial pyramids.

Third, we are working with the authorities to support the enactment of legislation that would impose substantial penalties for insider trading and establishes a framework for regulating transactions among affiliated parties.

Finally, we seeking measures to ensure there is adequate funding for enforcement by the Federal Securities Commission, including through assignment of a share of license fees charged on professional participants of the securities market and a share of the tax on securities transactions levied when security issues are registered.

Where Do We Go Next? A Policy Agenda for Russian Corporate Governance

I believe there are several key policy questions that we all need a better understanding of if we are to be successful in furthering corporate governance and enterprise reform in Russia.

First is the need to broaden the analytical focus of how to solve the corporate governance dilemma in Russia to include the incentives and disincentives faced by *all* stakeholders. In my view, and as one can clearly see from recent findings in the economics literature, this means going beyond concerns about minority shareholder protection or the functioning of boards of directors, to pick just two examples. This is not suggest the lack of importance of such issues. Rather it is to emphasize that one of the weaknesses in the analytical work on corporate governance today—worldwide, not just Russia—is the almost exclusive focus on the dilemma posed by the combination of entrenched management and weak, dispersed shareholders. But the fact is that the widely held firm a la Berle and Means[5] classic view is not the rule; rather it is the exception.[6]

Increasingly, the prevalent firm-form, even for listed firms, is one where there is concentrated ownership and a dominant shareholder—an individual, a family, institutional investors, a bank, an so on. As is well-known from the literature, the lack of investor protection is one of the reasons why we observe ownership concentration. Not surprisingly, for the closely held firm, the problem of corporate governance is less one of shareholder protection and boards of directors, and more one of cross-shareholdings, holding companies and pyramid or other mechanisms that dominant shareholders use to exercise control.

Precisely in this environment, which is likely to be characteristic of developing and transition countries, one needs a broader prism through which to assess control and corporate governance than simply the providers of (equity) capital. The fact of the matter is that there are multiple stakeholders in a firm—workers, input suppliers, distributors, customers, banks, government and other groups that affect governance. It seems to me that without this *general equilibrium* perspective, especially given the complexities of Russia's political economy and numerous stakeholders, the analysis of, and design of policy measures to reform corporate governance in Russian firms will be flawed.

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[5] Berle A. and Means G., *The Modern Corporation and Private Property*. 1932. MacMillan. New York.

[6] See, for example, Shleifer A. and Vishny R., "A Survey of Corporate Governance". *Journal of Finance*. 1997. 52: 737-783 and Berglof E., "Reforming Corporate Governance: Redirecting the European Agenda". *Economic Policy*. 1997. 93-123.

In a related vein, let me come back to an earlier point I made and suggest it as an important avenue for policy inquiry on how to improve corporate governance in Russia. It is the question of the relationship between corporate governance and *competition* – competition in product markets, and competition in factor markets, both for workers and investment capital. These linkages are key. However, there is a real dearth of serious empirical industrial organization research on Russian enterprises, especially in the manufacturing sector (i.e., outside of the infrastructure monopolies, where there has been a limited amount of such analysis).[7] In particular, there is very little that has been done in recent years looking at: how (i) *structural* impediments to competitive performance -- market concentration, and barriers to entry and exit protecting incumbent firms – or (ii) how the extent of anti-competitive *conduct* or *restrictive business practices* – for example mergers and acquisitions, predatory pricing, vertical integration or territorial exclusivity -- have influenced and are influencing Russian firms' performance.

Equally important, greater focus is needed on designing incentive mechanisms to the change *behavior* to compel better corporate governance in Russia. In particular, a key policy research issue is how to ensure *implementation* and *enforcement* of new policy measures. We have seen in transition country after transition country – and Russia is no exception – that simply enacting state-of-the-art legislation or regulations is insufficient. The new Russian Bankruptcy Law that came into effect in March of 1998 is a case in point. To be sure, it is a far better law than the previous one. But implementation by the law has been either stifled (especially where the state is creditor) or seriously abused with phony creditors aligning with managers to strip assets. By the same token, it is also not good enough to simply enlarge the number of court bailiffs or judges if they lack sufficient training or clout. The question is how to design policy measures that leverage and engender effective, on-the-ground implementation of reforms.

Another important area for further inquiry is to focus on developing data that identify who are the *ultimate owners* of Russian corporate shares. This is particularly important in light of the corporate governance vacuum and murky nature of Russian shareholding that we now find ourselves in. This is especially a need in light of the rise of the closely held firm. Several economists have begun to do this tracing exercise of ultimate owners with respect to some of the largest companies in the world in a series of cross-country studies.[8] This strikes me as incredibly important today in the case of Russia.

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[7] See, for example, P. Joskow, R. Schmalansee, and N. Tsukanova, "Competition Policy In Russia During and After Privatization," *Brookings Papers: Microeconomics*, The Brookings Institution, Washington DC, 1994; A. Brown and J. Brown, "Does Market Structure Matter? New Evidence from Russia," mimeo, Western Michigan University, 1998; H.G. Broadman, "Reducing Structural Dominance And Entry Barriers In Russian Industry," *The Review of Industrial Organization* (in press).

[8] La Porta R., Lopez-de-Silane F. and Shleifer A., "Corporate Ownership Around the World". National Bureau of Economic Research (NBER) Working Paper No. W6625, June 1998.

Finally there is the question of flow of funds of foreign direct investment (FDI) and corporate governance. There is of course the problem of "foreign" capital repatriated into Russia that is in fact Russian in origin. It flows back in disguised as foreign capital within joint ventures – disguised so as to not raise concerns about substantial control or take advantage of tax sweeteners and other concessions available to foreigners. In China this problem is pronounced – and called "round tripping" – but measuring its magnitude with real precision very difficult.[9] How large the problem is in Russia is not known. But it is a topic certainly worth investigating to shed light on the real owners of Russian firms.

[9] For the case of China see, for example, H.G. Broadman and X. Sun, "The Distribution of Foreign Direct Investment in China." *The World Economy*. May 1997; for Russia, H. G. Broadman, ed., *Russian Trade Policy Reform for WTO Accession*, The World Bank, 1999