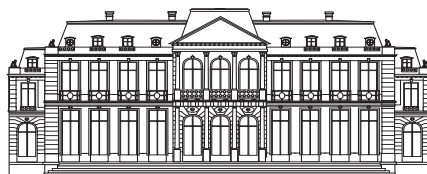


Organisation for Economic Co-operation and Development



Organisation de Coopération et de Développement Économiques

in co-operation with

the United States Agency for International Development (USAID)

and

the World Bank

Conference on

“CORPORATE GOVERNANCE IN RUSSIA”

Mr Sergey Molozhaviy

Deputy Minister, Ministry of State Property, Russia

**“Role of the State in Shaping Corporate Governance
Environment”**

Moscow

31 May - 2 June 1999

Conference on
“Corporate Governance in Russia”

by Mr Sergey Molozhaviy¹

Report on the
Role of the State in Shaping Corporate Governance
Environment

In Russia, the state is playing a major role in shaping the environment for corporate governance.

The reasons for this situation are as follows: first, the Russian Federation remains a major owner of property and, secondly, the state preserves and, in fact, plans to expand its regulatory function and that of the stimulator of the national economy. An expansion of the state's role that is currently underway is also apparent as the state is dropping its monetarist priorities in economic governance in favor of an emphasis on the development of the real (production) economic sector.

But these developments do not mean that the state intends to go over to economic dictate in the economic sectors in which it continues to play a major role. In fact, quite the opposite is true: the federal executive authorities' efforts will be largely aimed at shaping a favorable economic environment.

The government currently owns more than 14,000 federal unitary enterprises. In addition, the government has a stake in more than 3800 companies and partnerships, including the 2500 businesses in which it holds a 25 percent plus stake. Also, it has a Golden Share in 586 companies. There is a list of 697 companies that produce strategic goods (or render strategic services).

Below is a breakdown of federally-owned share packages in terms of size: the government holds a 100 percent stake in 364 companies; a 50 percent to 100 percent stake, in 489 companies; a 25 percent to 50 percent stake, in 1636 companies; and an under 25 percent stake, in 854 companies.

The data below characterizes the efficiency of the use of federal property:

Federally-owed share packages generated 115 million rubles in dividends in 1995 (in terms of the 1998 prices); 118 million rubles in 1996; 270.7 million rubles in 1997; 1357 million rubles in 1998. Leased federal real state generated the following sums: 95.5 million rubles in 1995; 223 million rubles in 1996; 305 million rubles in 1997; and more than 466 million rubles in 1998. And privatization of federal property generated the following sums for the public budget: 5713 million rubles in 1995; 1100 million rubles in 1996; 18,077.9 million rubles in 1997; and 15,442.5 million rubles in 1998.

It is a persistent trend that public budget revenue targets relative to the sale and use of public property tend to be exceeded. For example, the 1998 budget revenue target relative to dividends on [the government's] share packages was exceeded by 24 percent. Significantly, in 1998 this figure was 5 times as high as the corresponding 1997 figure. The budget revenue target relative to the sale of public property was exceeded by 90.1 percent.

But despite these successes, we accept that the above figures are less than a perfect reflection of the real situation in the **management of public property**, including the following aspects:

¹ The views expressed in this paper are those of the author and do not necessarily reflect those of the OECD.

Corporate Governance in Russia
Moscow, 31 May - 2 June 1999

the state does not receive any part of the profits generated by state unitary enterprises;

as of 1997, only 7 percent of the partly state-owned enterprises have paid any dividends [to the government]; what is more, more than 96 percent of the dividends that have been paid into the public budget have been generated by fewer than 1 percent of this kind of companies;

based on the above estimates, the rate of return on the state's capital in some of the companies is a scant 0.016 percent.

Nor is the state fully satisfied with the results of **privatization efforts that have been undertaken up to now**. Though mass privatization gave around 60 percent to private owners, a number of privatization objectives were not fully attained, viz:

Russia does not yet have a large number of efficient private owners;
economic restructuring has not produced a corresponding increase in enterprise efficiency – a result that would be a desirable target;
investments that have been attracted through privatization are clearly inadequate for fuelling the productive, technological and social development of enterprises;
a number of industries have lost their competitiveness on the domestic and world markets.

In view of the above, the task of creating an efficient and **integrated system for the management of public property** is assuming topmost priority in the government's policies. There is no alternative to this if the public economic sector is to be strengthened. Because of this situation, varied aspects of the state's role in the formation of a viable corporate governance environment are considered as **part and parcel** of the problems of reforming the system for the management of public property.

It is of note that though irregular efforts have already been taken to set up such a system, these efforts have largely been aimed at the privatization of public property, rather than at the management of public property as such.

So when discussing a system for the management of public property, we set two primary **and key tasks**:

we should determine how much public assets we actually need as absolutely necessary for the resolution of the state's tasks and for ensuring that the government economic sector is managed efficiently;

we should increase considerably public budget revenues from the use of public property.

If this system is to be duly integrated and efficient, it should be based on **the following principles**:

a federal authority for the management of public property should concentrate key functions relative to the management of public property and to responsibility for the results of this management;
the state must own as many federal assets as it can manage efficiently;
priority should be assigned to setting up an information-collecting infrastructure to provide for an efficient performance of functions relative to the management of public property;
approaches to the management of public assets should be individualized;
the objectives the government pursues in managing each specific public facility should also be defined on a case-by-case basis;
the means toward this end should also be spelled out for each specific public facility;

Corporate Governance in Russia
Moscow, 31 May - 2 June 1999

the government should exercise a tighter control over what results the management of public assets is expected to achieve;

it should be estimated how efficiently the public assets are managed; the persons who manage such assets should be made directly responsible for their performance;

vigorous efforts should be taken to assimilate all advanced management methods and financial instruments in the practice of management of public property;

priority should be assigned to getting renewable sources for increasing federal budget revenues.

So far as corporate governance is concerned, the state's interests chiefly lie in **partly state-owned joint-stock companies and in state unitary enterprises**.

Pursuit of government interests in joint-stock companies and a direct management of federal share packages is currently exercised via state representatives. On the other hand, the state has been paying increasing attention to hiring specialized managing companies to manage federal share packages.

The following authorities are regulators of the management of federal share packages: the Federal Assembly of the Russian Federation; the President and the Government of the Russian Federation, the Russian Ministry for the Management of Public Property, the Russian Federal Property Fund and industrial ministries and departments.

As of now, the government has delegated around 2000 officers as its representatives in company governance bodies. Ninety percent of them are employees of industrial ministries and departments and of authorities of Russia's constituent members, and only 10 percent are employees of the Russian Ministry for the Management of Public Property, the Russian Federal Property Fund, the Russian Finance Ministry, the Ministry of the Russian Federation for AntiMonopoly Policy and Support of Business and employees of territorial agencies of the Russian Ministry for the Management of Public Property.

Today the Russian government faces the following **key problems of corporate governance** with respect to partly state-owned joint-stock companies:

the Russian Federation currently owns more share packages than it can handle efficiently;

objectives have not been identified for each partly state-owned company and the financial/business performance of such companies is not monitored;

most state representatives in joint-stock companies are not doing a good job and in fact, they show inferior professional skills;

the procedure of decisionmaking in share management is quite complicated, including the transfer of shares for trust management; in each individual case such procedure requires a Presidential decree or a regulation of the Government of the Russian Federation;

there are no funds for the management of federal share packages.

It is noteworthy that **the functioning of state representatives in companies (as an institution)** is hampered by the following major **drawbacks**:

state representatives fail to respect instructions as to how they should vote on company governance bodies;

state representatives do not work in companies on a regular basis, which prevents them from sizing up situations correctly and from making decisions in keeping with the government's interests;

the number of state representatives on company boards is not in proportion to the size of state-owned share packages;

a state representative may sit on governance bodies of several companies, which keeps his/her from paying due attention to each company with an eye on industrial specifics;

state representatives fail to report regularly on their work in the companies.

Corporate Governance in Russia
Moscow, 31 May - 2 June 1999

To improve the environment of corporate governance in this sphere, **the following measures appear** to be in order:

participation of the Russian Federation in non-strategic companies should be analyzed in terms of how useful it is; any excess share packages should be sold or transferred to subnational authorities;

a register should be set up to record the economic performance of partly state-owned companies; and a body of measures should be carried out to start monitoring the financial/business performance results including the following: basic technical/economic targets should be approved for every partly state-owned company on an annual basis, including dividends to be paid into the federal budget; progress toward meeting approved targets should be monitored; outside auditors should audit companies; and financial/business performance results of companies should be checked and analyzed;

rules should be drawn up to cover the procedure of appointment and replacement of state representatives, reception of instructions as to how they should vote at a general meeting or a Board of Directors meeting, and reporting of their performance results;

the President should delegate to the Government of the Russian Federation the right to make decisions on share management, including a transfer of shares for trust management. Managing companies should be hired for the trust management of federal share packages;

the government should send special representatives to major companies that produce strategic goods; such representatives should be employees of the Russian Ministry for the Management of Public Property and such representative functions should be their principal functions.

If carried out, such measures will pave the way for a **tougher dividend policy** and provide a required level of federal revenues from the Russian Federation's participation in joint-stock companies, which is of paramount importance for the state.

Corporate governance problems **relating to state unitary enterprises** are in many respects similar to those we enumerated above, i.e., the number of this kind of enterprises is so great the state is unable to manage them and in fact, there are more such enterprises than the state actually needs; the objectives have not been set which these enterprises are supposed to seek to meet in the course of their operation; their financial/business performance results are not monitored; and enterprise directors do not have the professional skills that are needed today to run such enterprises.

But the thorniest problem is rooted in the legal construction of what is known in Russia as the "business management rights", a legal arrangement governing the rights of a unitary enterprise to its (public) assets: if a unitary enterprise's director has a right to run his/her enterprise under this business management scheme as prescribed by the Civil Code of the Russian Federation, such director has what amounts to an absolute right to dispose of property, including money.

This problem is interconnected with several other problems:

there are no non-tax federal budget revenues from enterprise operations;
the constituent documents of a large part of the federal state unitary enterprises do not conform to the Civil Code of the Russian Federation;
contracts have not been entered into with directors of more than half of all federal state unitary enterprises.

If the state is to have a more favorable corporate governance environment for its unitary enterprises, **the following measures would appear logical:**

Corporate Governance in Russia
Moscow, 31 May - 2 June 1999

the operation of all enterprises should be analyzed, to be followed by their restructuring as open joint-stock companies or government businesses; the status of a state unitary enterprises should only be retained by the enterprises that carry out state-prescribed objectives and tasks that cannot be undertaken by businesses of any other organizational/legal form. The maximum number of federal state unitary enterprises should not exceed 1000 to 1500;

a register should be drawn up to record the efficiency of enterprise performances and a system should be set up for monitoring and checking their performance that would be similar to the system used by joint-stock companies; the enterprises should be audited annually;

a standard deduction from enterprise profits should be set that will be paid into the federal budget, subject to annual adjustment; such payments will be monitored on a quarter-year basis;

rules should be promulgated to lay down the rights of directors of state unitary enterprises with respect to disposal of assets, including money, letting the Russian Ministry for Management of Public Property and industrial ministries and departments to monitor regularly how assets are disposed of. If an enterprise or the government incurs losses for which the enterprise director is responsible, the contract with such director should be cancelled;

if an enterprise fails to meet an approved target or respect a regulation of the Government of the Russian Federation or another federal authority, the contract with the director of such enterprise should be cancelled;

occupational qualifications of enterprise directors should be checked; and new directors should normally be hired on a competitive basis;

Company charters and contracts with company directors should be rewritten so as to meet the new formats of a federal state unitary enterprise's charter and an enterprise director's contract.

When implemented, these measures will help the state to get rid of unneeded assets; and with respect of whatever enterprises the state will eventually keep, payments of part of their profit into the public budget will be controlled, and the efficiency of the use of state assets held by such enterprises will be improved.

The state continues to **stick to the view that privatization** is one of the important instruments for improving the corporate governance environment. However, priorities in the government's privatization policies will be modified in 1999 and 2000, seeking first of all to boost the efficiency of Russian enterprises and of the Russian economy as a whole.

The following measures are called upon to meet this objective:

a case-by-case approach toward privatization of enterprises based on their liquidity:

high-liquidity enterprises should be privatized with an eye on the need to keep a balance between the attraction of investments to fuel enterprise development and the maximization of public budget revenues from the sale of such enterprises at prices as close as possible to the world levels;

most low-liquidity enterprises should be privatized with an eye on the need to attract efficient owners who are willing to assume and respect full investment and social obligations before the enterprise and the government (preservation or creation of jobs, resolution of environmental tasks, etc.). Low-liquidity enterprises may be sold at a minimum price to owners who meet the above requirements if they present a valid business plan and if a monitoring mechanism is in place to check a set of economic indicators a privatized enterprise is expected to meet;

Corporate Governance in Russia
Moscow, 31 May - 2 June 1999

use of new privatization tools, including:

- issues of derivative securities backed by government assets to tap the world capital market;
- purchase and sale of shares on the exchange and on the over-the-counter market;
- sales [of enterprises] by direct negotiation with investors, including the sale of share packages to effective trust managers who revive production and invest in the enterprise;
- bank-guaranteed sale under an installment plan.

combination of long-term and short-term privatization-related state interests:

privatization should be viewed, not as an isolated stage in the resolution of one-off tasks to generate a sum of money for the public budget, but as a structural element of an integrated government policy to manage public assets aimed at getting a short-term, medium-term or long-term gain from privatization in the form of a broader tax base, creation of jobs and saturation of the domestic market with goods and services;

improvement of a social safety net through privatization;

privatization methods, ways and tools should ensure equal rights and opportunities for all classes of Russian citizens, including the disadvantaged. One of the fundamental factors to be considered in any decision to privatize public assets should be the social cost of such privatization, including the development of a social safety net for enterprises to be privatized and the appropriate localities, environmental protection and public health. Commercial tenders should find a wider use in which bidders accept certain conditions to uphold and improve a social safety net.

government control of privatization and of post-privatization enterprise development that will envisage the following:

monitoring fulfillment of investment and social obligations by tender winners; introduction of procedures that minimize non-fulfillment risks (ranging from fines and penalties to nationalization of assets);

monitoring the use of privatized assets provided privatization conditions prescribe certain restrictions (social infrastructure facilities, historic and cultural sites, etc.);

development of a system of post-privatization development indicators to be complied with by privatized enterprises in view of industrial specifics, the nature of manufactured goods, etc.;

monitoring compliance with the system of post-privatization development indicators for privatized enterprises;

control and blocking of partly state-owned companies' actions if such actions aim at reducing a government share package.

The government policy priorities and measures aimed at shaping a favorable corporate governance environment as discussed in this report **are based on the projects of the Concept** for the Management of Public Property and the **Concept** of Privatization in the Russian Federation in 1999 and 2000. These projects are being considered by the Government of the Russian Federation.

When adopted, such Concepts will **certainly help** Russia get a large number of effective owners who are interested in long-term enterprise development, attract investments in the real (production) sector of the Russian economy, help Russian enterprises recover their positions on the domestic and world markets, facilitate economic restructuring and minimize federal budget expenditures on the management of public assets.

Corporate Governance in Russia
Moscow, 31 May - 2 June 1999