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Corporate reform in Russia and the former Soviet Union: the first ten years

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I. Introduction

The break up of the former Soviet Union (FSU) brought a sea change in economic organization. Central planning and command structures that had been in place for over 70 years collapsed. In some parts of the former empire, a quasi- centralized control of resource allocation remained the norm, albeit at a much smaller scale and with different goals to serve, than the previous socialist state. In many other parts, including Russia, the break-up of the central command structures was seen as the seed for the creation of market economy.

In this region, as in other transition economies, economic reforms were widely expected to lead to substantial reallocation of resources, rectifying the distortions inherited from central planning. While causing temporary economic and social upheaval, this allocation would then underpin the subsequent recovery. But even though market reforms have been pursued for almost a decade in the region, there is still little restructuring and a persistent lack of investment in the corporate sector. The results of corporate sector reform after nearly ten years of ongoing efforts show that the transition process is longer and more complex than initially envisaged.

History might be the single, most overwhelming reason for these difficulties. In contrast to other countries in Central and Eastern Europe, including the Baltics, the FSU countries had very limited precedent with markets and their institutions in their pre-socialist days. After 70 years, the scarce memories of previous economic arrangements, whether in government institutions or at the level of the civil society, had vanished. With the exception of Russia, FSU countries did not even have any history of statehood for many centuries. Thus, the institutional handicaps at the start of the reform process were enormous.

Building a market economy is precisely about building institutions: new state institutions to articulate and enforce rules of the game, but, most importantly, the quintessential institution of modern capitalism, the private corporation. Today, corporations account for a staggering part of wealth creation in the word. In the words of Robert Monks (2001):

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[1] Head, Corporate Affairs division, OECD. The opinions expressed in this paper are the author’s own and do not necessarily reflect those of the OECD. This paper has extensively used *S. Nestor, Takahiro Yasui and M-L Guy* “The Relevance of Corporate Governance to Eurasian Transition Economies”, presented at the first Eurasian Corporate Governance Roundtable (October 2000). The term former Soviet Union (FSU) includes all the former republics of the USSR, except for the three Baltic states whose history and politics warrant separate treatment.

The corporation has emerged in the later decades of the twentieth century as the premier institution for the identification, cultivation and realisation of genius-—and for the conversion of that genius into value.

The institutionalisation of today's market economies is a clear difference between our time and that of Adam Smith, where individual entrepreneurs were the norm. Institutionalisation could not have occurred without public policy intervention; and it will not continue to bear its fruits unless policy makers continuously upgrade the basic rules of company governance, to reflect rapidly changing environments. It is interesting to note that no less than 17 OECD member states are going through extensive company law reform efforts as we are speaking (OECD 2001). In the FSU early transition, this key function of building the corporate institution was assumed to take place quasi-automatically as a result of privatisation. Unfortunately, such optimism was not justified by events.

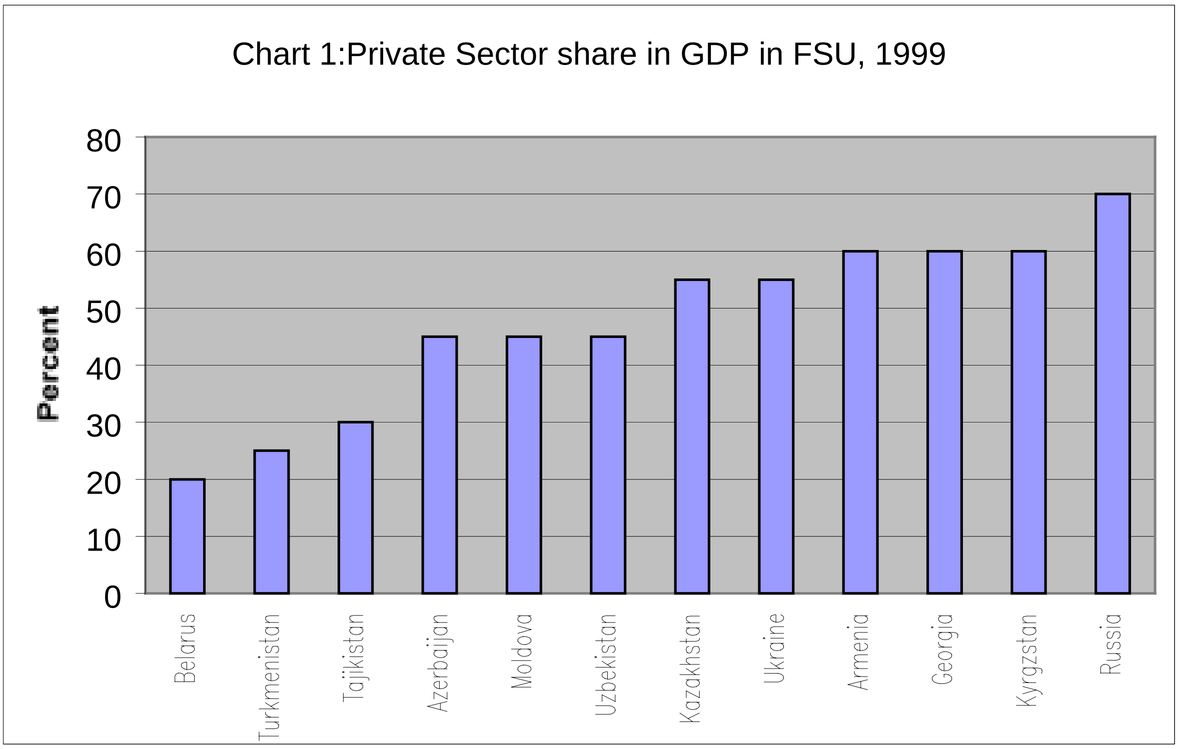
The emergence of a new corporate sector in the transition context depends upon a number of key, policy-related developments. First and foremost, privatization is required to free assets in the economy. These assets will then become the backbone of private corporate property. Second, a set of incentives need to be put in place, so that enhancing the long-term value of corporations becomes an attractive proposition to all the parties involved in that endeavor. These incentives range from a stable macroeconomy, the rule of law, external disciplines from the product and financial markets, tax policies, social safety nets. Finally, adequate corporate governance needs to emerge if the private corporation is to become the driver of investment and growth. Transparent and functioning corporate control structures and efficient norms to give them shape are key internal conditions for the development of the corporate institution.

This brief paper follows the above path to analyzing corporate reform in Russia and the FSU. After a brief introduction in part I, part II explores the topic of privatization and the latter's direct impact on corporate ownership and finance. Part III focuses on the external disciplines and incentives that drive corporate reform. Part IV reviews corporate governance in the region. Part V offers a set of concluding remarks and suggestions for future action

II. Privatisation, corporate ownership and finance

A decade ago, privatising inefficient state-owned companies became the symbol of change from central planning to capitalism. Privatisation seemed to promise an end to the inefficiencies of central planning--the key to freeing the resources and talents and lifting living standards. An unprecedented transformation has doubtless occurred as most FSU countries have changed from an almost 100% state-owned economy to one that is now primarily privately owned.

In Russia and the FSU , privatisation started in the Gorbatchev days as an ad hoc process that ranged from leasing of SOE assets to asset stripping, but never included formal property right transfers. Enterprises were not put on a privatisation track but were granted "full economic control" from their erstwhile planners. The result was a breakdown of the old governance structures with nothing new to replace them. The incentive to divert assets and cash flows was overwhelming. Privatisation in Russia was largely conceived as a way to stop this bleeding in a politically acceptable way



Source: EBRD (1999); staff estimates

Following the 1991 break up of the Union, Russia adopted a bold privatisation path. In 1992-94, it went ahead with the creation of more than 23.000 joint stock companies, with an average of 1000 workers in each one. It privatised approximately 16.000 of them through a voucher scheme, that initially created more than 40 million individual Russian shareholders. However, the key result of Russian mass privatisation was insider control. More than 75% of the companies privatised saw employees and managers acquire majority stakes. On average only 16% of equity went to outsiders as a result of voucher privatisation auctions (Boycko et. al. 1995).

Voucher privatisation has also been the main privatisation method in Ukraine, Georgia, Armenia and the Kyrgyz Republic[2]. It has created more than 19 million shareholders in the Ukraine. As in the case of Russia, its simplicity and distributional fairness made it politically and administratively quite attractive. Its main downside was perceived to be the dispersed ownership structure it promulgated, which would result in weak corporate

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[2] A thorough review and discussion of mass privatisation policies in transition economies can be found in the papers included in *Lieberman et al., 1997.*

governance and thus delay restructuring, leaving unchecked control to incumbent company managers. These problems have been partly addressed by pooling vouchers in investment or mutual funds. In Russia more than 600 of them were created. In Kyrgyzstan, the mass privatisation programme created around 400,000 shareholders, 25% of which became shareholders of investment funds. In Kazakhstan, citizens were required to invest their vouchers through these funds. In practice, voucher funds have not lived up to their assigned role as corporate governance principals. In very few cases did they evolve into real collective investment institutions. They were often captured by managers or other politically well connected parties. In some cases, they co-operated with insiders to strip assets off companies. In Russia, they were at the centre of some high profile cases of investor fraud (see Pistor and Spicer 1997).

As in Russia, Ukraine and most other countries in the region also saw insiders gaining the upper hand in the privatisation process, whether in the mass privatisation programme of the mid-90s or through trade sales that are currently taking off. Within the new privatisation programme, the Ukrainian parliament has for example approved, in July of this year, a law on the preferential sale of 50% plus one share of one of the largest metal producers in Ukraine, Mariupol Ilicha, to the company's management and employees, united in a closed joint stock company. This might be a dangerous path to take for the largest companies. Experience shows that a large scale sell-off to insiders creates important obstacles to corporate restructuring down the line, as insiders are unwilling to meet the conditions for attracting badly needed external finance, especially better corporate governance **(**Djankov and Murrell 2000**)**.

The second stage of privatisation in Russia was the infamous loans-for-shares scheme and the trade auctions that were linked to it[3]. The central idea behind this scheme was to find strategic owners for some of the very big Russian corporations who had already gone through partial privatisation for vouchers or other means.

From a political economy perspective, if mass privatisation was the first attempt to decentralise formally economic decision making and distribute power (though property rights) away form the state in the economy, the loans- for- shares scheme was an attempt to create a new economic elite. Strangely enough, it might have partly succeeded in this goal. The big problem is that this elite emerged on a faulty premise. Instead of gaining prominence through actual and potential investment, it was practically given the assets in a context that actually encouraged disinvestment and expropriation, as we will see later.

In most loans-for-shares auctions, the bank that was conducting the auction would be the only bidder for the control block on sale. Foreigners were excluded from bidding. Where outsiders got involved they were often disqualified. In the 1995 typical case of Norilsk Nickel privatisation, the biggest non-ferrous metal producer of Russia, the controlling block in the company was bought by the auctioning bank, the now defunct UNEXIM, for USD 171 million. The disqualified outside bid was for almost three times this amount. The company profits for 1995 alone amounted to 400 million.

[3] An extensive discussion of the loans for shares scheme and many other aspects of Russia's privatisation process can be found in *Freeland 2000.*

Two important characteristics of Russian privatisation are worth mentioning here, as they have impacted quite heavily on the level of corporate restructuring. The first is that Russian privatisation did not use enterprise liquidation and sale of assets as a tool. This contrasts sharply to the very successful experience of Hungary and Poland (Nestor and Thomas 1995). Through liquidation procedures, assets were freed for new entrepreneurs to acquire. They facilitated the emergence of a new private SME sector, which has been the driver of growth in Central European transition economies.

Linked to the above desire to maintain going concerns, no matter how value destroying they may be, is the disregard of any competition objectives in Russian privatisation. Not only were Russian enterprises discouraged from breaking up to promote competition (as opposed for example to the Czech republic); but the government encouraged big mergers and the creation of large holding companies in key sectors such as electricity, oil and telecommunications (Broadman 2000).

Trade sales to outside strategic owners are only now starting in most of the other FSU countries. Ukraine has initiated a programme of case-by-case privatisation to strategic, foreign investors, although there are indications of an insider bias in this programme (Brown 2000). Only Kazakhstan has pursued actively a programme of sales to foreign investors in the energy and utilities sectors. These sales seem to have engendered substantial investment, although they have not been without problems (Cadogan 1999). In general however, the involvement of outsiders in buying state assets has been very limited.

Thus, privatisation has produced much more limited results in the FSU area, outside Russia (see chart 1). While small enterprises have almost all been privatised (except in Belarus, Tajikistan and Turkmenistan), a high proportion of economic activity still remains in state hands, in most FSU countries. According to some estimates, approximately 50% of outstanding Ukrainian corporate equity is still in the state's hands while, in Kazakhstan, the 330 largest enterprises producing more than 1/3 of the GDP are still under state control.

Delaying privatisation does not seem to have helped the FSU countries. The situation of large state-owned corporations does not seem to suggest that prolonged state ownership might lead to better outcomes for corporate restructuring or for society as a whole. Average growth in their economies is even slower to emerge than in Russia. And the impact of slow privatisation on public governance and corruption has been even more pronounced than the quick and dirty privatisation of Russia (Nellis 1999). Various surveys by institutions such as the EBRD (2000) consistently rank privatisation laggards Ukraine and Moldova behind Russia in various investment climate and public governance indexes.

The initial hopes that privatisation would create the foundation for restructuring and transform firm-level incentives have not been realised. Voucher programmes have brought few tangible benefits to enterprises. With hindsight, institutional weakness was severely underestimated at the beginning of the process The expectation that corporate governance institutions and practices would develop overnight to the benefit of the firms and society as a whole has not proved realistic. As Professor Stiglitz (1999) puts it:

"…*Underlying some of these misguided views was a naïve belief in Coasian processes—that once property rights were appropriately assigned, efficient institutions would evolve. Such beliefs ignored both general theories that there may be inefficient institutional Nash equilibria and that evolutionary processes need not be efficient, and the problematic nature of property rights*."

Both the corporate sector and the new-born financial intermediaries suffered from the same institutional ailments: weak monitoring by their beneficial owners and a complete lack of a "fiduciary culture". Not surprisingly, capital markets did not develop and remained a vehicle for post privatisation corporate control transactions, not a primary source of raising finance for investment in Russian and FSU corporations. In terms of sources of funds, some --admittedly very limited-- survey data from the Ukraine indicate that retained earnings are still the major source of corporate finance. They make up close to 70% of investment needs, with the state budget being the second source with approximately 10%. Bank credits account for only 2% and foreign investment for 3% (see Shkurupyi 2000).

A McKinsey (1999) report for Russia points out that productivity remains at extremely low levels in Russian industry.1999 labour productivity in industry stands at 19, if one takes the US labour productivity as 100. Investment opportunities that would *ceteris paribus* bring returns in excess of 30% are foregone by managers and controlling shareholders. This might be largely attributed to the obstacles in raising outside finance, related to poor corporate governance. The lack of such outside finance sources, especially foreign investment, is acute. Russia is receiving foreign investment, which amounts to around 1% of its GDP, as opposed to more than 7% for Poland and Hungary and more than 5% in the Czech republic. In 1998, the Russian economy attracted less FDI in absolute terms than Hungary and only about 2% of the foreign investment inflows that occurred in China. In 1999-2000 the situation seems to be getting better with an increase of more than 150% in FDI inflows.

According to the EBRD (2000), the FSU region has seen the slowest enterprise restructuring compared to other transition regions. In the Ukraine 17% of all companies have not at all invested in fixed capital since 1992. As in Russia, the fact that privatisation did not favour the emergence of new private firms but rather emphasised the maintenance of going concerns might have been behind the slow pace of restructuring. Indeed, new entrants have been shown by all transition surveys of the last few years to be keener to restructure and innovate (Djankov and Murrell 2000). Privatised enterprises come second with state-controlled firms being the laggards.

Table 1:Ownership structure in medium and large privatised companies*

	Russia 1994	Russia 1996	Russia 1998	Russia 2000	Ukraine 2000
Direct insider ownership	60-65	55-60	50-55	30-35	55%
Outside ownership	12-25	30-35	35-40	50-55	37%
State	15-20	9-10	5-10	10-12	8%

Source:Radygin (2000), Shkurupiy (2000), estimates based on surveys

* Excluding very large firms

Notwithstanding important restructuring problems, the ownership landscape in Russian privatised firms seems to have changed considerably since privatisation, especially in the aftermath of the 1998 crisis (see table 1). Some survey data indicate a growing share by outsiders. This may to a great extent mask increasing ownership stakes by managers via "outside" companies and holding structures. What is clear is that there is a retrenchment of employee and state ownership in most medium-sized and large privatised corporations. But there are indications that pure outside ownership is growing, as well as FDI. These are in principle positive developments in Russian firms; they might signal the emergence of arm's length owners who at the same time could be less dispersed and more sophisticated than the initial voucher-turned-share holders.

One worrying trait of this data is the growing, albeit slightly, share of the government in the privatised firms. This probably reflects a re-nationalisation trend that has taken place through the courts and, sometimes, through insolvency proceedings. The Russian government should take steps to define the rules for state re-nationalisation as well as procedures for the transparent re-privatisation of these stakes.

In contrast to Russia, Ukrainian ownership data for privatised enterprises suggest extensive employee ownership. If one takes into consideration the state's considerable shares in the economy the situation looks somehow bleak, in terms of restructuring and future investment potential. From a dynamic perspective, though, it could present an opportunity. The state should be in a position to avoid the mistakes made in Russia during the loans- for- shares scheme, by privatising large blocks of shares in a transparent way, welcoming foreign direct investment and increasing the potential for outside investment to flow through the capital markets. The latter is an option only if it is accompanied by the introduction of robust listing requirements, distinguishing between the bigger "blue chips" and the thousands of post-privatisation publicly held companies, owned mostly by their work forces.

But, privatisation aside, what are the incentives that control agents in firms respond to? The way incentives function—or malfunction—will determine (in combination with the set of internal/corporate governance mechanisms to be discussed in part IV), the behaviour of corporate agents in charge of investment and resource allocation.

III. External drivers and incentives for corporate restructuring

a. The rule of law and judicial enforcement

The absence of rule of law constitutes a major shortcoming for the development of corporations in all countries of the region. Proper protection of property rights requires first, an adequate legal framework, and second, its effective enforcement. In FSU countries, however, both requirements are often not satisfied. While some countries rushed to adopt laws suggested by foreign consultants, they have often found that they bear little relevance to realities in the country (Nestor 2000).

In Russia, the joint stock company law and a major part of the civil code came into force in 1996 and 1997, after large- scale privatisation and the major company formation (or corporatisation) phase had already taken place. Ukraine and Armenia have yet to consolidate their legal framework. In Ukraine, key laws have long been pending in parliament (i.e. new civil code, tax code, land ownership code, etc.).

Throughout the region, courts are often described as corrupt and slow. Part of the capture issue in Russia is related to the very strong dependence of courts on local authorities. This year's draft federal budget for the first time addresses the needs of commercial (Arbitrazh) court system in its entirety, as a federal function. Judges will often argue that their work is particularly difficult since there are still many loopholes and contradictions in existing law. Legal changes are often ill- considered and are themselves subject to further change with little regard for the overall coherence of the legal system. The reform of the judiciary and its upgrading is a priority throughout the region. Where laws exist, their implementation should be a priority as opposed to continuing legal upheaval.

Without strong institutions that can uphold the rule of law, companies whether domestic or foreign, have trouble with enforcing contracts, collecting debts, and resolving disputes. In state-owned or newly privatised enterprises, incumbent managers find expropriation easy, as rules that would stop them from doing so are either non-existent or not being enforced. They also find it rational, as the weak protection for investment and property makes diversion of assets to foreign bank accounts more appealing: the government or a competitor may confiscate holdings or change the rules on the firms at any time (see Black et al 2000). Managerial or major shareholder focus on a long-term value enhancement becomes a difficult proposition.

b. Macroeconomic weaknesses

Weak corporate restructuring is also a result of the failure of policy to provide for a longer-term perspective of growth based on macroeconomic stability. Although Russia is showing signs of strong growth and most other countries in the region (except Moldova and Belarus) will be recording positive growth in output in 2000, a decade of macroeconomic instability, high inflation, and inconsistent fiscal and monetary policies have undermined confidence in the economy. The difficulties of operating in an uncertain environment shorten business horizons and negatively affect the private sector. Exchange rate depreciation and volatility also add uncertainty. Recent backtracking in trade liberalisation in Central Asia has changed again the economic prospects for many enterprises in Kazakhstan, Uzbekistan and Kyrghyzstan.

Because of unpredictable economic developments, local managers, even if they control and own large blocks of company shares, often perceive their positions as uncertain and temporary. As with the absence of rule of law, short time horizons make expected gains from increasing company value less attractive to control agents than what they can obtain by expropriating assets and cash flows (Fox and Heller 1999). Faced with the choice of maximising company value or diverting cash flows for immediate personal gain, controlling managers have frequently taken the second option, and not only because of the lack of a "rule-of-law stick". In an environment of prolonged instability, the absence of any "carrot" makes the situation even more difficult.

c. Competition in output markets

Weak competitive pressures have caused companies to remain inflexible to developments in output markets. As mentioned earlier, privatisation was not geared towards creating competition. Concentration in many sectors of the economy is very high and getting higher; recent data indicate 4- firm concentration ratio in Russian industries at 95 % when measure at oblast level (Broadman 2000). Regional and local authorities have often been active in encouraging anti-competitive mergers and in raising entry barriers to new "outside" entrants. Recently, some industries have seen a strong merger movement, carried out through unorthodox means but often condoned by federal authorities. In the aluminium industry, the state actively promoted the merger of two dominant private producers, whose combined new enterprise now controls more than 70% of the national market.

During the last two years Russia has also seen an increasing vertical integration trend is many industries, including oil, ferrous and non-ferrous metals, construction, transport and telecoms. After the 1998 crisis, many of the bank-centred conglomerates, the financial industrial groups (FIGs), have increasingly given their place to industry- based holdings (Radygin 2000).

More importantly, some of the key infrastructure industries are still dominated by powerful monopolies with little state regulation. Electricity, gas and telecoms in Russia have the power to differentiate between customers and to effectively allocate resources in the economy outside a market framework. They have been an important source of non-cash transactions, thereby confusing price signals in many markets[4]. Recently some of these monopolies are trying to reinvent themselves through "competitive" restructuring. It is important that any restructuring of these key sectors is not driven by the firms but by policy makers mindful of consumer and general public interest. Restructuring and subsequent regulation of utilities will not be effective unless its enforcement is left with

[4] *The OECD Economic Survey of the Russian Federation* (2000) discusses extensively the issue of non-cash payments and the role of Russian infrastructure sector as a key source of de-monetisation; see also the discussion below.

proper independent institutions are that are not-- and are not perceived to be --captured by the natural monopolies.

The pervasive presence of the state in the economy at a federal and, most often, regional/local level constitutes another important source of competitive distortions, mainly in the form of extensive direct and indirect subsidies. According to the a McKinsey study on Russia (1999), such distortions include: different effective tax rates within the same sector; preferential access to land and government procurement; different effective energy prices; different access to government controlled export infrastructure.

Thus, corporate behaviour is still pray to the persistence of soft budget constraints. The state provides a wide range of direct and indirect subsidies to firms, while firms provide public officials with a certain amount of control over company decision-making and cash flows. Hence, the management's behaviour continues to be motivated largely by the search for new direct or indirect subsidies, not by increasing productivity and attracting outside investment. For some of the older managers, a lifelong education in opportunism when it comes to using company assets for one's own welfare—in the absence of formal material rewards for success—has found new uses in the unpredictable transition context. As some commentators have pointed out, while the Soviet manager's experience in making input and output decisions for firms was largely non-existent, improving one's own welfare by diverting state resources was a high art (Rivkyna 1998).

Extensive licensing requirements are still present in many FSU countries, raising substantial barriers to new entry; in Kyrghyzstan some companies are reportedly required to obtain up to 100 licenses to carry out their activities (Baker and Mc Kenzie 1999). In Uzbekistan, state enterprises are being changed into shareholding companies and private enterprises account for 45 percent of all registered firms but business decisions to set prices, output, and investment often originate in the government and are not within the purview of business (World Bank 2000**).** In the absence of any product market discipline or measure of performance, managers are left free to pursue their own (or their political patrons') objectives with little regard for the firm's overall profitability.

d. The tax system

Important incentive distortions have their origins in the tax system. In Russia, corporate taxes are calculated on the basis of wages. This creates perverse incentives both in terms of wage arrears and profit distribution. Most enterprises will readily admit that they keep two sets of books—one for themselves and one for the tax authorities. It should not come as a surprise that outside investment is seriously hampered by this as wide spread tax evasion encourages opacity and the lack of transparency in the corporate sector. In Russia, in spite of the adoption of the first part of the tax code in 1999, important tax disincentives remain, especially as regards the treatment of capital gains.

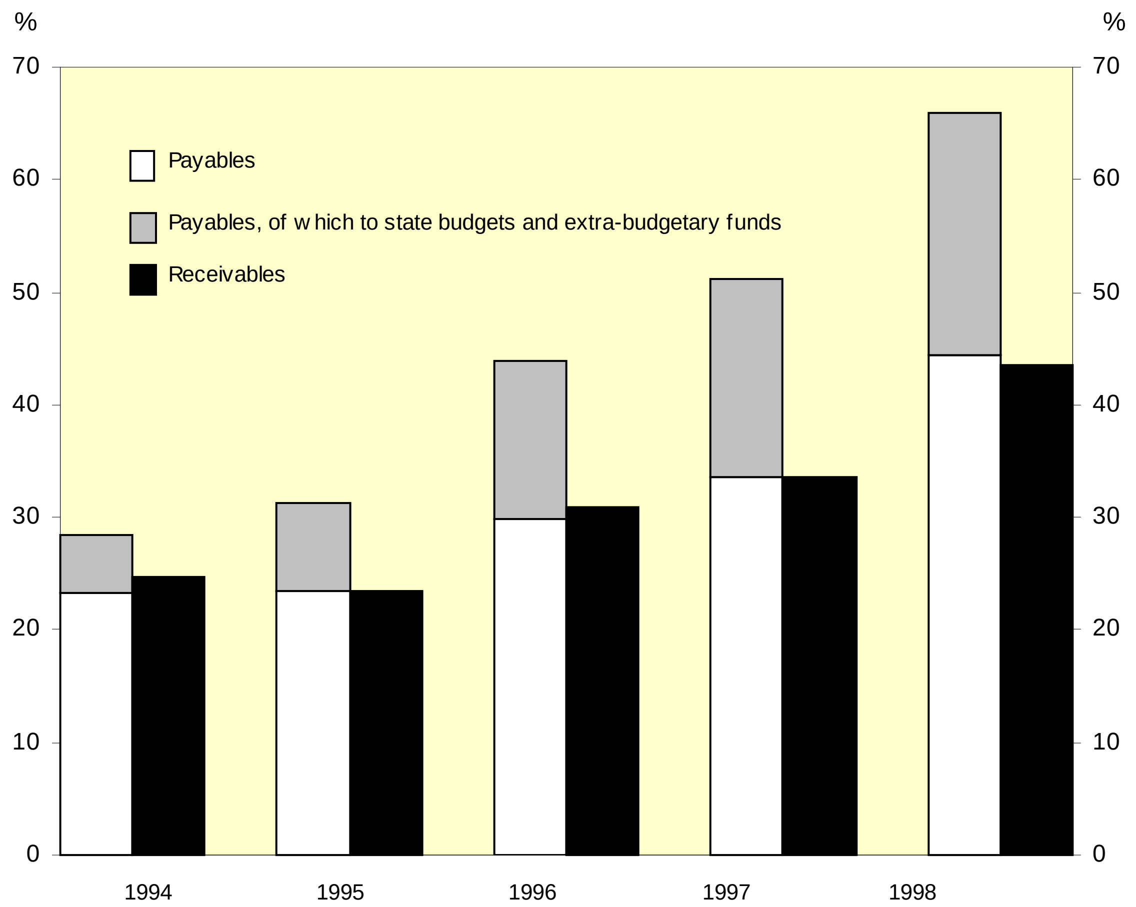
Tax arrears of Russian firms are an important part of enterprise arrears (see chart 2) and have contributed to both weak financial discipline and the de-monetisation of the economy (OECD 2000). In 2000, the new Putin administration has started, for the first time, to clamp down on companies with large tax arrears. Although a lot of complaints about the unfairness and selectivity of this approach have been voiced, some signal of enforcement was sorely needed. It remains to be seen whether the state will pursue these policies in a consistent way in the future.

Some FSU countries such as Kazakhstan, Kyrgyzstan and Armenia have outpaced Russia in introducing a new comprehensive tax code, although enforcement is reportedly still quite arbitrary. In contrast, Ukraine still has a tax code that results in punitive effective rates for enterprises

e. Financial and payment discipline

As mentioned above, in the mid-90s, bank- centred financial- industrial groups (FIGs) were promoted as the main governance lever in the new Russian corporate sector. They were at the source of the loans-for-shares scheme. The 1998 financial crisis brought down most banks that were driving these groups. It also showed clearly that the “internal capital markets” that were expected to develop within these groups were not functioning. Banks were not lending to corporations neither were they generating any investment in them.

Chart 2: Arrears of Russian Enterprises



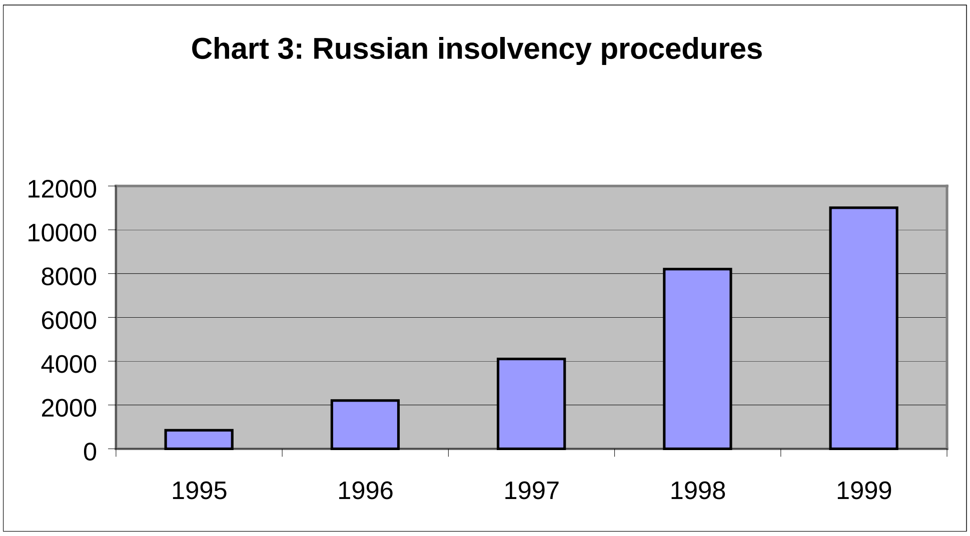
Source: OECD 2000

Although exposure to bank lending was almost completely absent in Russian and FSU corporations, most enterprises are known to run up wage arrears and inter-enterprise indebtedness remains substantial in all countries. Continuing arrears make the imposition of payments discipline more complicated, with illiquidity contaminating the whole corporate sector. Arrears are often accompanied by a proliferation of non-cash payments. The share of non-cash payments to Russian industrial firms, largely concentrated in the energy sector, peaked at more than 55% of GDP in 1998. Arrears and non-cash payments have two main effects on firm behaviour: they create a vicious circle of low payment discipline and thus discourage economic activity; and they lower transparency, thus discouraging outside investment (see OECD 2000).

In most countries, the insolvency system is expected to play a key role in imposing this outside discipline and re-allocate resources of failing firms[5]. While Russia first introduced a legal framework for insolvency in the early 90s, it was not until 1998 that a

[5] I discuss extensively the function and importance of the insolvency system in a transition context in *Nestor* (1997)

modern law was adopted (Reynolds 1999). The results from the implementation of the law were indeed impressive. Insolvency procedures more than quadrupled in the two years of its implementation, in spite of the fact that loss- making firms constituted only 40.6% of the corporate sector in 1999 as opposed to 48.3% on 1998. It seems reasonable to assume that a strengthening of the insolvency law has also contributed to the remarkably lower level of arrears in the Russian industry in the last 12 months.



Source: Davis Centre for Russian Studies, Harvard University

However, the success of the law in actually pushing insolvent companies to restructure was not without problems. The easy trigger for declaring insolvency stipulated in the law created some perverse incentives for corporate managers in the absence of strong courts and honest bankruptcy administrators. In the case of the oil company Sidanko, the major shareholders of the corporation managed to put the company into bankruptcy in order to reallocate ownership rights and freeze out minority shareholders. In the same vein, even majority shareholders will often bankrupt their companies, after not paying wages for long periods of time, in order to strip the few valuable assets, usually putting the proceeds outside Russia.

It is important to underline that most of these problems would not occur if the law was implemented correctly. The president of Russia was right not to give in to calls for a wholesale change of the legal environment and the conditions for declaring insolvency, which would once again have made insolvency quasi-impossible and would have exacerbated already existing bottlenecks in the re-allocation of assets of failing firms. In addition to some adjustments in the way insolvency is triggered, what is really needed is a concerted effort to boost the capacity for implementation of the insolvency law.

Insolvency systems have not been effective in other FSU countries, neither as a disciplinary mechanism, nor as a mechanism to re-allocate resources. In the case of Ukraine, for example, the current bankruptcy law-- which does not apply to the state sector-- provides for liquidation of a bankrupt company but does not clearly specify the procedure for financial restructuring during bankruptcy and is vague in many other respects. Thus, in 1998, 9075 cases reached the court, 3500 proceedings were initiated, but as of today less than 40 cases have had concrete results for debtors. Other countries such as Georgia or Kyrghyzstan have been endowed with relatively advanced insolvency legislation, which has, however, remained largely non-enforced.

f. Social issues

State enterprises in the FSU have traditionally provided many social services to employees. Dealing with social assets is a major problem in post- privatisation restructuring, as companies are often the only providers of key social services and the state institutions that could succeed them are not up and running. “Red” directors of state-owned or newly privatised companies, especially in one-company towns, refuse to go ahead with inevitable downsizing and change of economic activity of their companies using the provision of social assets as a justification. Divestiture of social assets is sometimes postponed or blocked by the same managerial elites that have benefited form the first wave of reforms [6]. Power to determine social welfare is often a key currency for capturing policy by these powerful vested interests.

IV. Corporate governance

While external market disciplines will go a long way towards making firms more efficient, they pre-suppose the emergence of efficient factor and product markets; these might not emerge in Russia and the FSU for some time to come. Under these circumstances, it is even more important to concentrate on the internal, institutional mechanisms that provide individual firms with the opportunity to effectively raise outside capital. Corporate governance is about better transparency, accountability and predictability in the allocation of resources by firms. It is thus crucial for the attraction of external finance, especially when product and factor markets are not efficient. While markets in most OECD countries will have mechanisms to price different levels of risk and allow discounts for badly governed companies, low liquidity and lack of sophistication does not allow this to happen in transition economies. Moreover, the overall market risk and subsequent market discount is already quite substantive, so the odds are against corporate issuers from these countries. The other side of the coin is that institutional investors are ready to pay important premia of more than 20% for well-governed companies in emerging markets—as opposed to much narrower premia for OECD companies[7]. The case of Vimpelcom, a well governed Russian company, which managed to raise outside investment in the midst of the 1998 Russian crisis, is a powerful example of the difference corporate governance makes in an unstable transition context.

Corporate governance is also important in addressing another characteristic of the corporate world in Russia and Ukraine (and, to a lesser extent, other FSU countries).

[6] *Black et. al* (2000) extensively discusses the argument that the beneficiaries of the first wave of reforms in the early 90s have transformed themselves to enemies of subsequent reforms.
[7] These are the results of a broad survey by *McKinsey* (2000) of institutional investors representing $3.25 trillion**.**

These are industrial economies dominated by large enterprises, much more than other mature or emerging economies. Privatisation has preserved these socialist behemoths as going concerns, but did not address their financing needs. It has also created a large number of small shareholders in these companies. The predominance of this enterprise profile suggests two things: that protection of outside investors is important and that, if such protection were to be ensured, the equity market could become more liquid with less of an effort than in, say, emerging economies with long-entrenched family ownership.

But in addition to attracting outside finance in individual companies or markets, the improvement of corporate governance should address a core property rights issue in the FSU countries. Here, "firms" barely existed in the sense we now understand them in a market economy. In the past, industrial capacity formed more or less a continuum with the state. Factories were extensions of ministries with no concept of separate firm property[8].

The corporatisation of the enterprise sector entailed the definition of Russian firms as separate institutions[9] with their own identity. A limited liability corporation is in fact a legal creation, established by the provisions of company law. We call it an institution because it has its own life-span, decision making procedures and, most importantly, property rights, different from the life-span decision making processes and property of its constituents. By limiting liability of shareholders to the amounts they invest in the share, the law allows such an institution to raise funds from the wider public, in order to conduct and expand a business. By enabling the corporation to have its own well-defined property, it provides creditors with an assurance that corporate assets support lending. Without adequate legal backing, such a complex institutional arrangement cannot function satisfactorily or develop soundly (Hansmann and Kraakman 2000).

When a manager of a privatised company does not have to give any information to his shareholders--who might be workers, some voucher holders and possibly a couple of funds-- or to others; when he does not have to answer to any board about his decisions and actions; when he can unilaterally and without any constraint alter the content of property rights of others in the company, by shifting assets and cash flows in and out of the company at will, and or by issuing new shares only to his name….

….. then the company does not really exist, as a separate entity for the benefits shareholders, its creditors. It does not really represent a stable source of employment for its workers who often cannot find anybody responsible to pay them; and it cannot be a tax-paying, law-abiding citizen of any state. Its inability to be perceived as an institution by other economic agents creates important costs for society as a whole. It constitutes a failure in mobilising the important assets to create capital and generate investment. The institutional weakness of firms because of corporate governance failures results in huge discounts on asset values. In the words of Fox and Heller (1999):

[8] A thorough description of the old Soviet economy can be found in *OECD et al* (1991)
[9]. *Oliver Williamson* (among others, 1985) has outlined the key institutional aspects of corporations and explained their emergence and boundaries as a function of transaction costs in markets.

"…Share prices represent a trivial faction of the apparent value of underlying corporate assets controlled by Russian corporations."

In this context—and in contrast to most OECD and emerging economies, the development of good corporate governance practices and rules is not simply about enhancing the efficiency of equity markets or "fine-tuning" corporate decision- making processes. It is more about the definition and enforcement of core property rights related to the private corporation, the key institution that will drive successful economic transformation. To paraphrase Hernando de Soto (2000), it is a fundamental ingredient of the institutional framework that gives the citizens an opportunity to produce wealth.

The need for better corporate governance has been acknowledged world-wide as a key determinant of outside investment in corporations, of the development of equity markets and of institutional development in the broader governance of our societies. In this respect, the OECD member countries adopted a set of Corporate Governance Principles to help policy makers and corporations raise their corporate governance standards. Since their adoption in 1999, the OECD Principles of Corporate Governance[10] have become the main point of reference for corporate governance reform world-wide. In March 2000, they were included in the Compendium of 12 global standards for financial stability, compiled by the Financial Stability Forum. As such, they are expected to be used increasingly for country assessments by international financial institutions, namely the World Bank.

From the perspective of the OECD Principles on Corporate Governance, corporate governance has a two-fold meaning:

- Corporate governance encompasses the relationships and ensuing patterns of behaviour between different agents in a limited liability corporation; the way managers and shareholders but also employees, creditors, key customers and communities interact with each other to form the strategy of the company. This is, one might say, the **behavioural side of corporate governance.**

- But corporate governance also refers to the set of rules that frame these relationships and private behaviours, thus shaping corporate strategy formation. These can be found in the company law, securities regulation, listing requirements of exchanges. But they may also have private sources in the form of self-regulation. This is what we could call **the normative side of corporate governance.**

With this in mind, it seems appropriate to look into some key problem areas in Russian and FSU corporate governance using the taxonomy of these Principles, i.e. following their five chapters.

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[10] The OECD Principles can be downloaded at www.oecd.org/daf/corporate-affairs/.

a. The rights of shareholders[11]

The perception of this region as having an unfavourable investment climate is, to a considerable extent, due to the lack of credible investor protection. In many FSU countries, corporate laws do not establish sufficient legal rights for shareholders. In the case of Russia, the legal framework, albeit slow to emerge, affords a decent level of protection. But enforcement mechanisms and remedies against violations of shareholder rights are inadequate or non-existent[12]. The protection of the rights of shareholders is a pillar of any effective corporate governance system. The first important right in this respect is an effective system for the registration of ownership. In the FSU, share registration has often been the victim of fraudulent practices in the past. Russia has seen some important abuses scandals in 1995-97, when corporation would simply delete shareholders form their registries. However, during the last few years anomalies in share registration seem to have subsided, largely due to an improving infrastructure of registrars.

The ability to participate in basic decisions concerning the company, chiefly by participation in general shareholder meetings is set forth as an important right. Most typical shareholder violations in the FSU include the refusal to provide information on a company's activity in view of the shareholder's meeting, the creation of important obstacles towards participating in the general meeting and the introduction of changes to company charters without a general meeting's decision. Share dilution by controlling owners has also been reportedly widespread and the ensuing transfers of control, mainly to incumbent management, have been quite opaque. In relation to the above behaviour, the Ukrainian Securities Commission received 9,345 complaints from citizens and professional securities market participants in 1999; this is 33.5% more than in 1998.

In Russia, dilution of existing shareholders through the issuing of new shares in closed subscriptions has been a key tool in freezing out minority shareholders. The company law does not adequately protect pre-emptive rights of existing shareholders. The latter are often not notified at all or excluded form the annual general meeting. Closed subscriptions of shares (i.e. subscriptions in which only certain shareholders may participate) doubled during the first 9 months of 2000 in Russia, compared to the equivalent 1999 period. The Federal Securities Commission (FSC) has not been in a position to address the issue effectively.

b. Equitable treatment of shareholders

The OECD Principles stipulate that the corporate governance framework should ensure the equitable treatment of all shareholders. To begin with, this includes the right to judicial protection. As we mentioned above, this right is severely limited under weak rule of law conditions prevailing in Russia and the FSU.

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[11] A number of papers on the rights and equitable treatment of shareholders in Russia and the FSU have been presented in the context of the OECD/World bank Roundtables of Corporate governance and can be found at *www.oecd.org/daf/corporate-affairs/*

[12] In an extensive survey on law and finance in transition economies, *Pistor et al* (2000) conclude that the effectiveness of legal institutions matters more than the laws themselves and that legal transplants and extensive legal reforms are not sufficient for the evolution of effective legal and market institutions.

Self-dealing by managers and controlling shareholders is the scourge of most FSU countries. Throughout the region, corporate governance is caught in a vicious circle of entrenched insider control and low outside investment. Company managers, who are often also shareholders, use the company's assets for personal gain, to the detriment of minorities. As a result, outside investors have little confidence that they will be able to weigh on the company's decision making process and stay away from further investing.

Self-dealing—or related party transactions as it is known in company law—may take a number of forms. It can be done through transfer pricing, i.e. selling at very low prices to companies set up by insiders or buying at very high prices from such companies; this is the main form of diverting cash flows. It can take the form of outright asset stripping through asset sales to insider-controlled companies. Self-dealing cannot be stopped unless very strong legal sanctions are attached to it. There should be a strong and enforceable requirement on managers, board members and other insiders, to disclose any direct or indirect interest they-- or a major shareholder of the company-- have in a transaction with the company. Remedies for self-dealing should arguably include criminal sanctions, as is the cases in some OECD countries, such as France. Criminal sanctions should be imposed when such behaviour damages the corporation and its perpetrators knowingly failed to disclose it. Securities Commissions should be given enough power to implement such requirements. In most FSU countries, there are no detailed rules on disclosure of related party transactions, even if parties are in theory subject to such disclosure according to the company law.

A common problem across the region is the absence of listing requirements. As a result of mass privatisation, thousands of firms find themselves being "public" and hence subject to Securities Commission requirements. Commissions are thus swamped with a duty to supervise the whole of the corporate sector according to a set of generic rules. Weak exchanges have been unable to impose rigorous listed requirements on the few large companies that are truly public and actively traded. While these are very few in number, their influence on corporate standards is great. Segmenting markets and targeting listing requirements (and their accompanying sanctions) will help regulators to put more emphasis on "blue chips" and to allocate their resources in a more effective manner. Raising listing requirements will in its turn help transform the equity markets in Russia and the FSU from post-privatisation secondary markets to primary sources of equity finance for corporations.

c. The role of stakeholders

The OECD Principles point out that it is in the long-term self-interest of firms to encourage stakeholder active participation in the governance process. Legal rights of stakeholders (i.e. employees, creditors, long- term suppliers and customers among others) should be effectively respected. Factors such as business ethics and corporate awareness of the environmental and societal interests of the communities in which a company operates can have an impact on that company's reputation and long-term success. But these issues are not yet on the agenda of FSU managers or investors.

Most importantly, the legislative framework that primarily ensures the protection of stakeholders' interests from abusive corporate behaviour is not in place. Consumer and environmental protection laws as well as an adequate, market–oriented labour law are still in their infancy in most of the region.

In Russia, stakeholders-- especially employees-- receive little information and have little voice in corporate governance, despite the fact that they are also shareholders of their company. Employee presence could potentially be a powerful force in monitoring the fiduciary functions of managers and in limiting self-dealing. However, at present, employee stakes are often manipulated through threats and strategic behaviour to consolidate the power of management and create a bigger divergence between control and cash flow rights.

d. Disclosure and transparency

Good corporate governance calls for a strong disclosure regime, acknowledging transparency as a key element of an effective market economy. The OECD Principles call for timely and accurate information to be disclosed on matters such as the company's financial and operating results. Most countries in the region have taken the initiative of improving transparency and reporting practices, by either adopting International Accounting Standards, as in the Kyrghyzstan, or by using International Accounting Standards as the basis for national accounting systems, as in Ukraine and Moldova. Indeed, in some respects, some FSU countries are more advanced than Russia in adopting market-based accounting practices and breaking with the Soviet, tax-based accounting system prescribed by the Ministry of Finance. However, in practice, many companies continue to have a double bookkeeping policy, to avoid paying heavy taxes.

Even though independent auditors are required, the company management usually appoints and dismisses them with little outside scrutiny. In the Ukraine, there are no clearly specified mechanisms or restrictions on the appointment and withdrawal of external auditors. Most strategic investors are familiar with lax accounting and audit practices and try to impose international independent audits before acquiring company stakes. But management is still in a position to raise important obstacles to a meaningful due diligence. In what has been a rather disturbing 2000 trend, some international firms, whether from the accounting or investment banking world, have lent their names to major Russian corporations, in the form of unofficial "letters of review" of rather dubious share dilution or self-dealing transactions.

An important task that lies ahead is the creation of adequate professional accounting and auditors bodies in the region that can impose a credible quality and ethics control on their membership and become the driving force for transparency. During the last couple of years there have been quite a few positive developments in this respect.

A look at the annual report of any major FSU company will demonstrate the infant stage of disclosure of non-financial information such as the company's objectives and strategy, major share ownership and voting rights, remuneration of key executives, personal material interests of the board and management in matters affecting the corporation, and material foreseeable risk factors. In Russia, some of these requirements do exist but there are no sanctions attached to their non-observance. In most FSU countries there are few requirements for non-financial disclosure. Under these circumstances, control structures are non-transparent and consequently self-dealing goes largely undetected. Reportedly in Kazakhstan there are five big corporate groups in the country but due to complex arrangements between companies, it is practically impossible to identify the real owners of these companies (World Bank 2000).

Developing stock exchanges might depend on the availability of financial and non-financial information. Stock exchanges should therefore take the lead in introducing international standards and practices, both in terms of regulation and enforcement. Until now the role has been minimal even in Russia where the volumes of trade are non-negligible.

e. The responsibilities of the board

The board of directors should be the main mechanism for the effective monitoring of management and for providing strategic guidance to the corporation. It is the duty of the board to act fairly with respect to all groups of shareholders and with stakeholders, and to assure compliance with applicable laws. Board members should be able to exercise objective judgement on corporate affairs, independent of management. Good corporate governance hinges upon the competence and integrity of directors and the board as a whole.

Boards of directors are legally mandated in most of the region's countries. The 1996 Russian Joint Stock Company law stipulates that all corporations of a certain size must have boards. Most importantly, it also stipulates cumulative voting, i.e. reserving board seats for the representatives of minority shareholders. This has allowed the appointment in outside directors in some large Russian corporations, a key weapon in the fight for better corporate governance. Since January 1998 Ukrainian joint stock companies with more than 50 shareholders have to elect a board of directors, which represents the interests of shareholders. But, in practice, management is often unwilling to recognise the body, which supervises its activities. As it stands, many established joint stock companies don't have operating boards of directors.

As the state is still an important shareholder is in the region, its power could be used to improve board structures. The government and its asset management institutions (i.e. State Property Funds) could adopt property management policies that force companies to have independent boards and directors who take their monitoring roles seriously. Directors could be trained to this effect. Important positive spillovers could be generated for private companies and the market as a whole, if the government were to become a paragon of corporate governance. In many OECD countries, the state is becoming an activist owner, while ensuring the independence of management: during the last few years, Sweden and Italy have both used their ownership stakes to improve board structures and enhance corporate governance. This is often linked to the partial privatisation of state-owned companies through initial public offerings.

In this respect, the case of Russia is telling. At the early stages of transition, a large number of state holdings resulted in the state being a passive, absentee shareholders, giving free reign to management. As state ownership became more concentrated towards fewer, larger companies, the state has been adopting more active corporate governance positions. With the support of minority shareholders, state representatives account for more than 2/3 of the board of RAO UES, the Russian electricity utility. A clear articulation of the state's corporate governance strategy as shareholder might be the next step to take, in Russia and elsewhere.

IV. Concluding Remarks

The Russian and FSU transition experience shows that reformers have underestimated the importance of institutions in building a new market economy. Poorly- defined private institutions, i.e. corporations, impairs creation and accumulation of capital, as the uncertainties over their property rights limits the availability of debt and equity investment. This has an obvious negative impact on growth. But corporate under-development – in the institutional sense-- also impacts on the distribution of income within a society: with more transparency and accountability major shareholders or controlling directors will have less of an opportunity to strip assets at the expense of workers, the state --and society as a whole.

The proper functioning of companies also depends on an adequate level of public governance. It hinges on the existence and integrity of public institutions, such as courts, bailiffs, securities commissions etc. that are ready to enforce property rights and governance. Lack of law enforcement by the appropriate institutions is indeed the major problem with Russian corporate governance at present. While good corporate governance cannot exist without an adequate level of public governance, public governance will likewise not take off unless the private sphere of the economy and its main players, the companies become transparent, law- abiding corporate citizens. Awareness of this mutual interdependence should be at the centre of any reform effort.

Privatisation is an essential element of transition. But it is not a panacea. If privatisation is to produce results it needs to help build the institutions of a market economy, not undermine them, as was the case in the 1994-96 period of Russian privatisation. In this respect, some privatisation auctions in 2000 have given the right signal. For the first time, competition between Russians and foreigners seems to have resulted in a genuine valuation process for Russian state assets.

Having gone through the privatisation of thousands of smaller and medium sized companies, some countries might still retain important stakes in some key large enterprises. While state asset management institutions cannot be expected to act as proper corporate governance principals for thousands of corporations, they might conceivably perform this role for a few pivotal large companies thorough (a) carefully building firewalls that may insure asset management does not get politicised and (b) use extensively outside expertise for the representation of state interest in boards, AGMs etc. This might produce positive spillovers for the rest of the equity market and corporate sector and improve the overall environment.

Government and legislative initiatives are not enough. Private sector action is essential if good governance is to take hold. For private sector action to take place, managers and other key decision-makers need to be persuaded that good corporate governance is good for business and translates into cheaper access to capital. In this respect, outside investors and, in the case of the FSU, international financial institutions such as the EBRD and the IFC could take a much more activist stance and give corporate governance more weight in their investment policies.

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