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## THE RUSSIAN MASS PRIVATIZATION PROGRAM

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On December 30, 1992, Russian President Boris Yeltsin said in a televised New Year's address to the nation that he and his family would invest their privatization checks in one of the specialized investment funds recently set up around the country. It was a highly symbolic conclusion to a remarkable year for the Russian privatization program. The necessary legislation has been produced at a frantic pace, more than two thirds of the population have received privatization checks (vouchers) and more than three quarters of the eligible companies are getting ready to be auctioned. Certainly, many roadblocks, both political and logistical, will have to be cleared in 1993. But the privatization movement has enormous momentum. The fact that Deputy Prime Minister Anatoli Chubais, chief architect of the privatization program, kept his job in the cabinet reshuffle at the end of 1992 only reinforces this impression.

These early successes should not conceal the difficulties encountered in implementing the privatization program. 1992 was not a easy year for Russia, and it wasn't a simple year for privatization. But 1993 should be the year of the real breakthrough for the privatization movement.

### Political and economic background to Russian privatization

Russia's privatization strategy should be understood against the backdrop of the larger economic picture. As in Eastern Europe, the collapse of communism has made possible a fundamental transformation of Russian society to democracy and a market economy, but this transformation must be carried out in highly unstable conditions.

Russia faces spectacular risks and instabilities: a deep financial crisis breeding hyperinflation; the collapse of the Soviet Union, leading to complexities of new state building and international relations with the other republics of the former Soviet Union; a

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Opinions expressed in this article are those of the authors and should not be viewed as the official position of the Russian government.

## Main Elements of the Russian Privatization Strategy

Given the strong and competing interests in the privatization process, and the pivotal role of privatization in the restructuring of the whole society, it is not surprising that the Russian Privatization Program which emerged by the middle of 1992 is a complex "compromise" between various stakeholders, both insiders and outsiders to the enterprises to be privatized. It was recognized from the outset that in a post-socialist country such as Russia no privatization was possible without the active collaboration of all the main stakeholders, and, in particular, of incumbent management teams and local governments. In fact, probably more than any other program of its kind, the Russian privatization program explicitly recognizes these stakeholders and provides them with appropriate incentives (preferred stock, common stock, cash revenues, privatization checks)<sup>3</sup>. The outcome which was reached after intense discussion in Parliament by June 1992 was strongly criticized by all sides, but was by and large accepted in the end<sup>4</sup>.

Also, in a country as large and diverse as Russia, a decentralized and "bottom-up" approach to privatization quickly appeared as the only realistic option. However, in order to remedy to the nearly complete absence of relevant legislation, and to avoid uncontrolled "nomenklatura" privatization, the State Committee of the Russian Federation for the Management of State Property was established in November 1991 (Goskomimushestvo, henceforth GKI). Under the dynamic leadership of Deputy Prime Minister Anatoli Chubais, and in collaboration with other governmental agencies<sup>5</sup>, the GKI prepared very rapidly a number of normative documents covering all steps of the privatization process. The result is

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<sup>3</sup> On the necessity to recognize various stakeholders to the privatization process, see J. Sachs (1992) "Privatization in Russia: Some Lessons from Eastern Europe". *American Economic Review*, May, A. Shleifer, and R. Vishny (1992) "Privatization in Russia: First Steps", mimeo., prepared for the National Bureau for Economic Research Conference on Transition in Eastern Europe, Cambridge, MA, February 26-26.

<sup>4</sup> See Exhibit 1 for various benefits offered to insiders under the three options allowed under the State Privatization Program. For the detail on benefits open to outsiders, including foreign investors, see the guide "Foreign Investment Opportunities in the 1992 Russian Privatization Program" prepared by the State Committee of the Russian Federation for the Management of State Property, October 1992.

<sup>5</sup> In order to meet extremely ambitious targets for a complex program, the GKI also uses Western technical assistance. Starting in November 1991, a small team of advisors affiliated with the Harvard Institute for International Development joined GKI for full-time work. In March 1992 a joint World Bank/EBRD team also helped to elaborate the methods for mass privatization. In May 1992, GKI selected through an international tender a consortium of Western advisors, headed by Braxton, a British strategic consulting firm, and CCF, a French merchant bank, initially financed by a grant from the European Community. With other members of the consortium, White and Case, a US law firm, and DRT, a British auditing firm, the consortium covers various aspects of the implementation of the program. Finally, other firms received mandates as the program developed, including Sawyer Miller, a US PR firm, the IFC, the merchant banking arm of the World Bank (for small scale privatization, and capital markets development), CSFB, a British merchant bank (for the first check auction), Price Waterhouse, a US auditing firm (for the organization of other check auctions), etc.

received a special treatment<sup>11</sup>. For instance, the oil and gas industries will be partly privatized, in particular through auctions opened to the general public, but corporate governance should be exercised in the foreseeable future by powerful holdings (Rosneft, Rosgazifikatsya). Also, agroindustry received considerable attention, with the reorganization of the sovkhozes and kolkhozes, and the sale of land, at the center of a heated debate. Experimental sales of land plots have begun near Moscow by November, and it is expected that this experience will be generalized. Finally, certain large companies, such as the automaker ZIL, were allowed to diverge somewhat from the general scheme for their privatization. But the bulk of the Russian industry is included in the general program.

More than six thousand companies were requested to complete their privatization plan by October 1, in order to be commercialized (transformed into a joint-stock company) by November 1, 1992. Initiative and responsibility for the preparation of various documents necessary for privatization was squarely put on incumbent management. Despite a very tight schedule, more than three quarters of the eligible companies<sup>12</sup> have entered the privatization process. Deadlines have been missed in many cases due to the absence of qualified lawyers, as well as logjams at local courts. For those companies having completed the process, it appears that incumbent management played a crucial role in the choice of the option for privatization<sup>13</sup>. The first private shareholders of the Russian industry emerged through closed subscriptions, which enable employees to receive preferred and non-preferred stock at attractive prices. Anecdotal evidence seems to show that managers and employees will try to buy at subsequent auctions more equity in their companies. Local committees and funds are currently preparing the crucial next step in the process: the privatization check (voucher) auctions, this time usually without the active participation of top management of companies.

#### The Role of Privatization Checks (vouchers)

More than one hundred million Russians have already decided to participate in the program by collecting their privatization checks<sup>14</sup> for a nominal payment of 25 rubles (\$US 0.06 in

<sup>11</sup> See Table 1 for a list of relevant normative documents governing privatization in these industries.

<sup>12</sup> See Table 2-2 for early results, subject to significant adjustment. Moreover, figures found in this table understate significantly the degree of compliance by the firms, as several thousand companies are currently finishing their privatization plan and commercialization process. The

<sup>13</sup> So far, option 1 and 2 have been chosen respectively by half of the firms, with option 3 being almost completely ignored. Option 2 became more and more attractive during the second semester as inflation rapidly "eroded" the price (bookvalue times 1.7) at which shares can be purchased by insiders.

<sup>14</sup> See Table 2-3. For a technical account of the role of vouchers in the privatization process, see B. Djelic, (1992), "Mass Privatization in Russia: The Role of Vouchers", *RFE/RL Research Report*, Vol. 1, No. 41, October 16. When the voucher program came under attack during the December session of the Congress, the idea of simply stopping distribution was rejected as around two million citizens were collecting their vouchers every day. It is an interesting illustration of the "irreversibility" effect that such a scheme might produce.

the population invest their privatization checks as safely as possible. Learning from the unsettling Czech experience with unregulated funds, the Russian authorities have already issued the necessary regulations<sup>18</sup> and prepared the licensing procedures. As licensing is done on a decentralized basis, it is difficult to estimate the number of funds ready for operations. In Moscow, for instance, around thirty entities have been licensed so far. Funds are closed-end, and have to specialize in operations with vouchers. They will have to follow "Western" type prudential rules, be audited, and disclose regularly their results. It is expected that several foreign banks will sponsor funds of this type.

### **Mechanics of Auctions for Vouchers**

Partly because the emergence of numerous, professionally-run specialized investment funds is not, so far, a fact of life, the GKI decided to devise an auction procedure which would be accessible and fair to small investors. Moreover, a simple, one-round system was necessary if several thousand auctions were to be held in December 1992 and during 1993. This is all the more important as the Presidential Edict increasing the share of the equity sold for vouchers confirmed that auctions for vouchers will be the main path for privatizing Russian companies. At least 30% of the equity of companies is to be sold at such auctions<sup>19</sup>, and possibly much more if option 1 has been chosen by employees. Remaining stock, a small share of the equity, would be sold later for cash.

Investors will be able to choose between two types of bids. Type 1 bids are "unrestricted", where the investor indicates only how many vouchers he/she would like to invest in the company. This type of bid guarantees to the investor at least one (possibly, split) share. Type 2 bids include a "stop price" and are designed for more sophisticated investors, including wealthy individuals, investment funds, or foreign investors. Importantly, all investors, small and large, pay the same "price" (in vouchers) in the end<sup>20</sup>.

Local Committees have prepared lists of companies with target dates for their voucher-only auctions. Those lists will be published in national and local newspapers during 1993. Indeed, several auctions have already been held. The sale of the Moscow Bolshevik factory in December was well-publicized. But during the the same time authorities in Vladimir, Perm, St Petersburg, Yaroslavl and other cities, quite often with the help of the local stock exchange, have also launched voucher-only auctions.

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<sup>18</sup> Through the Presidential Edict No. 1186 of October 7, 1992.

<sup>19</sup> For instance, if a federally-owned company has chosen option 1, and insiders have paid all 51% of equity with vouchers at the closed subscription, then, the voucher-only auction will be for  $85-51=34\%$  of the equity.

<sup>20</sup> For details on auctions, see the Regulations contained in the Order No. 701 issued by the GKI on November 4, 1992, as modified by the Order No. 1142 of December 16, 1992.

understanding of the motivations for privatization as well as the mechanics of private corporate ownership. In the final analysis, the continued democratization of Russian society will be an important protection of the continuation of privatization, since the pressures from the general society will find their way into economic policy. In the other direction, success in mass privatization would create a society of private property owners that would likely be a fundamental bulwark for the new democracy that is just beginning to take root.

Key text on corporatization.

Governmental Resolution "On Measures for the Implementation of the Presidential Edict No. 721 of July 1, 1992", No. 547 of August 4, 1992.

Provides for practical details surrounding corporatization.

Regulation "On Closed Subscription for Shares in the Privatization of State and Municipally Owned Enterprises", approved by Order of the State Committee for the Management of State Property No. 308 of July 27, 1992, as modified by Orders of the State Committee for the Management of State Property No. 749 of November 11, 1992, and No. 1143 of December 16, 1992.

Organizes closed subscriptions for employees and determines the price at which preferred stock can be purchased.

#### Privatization checks (vouchers)

\* Presidential Edict "On the Implementation of the Privatization Checks System in the Russian Federation", No. 914 of August 14, 1992.

Key text on vouchers.

Regulation "On the Rules for the Distribution of Privatization Checks to Citizens of the Russian Federation" of the State Committee for the Management of State Property No. 369 of August 20, 1992

Practical organization of the distribution of vouchers.

\* Presidential Edict "On the Sale for Privatization Checks of the Housing Fund, Land Plots, and Municipally Owned Assets", No. 1228 of October 14, 1992.

Enlarges significantly the scope of the voucher program.

\* Presidential Edict "On the Development of the Privatization Checks System in the Russian Federation", No. 1229 of October 14, 1992.

Increases drastically the share of equity to be sold for vouchers.

\* Letter of the Chairman of the Russian Central Bank "On Banks' Operations with Privatization Checks" No. 18 of October 7, 1992.

Authorizes banks to handle vouchers.

#### Investment Funds:

\* Presidential Edict "On Measures for the Organization of the Securities Market During the Process of Privatization of State and Municipally Owned Enterprises", No. 1186 of October 7, 1992.

Key text on investment funds.

\* Presidential Edict "On the Use of Privatization Checks for the Social Protection of the Population", No. 1304 of October 26, 1992.

Provides for specialized funds collecting vouchers of vulnerable categories of the population (orphans, etc.).

**Table 2: Privatization in Russia: Results for 1992**

**2-1: Small Privatization: Number of Enterprises Commercialized and Privatized (as of December 4, 1992)**

	Total Enterprises	Commercialized	%	Privatized	%
Russia	320,953	77,803	24	28,245	9
City of Moscow	16,220	9,600	59	8,355	51
Nizhny-Novgorod	2,911	2,618	90	1,008	34
St. Petersburg	8,926	2,804	31	1,912	21
Krasnodar	13,793	3,192	23	1,003	14
Irkutsk	6,447	1,578	24	307	4
Tatarstan	6,940	69	1	4	0

Source: Goskomstat.

**2-2: Large Companies: Number of Companies Registered for Commercialization, With Completed Privatization Plans, and Registered as Joint Stock Companies under the 1992 Privatization Program (as of December 15, 1992)**

	Companies Registered for Commercialization	Privatization Plan Completed		Registered as Joint-Stock Com.	
	Number	Number	%	Number	%
Russia	6,329	1,263	20	637	10
City of Moscow	NA				
Nizhny-Novgorod	271	41	15	30	11
St. Petersburg	201	20	10	6	3
Krasnodar	171	46	27	44	26
Irkutsk	400	100	25	22	6
Tatarstan	NA				

Source: GKI

**2-3: Number of Privatization Checks Distributed (as of December 17, 1992)**

	Number of checks	% of population covered
Russia	101,356,059	68

Source: Sberbank

