

THE AMNESIA OF REFORM

A Review of Post-Communist Privatization

by Peter Young and Paul Reynolds



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Adam Smith Institute

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1.0 Introduction

The collapse of communism and the associated reforms in Eastern Europe and the former Soviet Union (FSU) over the last four years, have changed the face of political and economic debate across the world. It is not just the central tenets of state ownership and central planning that can no longer be supported. The wider political features of the old system in these countries has also been discredited - features such as central single-party hegemony, media control, elite dominance and extreme government secrecy. These features are not exclusive to communism, and so the worldwide impact of the collapse of this system extends beyond just communist or socialist economies. Furthermore, the collapse of communism has renewed interest in the free market and the ideas of Adam Smith, and intensified the debate on the economic role of government under a free-market system.

Economic liberalisation, privatization, and reform of government itself have swept across the world from South & Central America, Africa and the Far East to Asia, and now to traditionally statist economies in Western Europe and the Middle East.

However, despite the far reaching consequences of the changes in post-communist countries in Europe and the FSU, any survey of media opinion would lead one to conclude that the reforms in these old command economies have been either too slow or disappointing in their effects.

With the impatience that follows the early euphoria of liberation it is perhaps easy to forget the extent of the changes which have occurred in Eastern Europe and the FSU. These are very significant indeed and should be recognised as such. It is extraordinary, for example, to observe some of the southern states of the FSU embracing democracy and market economics when few if any politicians have direct experience of such concepts and when their populations are wholly unfamiliar with the principles underlying the system they are now moving towards.

Whilst it is clear that these reforms need to be maintained and accelerated, however, (with the help of Western and other countries), this cannot be done without understanding more deeply the reasons for delay or the extent of the obstacles to reform.

During the early days of post-communist reform (1989 - 1991) a consensus existed amongst informed opinion as to the main reforms required and the focus of assistance.

The priorities for reform were clear.

- (i) The need to define state-owned enterprises and ensure they reach the private sector in ways which took into account their economic condition,

and the ability/willingness of domestic or foreign investors to purchase them.

- (ii) The need to break down the old command-economy hierarchical structures in order to create pressures for enterprises to behave in ways compatible with the market economy.
- (iii) The need to create pluralist democratic structures and instil principles of constitutionality essential for the workings of a market economy.
- (iv) The need to create a new legislative framework in order for a market economy to function: e.g. company law, contract law, private ownership, bankruptcy laws, banking regulations, etc.

The crucial importance of rapid privatization was acknowledged as a key element of successful reform. Without it, the transition to a market economy could not properly take place. Much emphasis has since been placed by the West on helping post-communist countries develop and implement privatization programmes. Britain has taken the lead in this, and with help from the British Government's Know How Fund, British advisers have helped get privatization started throughout the post-communist world.

However, although much has been achieved over the four year period since the abandonment of communism, there must be serious concerns over the implementation of privatization in many post-communist countries. Whilst new and innovative methods have been devised to "sell enterprises that nobody owns and nobody wants to buy to people who cannot pay", (in the words of the former privatization minister in Poland Janusz Lewandowski), such as voucher schemes and the sale of shares to employees with little money changing hands, with the partial exceptions of Poland, the Czech Republic, and Hungary, progress has overall been painfully slow. This is particularly the case in southern East European states and in the southern former Soviet republics.

Experience has shown that success in implementing real privatization depends on a number of critical factors. These success factors can be summarised as follows:

- * The institutional and technical capacity to handle the privatization programme with speed and efficiency - mostly the privatization of small enterprises by auction.
- * The existence of appropriate privatization institutions which are able to operate independently and without continual assistance from foreign donor organisations.
- * Public and political awareness and support for the privatization programme and those measures - including legislative change and restructurings necessary for success.

- * The momentum of the programme. That is, the propensity of government to get on with the process quickly rather than argue endlessly over legislative and operational details. Momentum will require the acquisition of early expertise in different methods of privatization such as cash sale of enterprises at auction and through vouchers.
- * The establishment of an appropriate legislative environment for privatization - particularly relating to the efficacy of voucher schemes, demonopolisation, company/corporate governance law, etc.
- * The ability of new shareholders to trade shares in an equitable way so as to create pressures for profit, reward success, and create a market for corporate control.

Furthermore, a significant proportion of the privatization that has been carried out is significantly flawed, involving the transfer of monopolies to the private sector, the inability of the new owners to exercise their ownership rights properly, the entrenched positions of the old management, restrictions on the scope of activity of the privatized company, inability to trade shares effectively, regulatory restrictions on private sector activity as a whole, etc.. The primary *raison d'être* of privatization - to create a competitive market economy - - appears to have been at least partially forgotten or misunderstood by many. This one may term *the amnesia of reform*. Instead, 'technical' privatization, without liberalisation, has become the new objective.

Success in privatization is usually defined as the achievement of the transfer of a significant proportion of the economy from state hands into private hands. However, with the above reservations in mind, there are three key qualifications which need to be made to this goal if it is to be compatible with the wider aim of creating a prosperous market economy.

- (i) Privatization must be defined as the majority of shares or controlling shares being fully in the hands of private individuals and private businesses. For example, ownership of a majority of shares by another state enterprise, state bank, or any other organisations controlled by the state does not represent, in our view, privatization. Throughout the postcommunist world, there are many enterprises describing themselves as privatized which do not fit our definition - - either through indirect state ownership or through leasehold arrangements initiated under the pre-1991 Gorbachev reforms, or some other forms of indirect state control.
- (ii) Privatization is a necessary (but not sufficient) condition for the creation of a market economy. For example, if a whole sector is privatized but existing monopolies, cartels, and cartelised networks are maintained, the benefits of privatization could be small. Furthermore, the benefits of privatization can be severely diminished if shares in privatized enterprises cannot be traded (legally or informally) or if licensing, business regulations, or terms under

which enterprises are constituted have the effect of erecting insurmountable barriers to market entry. Thus privatization must be accompanied by liberalisation measures which create competitive pressures, ownership pressures, and economic freedom.

- (iii) The success of privatization will be short-lived if the process is conducted in a non-transparent way and if the process is managed as an opportunity for enrichment amongst a bureaucratic or economic elite. In most postcommunist countries, a number of joint stock companies of closed type have been created, the structure of which prevents shareholders from selling their shares and provides the scope for directors of enterprises to exercise effective full control and sometimes to allocate themselves large, artificially created, dividends. Whilst such enterprises describe themselves as having been privatized, we would not agree. Therefore, a third qualification is that privatization must be conducted in an open, transparent and equitable way, and must involve real ownership, where shareholders can exercise ownership rights and freely sell the shares they own.

The political and economic power of directors of state enterprises is a primary problem and a very significant barrier to liberalised privatization, which explains much of the difficulty experienced in implementing privatization properly. A coherent *politico-economic* strategy must be developed to overcome this barrier.

With these observations in mind, this report discusses some of the main current issues in post-communist privatization, highlights reasons for flawed approaches and the slow speed of implementation, and discusses potential solutions.

2.0 Current issues in post-communist privatization

The issues outlined below are those which appear to us to require the most attention. A common thread running through many of the issues is the impact on policy of directors of large state enterprises. The political and economic influence of such directors is considerable and may in the past have been underestimated.

Some brief analysis of the reasons for this influence is appropriate here. As the command economy system gradually broke down, power passed increasingly to the directors of larger state enterprises, often with monopolistic positions. With their monopoly power and increasing freedom brought about by an undermined system of central commands, these directors became more and more contemptuous of the central planning system and of obligations upon them. They began to see the old system as restricting their pursuit of financial gains for themselves and their companies - gains that were often easily made under conditions of monopoly, enforced low wages, and protected markets.

Despite the fact that they generally owed their appointment to the old system, their power is not diminishing but rather is being enhanced in the twilight world of economic transition. When the political infrastructure of communism was destroyed and the power of local communist party committees was removed, the influence of large enterprise directors in their local communities was that much greater. They stood out as some of the few remaining figures of authority. In the FSU countries in particular, the role of the enterprise in securing the livelihood of the worker was that much greater. For a time at least, the enterprise was even crucial in securing food for the worker on a daily basis. With towns often dependent on just a few large enterprises, the prosperity of the town was closely identified with the prosperity of the enterprise. It was natural in these circumstances that in many cases enterprise directors went forward as the parliamentary representatives of their districts.

Having been powerful drivers of the call to dismantle the restrictions of the old system, these directors now face exposure to international and domestic market forces and therefore resist the liberalisation that would erode their power and money making opportunities. Being naturally fearful that change will undermine their position, they seek to preserve the structure and relationships of enterprises much as they are. In this they are aided by officials of sectoral ministries, who seek to preserve their original roles in the economy. Persuading enterprise directors and ministry officials to accept the concept of a full market economy is indeed a challenge, but one that must be faced.

Ministry officials who must take decisions in the privatization process are hampered by their relative inexperience, both of the market economy in general and also of privatization in particular. A crucial problem is that most Government officials believe state assets to be far more valuable than they are in fact. Whilst this problem exists everywhere, the differences in post-communist

countries between perception and reality are usually very significant. As we have argued elsewhere (e.g. *Eastern Promise*, Adam Smith Institute, 1992) a large number of postcommunist companies, particularly manufacturing ones, are worthless or even have negative value due to:

- (i) lack of market for product;
- (ii) environmental problems;
- (iii) high staffing levels and social costs;
- (iv) inefficient and out of date production techniques, as well as various other problems.

Such factors as inexperience, excess bureaucracy, the low quality of assets and the difficulty in gathering accurate and reliable information make for a much slower privatization process than would be desirable.

2.1 The balance between privatization and restructuring

In every post-communist country there must be careful consideration of the balance between privatization and the prior restructuring of companies which remain under total or partial state control. This is one of the key issues affecting all post-communist privatization programmes.

On the one hand, privatization without restructuring can involve a number of serious deficiencies, including:

- * the transfer of monopolies into the private sector;
- * the transfer of companies with inappropriate ancillary assets such as workers' housing, schools and recreational facilities into the private sector;
- * the transfer of companies into the private sector in very weak financial condition, often with excessive debt, and on the point of collapse;
- * the problem of non-performing parts of enterprises not being addressed prior to privatization;
- * no thought being given to the merger of some enterprises prior to privatization, which might make them stronger and more attractive to investors.

On the other hand, restructuring before privatization can involve a number of problems, including:

- * delay to the process of privatization, during which time additional difficulties can develop, and enterprises may be starved of new investment and new

management;

- * the additional cost of consultants involved in restructuring, for which funds are not available;
- * an additional administrative and decision-making burden for government, for which human resources are not available.

In the 1992 Adam Smith Institute report, *Eastern Promise*, we argued for a more coherent approach to restructuring in Eastern Europe on a sectoral basis, documenting how the privatizability of firms would be increased by such an approach. However, it is more doubtful whether such a fully coherent approach to restructuring can be carried out in the context of post-Soviet countries, where the condition of enterprises is usually significantly worse, the institutional base for privatization weaker and the resources available for restructuring even more sparse.

Experience tends to suggest that restructuring should largely take second place to intensive privatization, and that the private sector should be relied upon to carry out post-privatization financial restructuring. Pre-privatization restructuring should largely be limited to structural changes such as the break-up of enterprises that would otherwise be monopolies and the removal of inappropriate ancillary services from enterprises about to be privatized. [Of course, in some circumstances the hiving off of social or ancillary assets is difficult, because the state or municipality does not have the budgetary means to support these social assets. There is no easy solution to this problem. In cases where the social assets are crucial for the local population one answer may be to require the firm being privatized to maintain those assets for a set period, such as three years, before transferring them to municipal or national government control].

In most cases the resources simply are not available to perform a firm-by-firm analysis by experienced consultants of the necessary financial and management improvements, or to implement the recommendations once they have been made. In practice, most companies that are retained by the state continue to deteriorate, thereby compounding the problem. Although the situation tends to differ from country to country, restructuring efforts generally should be directed at those very large enterprises that are crucial to the economy and which would otherwise not be privatizable.

Those who argue for extensive restructuring before privatization are often against privatization per se, but unwilling to say so. In many respects the debate between privatization and restructuring is a false antithesis set up and exploited by people in the West and the East who want to stop or delay privatization. An immediate move to privatization of appropriately structured assets (e.g. demonopolised & shorn of ancillary services if necessary) is the best approach. Another way of putting it is that good privatization is good restructuring and bad privatization is bad restructuring.

2.2 Mass or case-by-case privatization

Several of the first post-communist countries to embark upon privatization programmes, most notably Hungary and Poland, chose to deal with each company individually in the context of privatization. This occurred for a number of reasons. Firstly, this was the approach taken by almost every other country in the world that had sought to privatize. Secondly, the sheer size of the task and the human resources required to implement it may have been underestimated.

Thirdly, there were reasons particular to each country for taking an individual approach. For example, in Poland, workers' council in which *Solidarity* had a strong voice already had much influence over companies and were reluctant to give it up. In Hungary, individual privatizations had already been carried out 'spontaneously' by company managers, and there was pressure to continue this basic approach.

However, all post-communist countries have found that the company-by-company approach to privatization takes too long. There are several reasons for this. Firstly, there is insufficient buying power in the local population to acquire all the companies for sale, and insufficient foreign interest to purchase very many of the companies on offer. Secondly, the time and human resources involved in the negotiation of the sale of each company is great. Thirdly, a company-by-company approach allows political controversy to arise over the privatization of each company.

For some or all of these reasons, all post-communist countries have introduced or are considering the introduction of some form of mass privatization, in which buying power is injected into the domestic population, through vouchers or other means, and a more uniform approach is taken to the privatization of a large number of companies. The mechanics of these schemes are discussed below.

All countries, however, including those which have relied largely on mass privatization, have continued with some privatization on a company-by-company basis, especially involving those companies sold to foreign investors, and some large companies especially important for the economy. These privatizations have been carried out in a number of ways, sometimes involving tenders, other times direct negotiation with one purchaser or joint ventures. In most countries, privatization to foreign purchasers has not constituted a particularly large part of the privatization process. In Poland, for example, as of the end of September 1993 strategic foreign investors had bought shares in only 55 privatized enterprises, out of a total of over 900 companies sold as going concerns.

In Hungary, the proportion of state enterprises sold to foreigners has been relatively higher. In the Czech Republic, the governments' primary strategy has been to encourage foreign investment into companies after they have been privatized, although there have been a number of significant privatizations and joint ventures involving foreign firms, such as the Skoda-Volkswagen deal. In South-Eastern Europe, where the total volume of privatizations has been relatively small, the number of sales to foreigners has been very small indeed.

In much of the case-by-case privatization that has occurred and is occurring there have been significant difficulties both with achieving a consensus on valuation and bringing together sufficient accurate and relevant information to give comfort to investors. Whilst a lot of raw data is available, it is very difficult to access the appropriate financial and commercial information. In any event, the relevance of such information is highly questionable, given the major changes in macroeconomic and other conditions. Thus, these difficulties with information, valuation, plus uncertainty in decision-taking have meant that the time taken to conclude individual transactions in post-communist countries is usually much greater than the time taken in market economies. Given the huge number of companies to be sold, this further reduces the viability of case-by-case privatization as a primary approach to post-communist privatization.

2.3 Mass/voucher privatization

Mass privatization, usually through vouchers, has been an important method of privatization that has been chosen by many post-communist countries. The main reasons advocated for mass privatization are usually that the cash resources do not exist to purchase all assets and because of considerations of equity. Vouchers, sometimes known as investment coupons, are the only substantive means for the population at large to participate in the process to any significant extent.

Other advantages of mass privatization are that it avoids the need to value businesses, overcomes the privatization versus restructuring debate, and can shift very large quantities of assets into the private sector quickly. On the negative side, mass privatization introduces neither new capital nor new management.

Technically, the design of mass privatization programmes can be complex and time-consuming. The use of vouchers raises many difficult issues, and different post-communist countries have taken quite different approaches and had quite different experiences.

For example, the notable fact about one of the earliest mass privatization schemes, the Polish one, is that it hasn't happened yet. The Polish scheme was devised in such way as to overcome the most frequently trumpeted defect of

voucher schemes - that the very widely dispersed ownership would mean an absence of any effective shareholder pressure on management. The Polish scheme involves the allocation of companies to state-owned investment funds that are managed by private (largely foreign) companies. The fund managers would seek to restructure, improve, and (if they wished) sell the companies under their control, with the objective of maximising the value of the fund prior to the distribution of ownership certificates to the Polish population. However, the scheme has met strong resistance. Firstly, there has been resistance from the companies designated for inclusion into the scheme. Because a majority of the equity of selected companies was included, many resisted inclusion strongly, seeing it as a step into the complete unknown with a loss of control on the part of the existing management.

Thus, the Ministry of Privatization has had great difficulty in bringing enough companies into the scheme. There have even been disputes within the Ministry of Privatization, between the mass privatization department and the department responsible for direct sales to foreigners, over attempts by the latter department to "poach" companies from the mass privatization list. Furthermore, if the Polish scheme ever starts, it is an open question, whether the foreign managers - given the facts that the funds will be initially state-owned - will have sufficient political support to take unpopular decisions such as dismissing large numbers of employees from the companies under their control. Indeed, another reason why the Polish scheme met strong political resistance was that it was perceived to involve handing control of many companies to foreigners.

Furthermore, because the Polish scheme, unlike the Czech and the Russian ones, did not involve giving ownership or any type of investment coupon to the general public, except after a considerable period, there was little support from the population for the scheme. The population did not feel involved. Whether it would have been preferable to go to the opposite extreme and hand people vouchers that were roughly equivalent to cash, as in Russia, is open to question however. Clearly, there is a tradeoff between speed and the quality of the scheme.

Thus, one key issue in all voucher schemes is whether the vouchers themselves should be tradable, (as they are in Russia and Romania, but are not in the Czech Republic, Poland and Moldova). If they are tradable then the fear is that many people will sell them immediately for a pittance or for a bottle of vodka, and that large amounts of vouchers will end up in the hands of mafia elements who will use them to manipulate the privatization process. Forgery is another problem that affects tradable documents. For example, in Romania there have been widespread reports of forgery of Certificates of Ownership.

If the vouchers are not tradable, then many argue that this restriction is counter to the basic principle of a market economy, and that the holders will not value them. Also, a ban on trading will prevent the accumulation of vouchers by keen investors, which could well be a beneficial development.

Clearly, the decision on whether vouchers should be tradable or not will be affected by a number of other factors, including the extent to which the Republic in question feels threatened by outsiders, and wishes to discourage their acquisition of assets. More crucial, however, is the method by which vouchers can be exchanged for shares.

In Poland and Romania, for example, the vouchers already represent share ownership, although in a very indirect manner. In the Romanian case the vouchers are certificates of ownership in five Private Ownership Funds, which themselves hold 30% stakes in virtually all Romanian companies. The certificates of ownership can themselves be used to buy shares in companies being privatized. In Poland, the vouchers will be participation certificates in investment funds which will themselves own companies.

In Russia, on the other hand, the vouchers are much more akin to cash, and can be mixed with cash for the acquisition of shares and other assets by a variety of methods including auctions, employee buyouts, etc.. In the Czech Republic, only vouchers can be used to bid for shares. In Moldova, also, it is intended that vouchers only may be used at auctions to buy shares. Such an approach raises several other important issues. The first is what auction method is the most appropriate, and the second is how vouchers may be combined together for purposes of bidding.

The Czech tendering method of adjusting the price of shares (in voucher points) in line with demand and putting companies through several (up to 6 or 7) rounds of bidding is intellectually very coherent but may be too complicated and time-consuming for some countries. A simpler method, whereby bidders simply receive shares in line with the amount of voucher points they bid, may be more appropriate.

The more recent Hungarian approach to mass privatization has been quite different. Under the small entrepreneur share ownership programme Hungarian citizens will be given access to an interest-free credit line from which they may purchase shares. This amount, without interest, must be repaid within five years. Other means of providing the domestic population with buying power are already in operation in Hungary. For example, the 'E-loan' is available to Hungarian citizens for the purchase of state-owned assets. The interest rate is 7 per cent and the term 10 years.

Clearly reformers have a difficult choice to make between rapid and possibly imperfect action or delay to improve the mass privatization scheme with the danger that delay may serve the interests of the anti-reformers. Some mass privatization schemes that have been implemented very quickly, such as the Romanian one, could definitely have benefited from a lengthier process of reflection and preparation. Indeed it is difficult to describe the Romanian scheme as privatization at all, since it leaves 70% of the equity of companies in the hands of the state.

Most post-communist governments intend to continue to pursue mass privatization programmes. In most cases substantial work remains to be done on both programme design and implementation. Little work appears to be being done to help countries draw upon the experience in others in voucher privatization. There is a need for some international comparative work, so countries currently embarking upon voucher programmes, or introducing new versions of voucher programmes can see how others did it and what the consequences were. To produce such a detailed guide is beyond the scope of this short report, but may be the focus of future Adam Smith Institute research.

2.4 The combining of vouchers

Also, crucially important is the question of how vouchers may be combined. In some cases they are compulsorily combined, as in Poland and Romania as described above. In other cases people may voluntarily combine their vouchers. Unless there are some rules to guide this process, there are severe dangers of abuse and general confusion, which may jeopardise the whole privatization programme. For example, in Russia, people contributed thousands of (bearer) vouchers to investment funds, which promptly disappeared (with the vouchers).

In many cases, including the Czech Republic, investment funds made unrealistic promises of guaranteed returns to their investors, based on unrealistic dividend expectations. It remains unclear what will happen when those guarantees are not met. Such an approach may place damaging pressures on companies to pay dividends rather than reinvest profits, insofar as there are any profits at all.

In Russia investment funds have sought to meet their promises of guaranteed returns by issuing new shares in their own funds and distributing them to existing shareholders. This of course dilutes the value of the existing shares and results in a proliferation of increasingly worthless paper.

Clear rules must be laid down. They must specify, amongst other matters, the following:

- * What is the legal relationship between the voucher holder and the investment fund? Is the voucher holder buying shares in a closed-end investment trust (to take the UK model), or is he buying units in a unit trust (difficult, if there is no stock exchange), or is he acquiring no ownership rights at all, but only a promise to be paid a certain amount of money on a certain date?;
- * Whether there is a distinction between an investment fund with many investments, or a holding company with one or more majority stakes, and whether, as in the Czech Republic, there should be restrictions on the

maximum percentage holdings of funds in individual companies;

- * Whether there should be restrictions on the making of promises on guaranteed returns or the payment of dividends;

- * Whether and how investment funds can have their own shares traded or create new shares.

Alternative methods of combining vouchers should also be considered. For example, in the case of Moldova, as well as defining the investment fund concept, the Adam Smith Institute created two other models, the *voucher club*, to be used for groups seeking to buy shares of a single company at auction, and the *single bidding group*, to be used for groups seeking to buy whole assets, such as shops, which were small enough to be sold (for vouchers) as one unit and not in shares.

Our view is that straightforward regulations governing investment funds and other collective investment vehicles involving vouchers are very much needed and should be introduced as a coherent part of a mass privatization package and not as an afterthought in response to abuses that have occurred. It would be sensible for such regulations to be part of general regulation of securities, but in practice that may not be possible if securities legislation does not exist. In these circumstances the investment fund legislation will most likely have to be created and policed by the Privatization Ministry or Agency. A careful balance will need to be struck between the principles of protection of the investor, which might lead to excessive restrictions, and encouragement of entrepreneurs to develop funds, which might be considered by some as an open invitation to swindle the public.

A general rule is that the regulations should define clearly what the particular collective investment vehicle for vouchers actually is, and prevent it from being all things to all men. In other words, it should not be able to be an investment fund for vouchers, an industrial holding company and an investment company which issues new shares for cash, all at the same time and in some confusing combination. This appears to be what has happened with many of the Russian voucher funds, which are busily issuing new shares for cash in a form of pyramid selling scheme in order to keep themselves going. This is not to say that investment funds should not be allowed to develop. If a voucher-based investment fund wants to convert itself into a holding company, after having made various investments and consolidated them, then it should be able to do so. The crucial point is that there should be clarity and transparency. The roles of the different parties, managers, investors or whatever, should be clear, as should be the respective potential risks and rewards.

Given the almost complete lack of knowledge on the part of the public about how the voucher programme and associated investment funds will operate, there is a strong case for a substantial publicity campaign to be launched by the Government to explain exactly what the role and form of the investment funds

will be, how citizens may participate in them, what regulations govern them, and in what light to view various offers made by these funds.

Clearly, apart from the regulation of investment funds, a number of other detailed administrative issues also have to be tackled in those countries yet to launch voucher programmes, such as how vouchers are distributed. In Russia people had to go to distribution centres; in Moldova vouchers are distributed through people's place of work; in Kyrgyzstan people's bank accounts are credited and they receive their vouchers from the bank. Another issue is how vouchers are cancelled after use.

2.5 Institutional structure and transparency

The institutional structure which supports the commercialisation and privatization process is obviously crucial to the success of that process. Many different approaches to institutional structure have been taken in postcommunist countries.

In many countries new privatization ministries or agencies have been established to handle the privatization process. While it is undoubtedly sensible to concentrate power in the privatization process in a new body of people not beholden to the old structures, it is also important to think carefully about how such new bodies relate to the old. A new privatization ministry is usually considered a rival by most ministries who previously had control of the underlying assets. The resultant battles can lead to delay or even paralysis. The privatization ministry therefore needs powerful political allies. One solution may be for it to be linked to or be part of the Ministry of Finance, which normally has the power and durability to see through policies over the long term. A danger may be that the Ministry of Finance focuses too much on raising proceeds from privatization, and care must be taken to ensure that this does not happen.

Some countries have established not one privatization structure, but two. The Russian model is to separate decision-making from implementation of privatization. Privatization Committees, responsible to the government, decide how something should be privatized, and Privatization Funds, responsible to the parliament, actually carry through the process. The argument for this structure is that it guards against corruption, but it undoubtedly also arose because the different legislatures throughout Russia wanted some involvement in the process.

In the week beginning October 4 1993, the then Russian parliament was fully dissolved by President Yeltsin and measures were taken to disband other regional and local legislatures. Later that week Mr F Tabeev, the then Chairman of the Federal Property Fund of the Russian Federation, was instructed to report to Privatization Committee head Anatoly Chubais. In effect the dual structure is

no more in Russia.

The Czech Republic is another country with a dual structure - - the Ministry for National Property Administration and Privatization for decision-taking and the National Property Fund for implementation. As in Russia, it has been found that this dual structure leads to delays.

In the Ukraine, where there is also a dual structure, there was conflict between the State Property Fund and the government, although this diminished when the reporting responsibility of the Fund changed from solely the parliament to dual parliament and government in June 1993.

The role of sectoral ministries in the privatization process is another important institutional issue. Should transport be privatized by the Transport Ministry or by the Privatization Ministry/Committee? Should the role of the sectoral Ministry be to restructure the sector in preparation for privatization - - as is largely the case in the Czech Republic and partially the case in Russia? Should the Agriculture Ministry be left to pursue agricultural privatization, as is the case in Moldova? Should telecommunications privatization be left to the sectoral ministry with that responsibility, as is the case in almost all post-communist countries?

The danger of having too great a role in the process for sectoral ministries is that they have an understandable tendency to preserve things largely as they are, and may not take the best decisions with regard to demonopolisation and restructuring. They may also seek to preserve their existing role. For example, in Kyrgyzstan the Ministry of Industry still holds minority stakes of around 30% in most privatized companies and is still controlling some of their activities. Many companies have been privatized with monopolies intact.

In the Czech Republic, for example, the energy distribution system has been prepared for privatization by the Ministry of the Economy, which has line responsibility for energy, and partially privatized through sales for vouchers, but little thought appears to have been given to the establishment of an appropriate regulatory framework.

On the other hand, the staff and other resources of the Privatization Ministry/Committee may be insufficient to take on all the work. Involvement of sectoral Ministries may be unavoidable. In this case proper working relationships between the two bodies must be developed. Joint teams may be the most appropriate solution.

One solution to the problem of insufficient authority in the Privatization Ministry/Committee may be to locate it within the Ministry of Finance or as an adjunct to the Ministry of Finance, although this obviously is not available as a general solution, as the circumstances of individual countries differ. However, in most countries the Ministry of Finance is a very powerful institution both because it controls the purse-strings and is a centre of economic policy-making.

There are some dangers of control of privatization by the Ministry of Finance. One does not want to encourage the Finance Ministry to focus the privatization programme merely on maximising the revenues from privatization and retaining them for the state budget. New capital is needed by companies, and in any case mass privatization without revenues may be the only feasible means of fast privatization of most of the assets. In practice, though, the goals and nature of the privatization programme are not decided by the agency that controls it, but rather by the Parliament. The advantage of having the Ministry of Finance as the implementing agency is that it may have sufficient power to override the obstructive activity of other Ministries and push the programme through.

How the government's ownership role over state assets is exercised in practice is another question that has caused much debate in the post-communist world. The intention in many cases has been to remove control of government owned companies from sectoral ministries, which sought to manage the companies in detail in the old fashion, and transfer the ownership to a new state ownership fund or agency, which exercises a more traditional private sector type of ownership role.

In Romania, for example, ownership of 70% stakes in almost all Romanian companies has been transferred to the State Ownership Fund (SOF), whose board is appointed in equal numbers by the parliament, the government and the president. However, the SOF also took over the role of implementing privatization from the Privatization Ministry (the National Agency for Privatization). With only 100 staff it has proved to be neither capable of exercising control over 7,000 companies nor of carrying through privatization. The government is seeking to reduce its powers because it complains that a state within the state has been created, with control of much of the economy. Across the border in Moldova, the State Property Fund has only 2 employees but is seeking to persuade Parliament to give it a similarly extensive mandate.

Thus the main issues on the ownership fund question include the following:

- * Should a separate ownership fund exist or should it be a subsidiary of the Ministry of Privatization?;
- * Should the ownership fund have responsibility for only corporatised companies or for all state enterprises?;
- * Should the ownership fund have the responsibility for carrying through corporatisation and/or restructuring;
- * How should it exercise its ownership role?;
- * If an ownership fund does not exist, who should exercise government's ownership role and how should that role be exercised?

Our own view is that the creation of state ownership organisations should be avoided if possible, and the aim should rather be to have a sufficient speed of privatization to ensure that lengthy periods of state ownership are not necessary. Although the idea of more effective corporate governance of state-owned companies is a good one, introducing it in practice through a new organisation such as an ownership fund is more difficult, quite apart from the problem that the new organisation try and become a rival to the Privatization Ministry/Committee, resulting in bureaucratic warfare and consequent waste of time and diversion from the real task of privatization.

2.6 The integration of privatization and competition policy

Competition policy and privatization policy have yet to be integrated effectively in any post-communist country. This has led to criticism that privatization has in many cases resulted in the transfer of monopolies to the private sector which have exploited the population through large price increases unmatched by service/product improvement. The focussing of competition policy and its integration with privatization policy is an urgent priority. Poland is probably the only example of a post-communist country where there is at least partially effective cooperation between the antimonopoly agency and privatization ministry.

It is clear that the focus of reform in each post-communist economy requires more emphasis on the legislative and regulatory structures that make privatization itself more beneficial. As observed above, in several post-Soviet Republics, much of the privatization which has occurred so far has been merely technical privatization with little commensurate effect on economic pluralism, competition, and the dismantling of the command economy system.

For example, in some republics, anti-monopoly institutions have been formed but have reimposed price controls over organisations they deem as monopolies in order to substitute for formal price liberalisation. Monopolies have been defined as all those companies with more than 30% market share (a large proportion of the economy) and price controls have been imposed upon these in the name of competition policy. This constitutes reintroduction of the planned economy by the back door.

Particularly worrying is the approach being taken to the privatization of utilities in many post-communist countries. Work is proceeding to privatize telecommunications and power utilities as monopolies, despite the fact that these sectors are today clearly not natural monopolies and that consumers would benefit greatly from the introduction of competition. In telecommunications in particular, an approach of immediate liberalisation accompanied by the introduction of an independent regulator for the sector would bring fast results.

Since post-communist companies are usually in poor shape and worth little, there is sometimes pressure from Western advisers who are retained on a percentage success fee basis to sell *markets*, rather than companies. For example this is largely what occurred in the case of the privatization of telecommunications equipment manufacturing companies in Poland, whose product was so obsolete and financial condition so appalling that they were less than worthless. However, several were sold for large sums because they were packaged together with portions of the lucrative future market for telecommunications equipment in Poland. As a consequence of this mistaken monopolistic policy Polish citizens will be paying significantly more for their telephone calls.

Of course, Western advisers seeking to increase their success fee are not the only guilty parties when it comes to packaging monopolistic markets with companies. Western companies seeking to buy those monopolistic markets, such as equipment suppliers, are often only too willing to agree to take over a run-down state enterprise in return for the guaranteed market. Such behaviour, is of course economically rational on their part, but that does not mean that it should be condoned.

As far as ordinary manufacturing sectors are concerned, in small countries it is inevitable that some sectors will be dominated by one or two producers, which will continue to raise concerns about monopolistic behaviour and exploitative pricing. However, in most cases there are liberalisation measures that can be undertaken to reduce the potential of abuse of monopoly power. Firstly, removal of barriers to international trade will do much to increase competition and prevent such abuse. Most goods are internationally traded.

Secondly, strong action must be taken to ensure that new enterprises are free to enter markets and compete with dominant enterprises. Action is also needed to ensure that production units producing similar goods are separated out as free-standing enterprises that compete for supplies and for customers. This will not necessarily disrupt existing trading relationships since enterprises will be free to continue with established trading patterns. However, it is essential for economic success that incentives for increased efficiency are created and that opportunities for new enterprises are not diminished by allowing old monopolistic relationships to become entrenched.

Bodies responsible for implementation of competition policy require powers to:

- * require the break-up of state enterprises into smaller production units where there is more than one unit producing similar goods;
- * declare null and void all those contracts and other agreements which reinforce monopoly or restrict market access;
- * recommend that unnecessary licences or permissions no longer be required;

- * declare regional monopolies illegal;
- * reduce tariffs where they can be shown to be providing excessive protection to inefficient monopolies;
- * disallow mergers of enterprises or the formation of joint ventures where designed to create either monopoly or monopsony.

Bodies responsible for implementation of competition policy should not automatically assume that an existing dominant market share necessarily results in harmful monopolistic behaviour but instead should focus their activities and limited resources on those cases where there is evidence of harmful monopolistic or restrictive practices, cartelization, or complaints from injured parties. Particular attention should be paid to cases where dominant enterprises or groups of enterprises take actions which unfairly inhibit the growth of the private sector.

Of course, in post-communist countries it is not always clear which organ of government should have responsibility for competition policy and its implementation, especially insofar as its application to state enterprises being prepared for privatization. How should the competition body liaise with other organisations involved in the privatization process?

2.7 The interlinked nature of enterprise relationships

A very significant but often overlooked factor slowing up the reform process in FSU countries is the nature of trading relations across the old union. In most FSU republics, the political elite and the industrial elite are one and the same. Managed trade with managed prices and output levels under monopolistic conditions enable a relatively small number of large enterprises to control decision-making within governments such that directors of enterprises, many of whom have senior political positions, can continue to do very well for themselves.

In many senses, the existence of monopolistic and monopsonistic networks provide very strong disincentives against reform. The existence of these networks argues in favour of increased emphasis on economic reform in the non-Russian FSU republics -- particularly the southern states. The lack of reform in Central Asia, the Caucasus republics, Ukraine and Belarus enable Russian enterprises to continue to operate as before by profiting from closed and often corrupt economic structures in the 'near abroad'.

Greater assistance must be given to assisting enterprises to break free from old trading relationships that prevent them becoming independent commercial

companies with control over their own destiny. Some of the smaller countries themselves need encouragement to break away from the old barter arrangements.

2.8 The corporate form of the privatized company

Too many of the companies that are being privatized in the post-communist world are being privatized in the form of *closed* joint stock companies, that is companies whose shares are not available for purchase by outsiders. This usually occurs in the context of a management and/or employee buyout, where the existing management retains tight control over the company. Employee shareholders are often unable to sell their shares even to other employees, and often have to return their shares to a central pot if they leave the company.

Obviously this approach has many defects. It does not represent true privatization, at least according to the maxim that one only owns something if one is able to sell it. Employee shareholders are often in a very weak position, in that if they stand up to management they may be fired and thus lose both their jobs and their shares.

Furthermore, closed company privatization prevents the development of capital markets, with the opportunities for shareholders to realise a proper market value for their shares and for companies to access additional capital. There is little or no shareholder pressure on management to perform.

In fact, closed company privatization, especially when combined with the preservation of monopolies and a suffocating blanket of regulations, serves to preserve the old economic structure and system, rather than helping to create the new.

3.0 Capital markets issues

In most post-Soviet countries there do exist institutions called stock exchanges, but they are in reality auction houses for the trading of physical goods. Capital markets legislation often does not exist or is very rudimentary.

So should one establish a single national stock exchange for the trading of securities? Who should finance and own the exchange and what should be the relationship with brokers trading on the floor? What form of trading system should be adopted? Should it be electronic or open outcry? How can costs be kept down so that small amounts of shares can be traded? How can people in outlying areas of the country get access to the exchange without travelling long distances?

These are some of the key questions which must be addressed. Our own preference is for as simple trading procedures as possible and one which does not involve expensive electronic systems. This would probably imply an auction-based trading system with open outcry on the trading floor.

Many of the East European exchanges have adopted complicated and expensive western systems, usually financed by western aid money, with rules and regulations not dissimilar to a large western exchange. The result has been that the exchanges have not been able to play a very useful role in privatization. For example, as of October 1993, only five privatized company shares were traded on the Budapest stock exchange. The number of companies quoted on the Warsaw exchange is larger, but the exchange's role in privatization has nevertheless also been very small.

3.1 The need for openness and competition

Equity markets exercise a vital economic resource allocation role by:

- * supporting the price system in ensuring money follows success;
- * providing a mechanism for wealth creation;
- * creating incentives for entrepreneurs to create value;
- * providing a source of finance;
- * enabling investors to spread risk;
- * creating a market for corporate control, including privatizations;
- * providing an informational barometer of economic activity;
- * creating a discipline on government decisions.

However, equity markets are more effective if they are pluralistic -- that is, if they comprise different methods of trading equity. For example, a pluralistic equity market in a post-communist country might include private trading between

individuals, off-market trading companies for the large and small investor, local exchange systems, voucher schemes with their own separate trading systems, employee schemes, share option schemes, and private trading between businesses. It is clear, for example, that a normal 'western style' stock exchange is not particularly suitable for the trading of large quantities of very low value shares that have resulted from a mass privatization programme.

In several former Soviet countries attempts have been made to give one stock exchange a legal monopoly over all securities trading. These attempts have usually been orchestrated by groups of would-be brokers, often associated with state banks, who offer to finance the exchange in return for a monopoly on it. However it is important for stock markets not to be monopolistic. If they are, they will be prone to all the familiar problems associated with monopoly - high prices for services, many participants excluded from the market, inward looking management, and restrictive and harmful bureaucracy.

Guarantees of openness and reduced opportunities for monopoly can be provided both by the laws and regulations governing stock markets and the internal regulations of stock markets themselves. Openness is also supported by competitive pressures arising from the existence of different forms of trading. These different forms of trading will normally emerge unless prohibited by laws and other rules, or unless trading becomes monopolistic. Formal stock markets should therefore not be allowed to succeed in any campaign to impose monopolistic regulations, since these restrictions will be harmful in the long term.

However, in fledgling trading markets it is important to ensure that there is sufficient volume, otherwise trading will not materialise, or if it does, will do so slowly. Consequently, particularly if the country in question is small, there is a strong case for the government to encourage trading - at least of large quantities of shares - on one national stock exchange. Such encouragement can involve the provision of technical assistance as well as a firm regulatory base that ensures, inter alia, that one group of brokers does not monopolise trading. Encouragement of one national exchange for 'western size' transactions does not mean that other exchanges - such as for example electronic ones for mass privatization derived shares - should be prohibited.

Other than 'openness' and anti-monopoly provisions, perhaps the key regulatory objective in all types of equity transactions is protection of the interests of shareholders, with rules that seek to ensure the validity of financial information. Rules such as these generate the open and pluralistic trading systems required.

3.2 Post-privatization share trading

Once a voucher programme has been put into effect, (or if any other method of

mass privatization has been used), there will be large quantity of shares distributed throughout the population -- (for example, there are currently 6.5 million shareholders in the Czech Republic) -- and a desire will exist on the part of some to trade those shares.

The question then arises as to what mechanisms exist, or should be created, for trading these shares. It may be the case that a computer-based national system which has been used in the voucher process can be adapted to provide a low-cost share trading system with national coverage. This is what the Czech Republic has done with its RM system, and is currently being considered by the Moldovan government. Such a system might or might not be linked into a national stock exchange, or be freestanding, as in the Czech Republic. The RM system has 450 outlets throughout the Czech and Slovak Republics, where people can go in and place orders for the sale or purchase of shares. These are written out on simple forms, which are then scanned, electronically, into the RM-S computer system. Auctions are held every two weeks or so, at which sellers and buyers are matched.

A crucial element of the securities trading system in the Czech Republic is the existence of a 'dematerialized' national share register in the Ministry of Finance. By 'dematerialized,' one means computerised. Thus ownership is represented by entries on the computer, rather than pieces of paper which are exchanged. In this respect the Czech Republic is more advanced than the London Stock Exchange, which has been seeking to convert to a dematerialized system for some time. Contrary to initial impressions, Czech shareholders seem happy with this system, and do not appear to want the comfort of actually holding a physical piece of paper which represents ownership of shares. The RM system's computer is directly connected to the National Share Register Computer, so transfers of securities through RM-S result in immediate registration of the change of ownership.

Of course, this dematerialized system is considerably more efficient than one which involves the storage, transport and exchange of pieces of paper. Other post-communist countries who have yet to establish share registers should consider a similar system.

However, the most important aspect of a national share register is not its nature, computerised or otherwise, but its existence. Through a national share register, ownership can be registered by a neutral third party. This is clearly preferable to the current situation in Russia where the maintenance of the share register is left to each individual company. What that effectively means is that the managers of a company can have a considerable influence over who the owners of the company are, and can choose to frustrate or deny changes on ownership, if they so wish. Recourse to the courts in these circumstances does not usually provide adequate redress, given the inefficient nature of the court system in most post-communist countries. Thus, the establishment of a properly functioning national share register is a vital element in ensuring that securities markets function effectively and that there is a proper market for corporate control.

4.0 The regulatory environment for the private sector

4.1 The importance of the regulation issue

The environment within which both new private companies and privatized companies can grow is an essential determinant of the success of privatization.

In many post-communist countries -- post-Soviet ones in particular -- the regulatory and fiscal environment is not conducive to the growth of the private sector. Too many regulations from the old central planning days remain, and new regulations are adopted and adapted with insufficient thought for their effect on the private sector. Too many bureaucrats still think that reforms are less important than forms.

Post-communist enterprises, particularly post-Soviet ones, whether private or directly/indirectly state owned, face a mountain of official regulations. Many regulations have been reformed, but the overall burden of regulation has not declined to the extent that unnecessary barriers to economic activity have been removed. Additionally, the political and economic upheavals of recent years have meant that many long-established regulations have remained in place, but are widely ignored or enforced unevenly. This has created a situation of arbitrariness and uncertainty that is damaging to economic advancement.

In the transition to a market economy, an almost completely new set of micro-economic regulations is required. These new regulations inevitably emanate from different sources, and in addition, many old regulations which have an impact on the new regulations still remain valid. These factors create a danger that in the creation of new and necessary regulations, the overall burden of regulations will increase, and contradictions will arise that will hinder the ability of enterprises to become more efficient and increase trade.

The burden of over-regulation has many unfortunate effects. The first of these is macroeconomic. Many post-Soviet governments have been hindered in their attempts at macroeconomic reform by widespread tax evasion and massive capital flight. There has been extensive comment on the large quantities of hard currency being deposited in foreign banks.

Whilst there are many reasons for this, one key factor is the complexity of tax regimes and regulations, and the associated inconsistency in the way that taxes and related regulations are applied. This is partially understandable in circumstances of rapid administrative upheaval and constitutional uncertainty, but it emphasises the importance of the need to make taxes and associated regulations easier to comply with and easier to enforce. Many observers have commented on the culture of semi-illegality which prevails in post-Soviet industry and within administrative functions.

This does not necessarily mean that all post-communist industrialists and officials are intentionally acting illegally. The point is rather that it has become accepted that many regulations still apply more to a command system than to a market economy system, and cannot be adhered to fully if the new direction of government is to be followed. This means that central and regional authorities, who have very limited resources, need to make choices as to those regulations that they choose to enforce fully. The result is inevitably wide variances in the way that regulations are adhered to.

This problem of inconsistency and selection has very significant side-effects. Apart from the undoubted increased scope for corruption, it undermines the authority and perceived legitimacy of government when critical regulations *are* enforced. The ability of administrations to secure the tax base and minimise capital flight is severely hampered. A regime of simpler regulations, greater consistency, improved enforcement and greater logic in the regulations themselves (in line with market economy conditions), better enables government to bring more transactions within the tax net, consequently increasing revenues and providing the scope for tax reductions.

Microeconomic reforms in general are undermined by over-regulation. If enterprises still require administrative consent for new activities they will tend to focus on 'permissions' rather than market signals in order to make resource allocation and investment decisions, and markets will still be seen as 'managed' and monopolistic. New market entrants will be discouraged and sorely needed new employment will not be created.

The damage caused to private business activity by some regulatory regimes is enormous. For example, in Moldova there actually are regulations which prevent private companies from trading with state companies. Of course this is a major disincentive to privatization itself. Other unnecessary regulations often restrict exports, because in the past times of shortages, every product exported (usually at subsidised prices) was considered as a 'loss' to the local economy. This anti-export mentality is a particular problem in many post-Soviet countries.

Bureaucratic barriers to the establishment of new businesses are a significant problem in many post-communist countries. The process of registration of new businesses is often too complicated, lengthy, bureaucratic and arbitrary. Depending on the size and scope of activity of the proposed business, legal and monetary barriers can be substantial. For example, in Kyrgyzstan new businesses have to register their scope of activity and then seek further permission if they wish to change it. In cases of more complex businesses it can take some months for a them to be approved, after questioning by a commission. Investors also need to get the permission of the local militia to start the business, in that it is they who must issue the official seal. Needless to say, the more permissions that must be gained the greater the scope for corruption.

Other common problems include:

- * restrictions on import and export, both fiscal and regulatory, at borders;
- * restrictions on access to foreign currency;
- * restrictions on access to credit;
- * high and discriminatory taxes which also lack clarity in their application.

Undoubtedly, one of the worst parts of the regulatory burden is fiscal. In many post-communist countries new taxes are introduced almost like confetti, with different levels of government scrambling to gain extra sources of revenue. Furthermore, existing taxes are constantly changed, with the result that many businesses don't know how much taxes to pay, when, and to whom. In many cases, if businesses paid all the taxes that were due, then they would immediately go out of business. This of course forces business activity underground into the black market, and/or requires the need to secure exemptions, which make the system even more complicated and open further opportunities for corruption.

The situation in Russia is one of the worst. Even the name of the country itself is taxed. Businesses using the words "Rossiya" and "Rossiiskaya Federatsiya" in their company name or in advertising have to pay a tax to the Federal Government. The situation for the individual business is truly confusing. For example, businesses operating in Moscow today have to pay 51 separate taxes. In March 1994 some of the main taxes were as follows:

FEDERAL TAXES

Payroll tax	39%
Corporate profits tax	38%
Value-added tax	23%
Income tax	39%
Transport tax	1% of payroll
Road use tax	0.4%
Vehicle owners tax	varies
Export tax	varies
Import duty	0-100%
Minerals tax	varies
Purchase of vehicles tax	varies
Tax on words Rossiya & Rossiiskaya Federatsiya	0.04-0.4%

MOSCOW TAXES

Corporate profits tax	38%
Assets tax	1.5%
Housing tax	1.5%
Education tax	1%

The problem has worsened since December 1993, when President Yeltsin passed a decree allowing local governments to impose their own taxes. Different regions have rushed to bring in new taxes. For example, new taxes in the first three

months of 1994 included an environmental tax in Arkhangelsk, a logging tax in Vladivostok, and a medical support tax in Komi. Most of these local taxes are based on company turnover. The picture for some sectors is particularly bad. For example, it has been calculated that the rate of tax on oil companies in Russia is 130%. It is only possible to survive by gaining exemptions. The complexity of Russian taxes is also a major challenge for businesses. For example, in the case of the tax on the word Rossiya, some categories of businesses are required to pay 0.4% of turnover, others .04%. Others still have to pay 100 times the minimum wage.

Of course it is much easier for large businesses to fight their way through the tax jungle than smaller ones. Larger businesses are more likely to have the political influence to achieve results. A tax exemption for a large business is a significant sum and thus larger businesses can afford to make the necessary 'informal' payments necessary to secure the requisite exemptions. In some post-Soviet republics the largest and most profitable companies pay virtually no tax. The general result, of course, is that smaller businesses shoulder an even heavier burden.

There is another problem which, although on the face of it less significant, is a major obstacle to privatization, demonopolisation, and credit reforms creating real economic development.

Post-communist enterprises are obliged to provide excessive information to the state on their activities, which require an army of clerical workers. Often these workers see themselves as part of government administration rather than beholden to the enterprise which employs them.

At the same time, managers of enterprises in general have little useful information on which to base critical 'market economy' decisions. For example, managers rarely know the relative real profitability of different products or services, as they would in enterprises in more market-driven economies.

Consequently, they are unable to ascertain which products or services to focus on when attempting to improve performance. They are unable to assess the viability of new or improved product investments, and thus are irrational in the use of loans and credits.

These and other types of regulations increase not only the cost of production, but also increase the costs of government administration when there are more important matters for government officials to focus on. This is a problem of the past as well as of the present. When new regulations are introduced, it is not customary for the compliance costs to enterprises and the full costs of enforcement to be taken into account during their formulation.

Furthermore, over-regulation also undermines the authority of the state when the very constitutional upheavals of the present make respect for state authority paramount.

Overwhelmingly, most managers of state and private enterprises are committed to complying with the law and fulfilling their obligations in terms of all the myriad of rules and regulations that apply to their businesses. They take a responsible attitude to those regulations that are now uncertain and attempt to seek guidance on the application of the regulations from the authorities (central, regional and local). While they wait for answers, however, the business still has to survive.

The burden of regulation is such that those managers who are more effective at reducing the costs of regulation and overcoming restrictions on their activities are those that are more likely to survive. The pressures to escape from many regulations and 'bend the rules' are enormous. Managers who don't bend the rules can see their less law-abiding counterparts achieving more in their attempt at survival.

The extent of the problem can be seen in its fullest sense only from the point of view of an individual enterprise. A typical manager of an enterprise faces several regulatory instructions from different government departments that contradict each other. The result is a diminution of the authority of the state which, combined with the economic pressures produced by over-regulation, restricts the effectiveness of new legislation that might be critically important. Therefore, the whole reform process itself is affected.

Plainly, measures to deregulate post-communist economies and rationalise the rules that apply to enterprises in the transition to a market economy will strengthen the authority of the state rather than weaken it as some might argue.

Ultimately, the problem of regulatory rationalisation is a political problem. It is widely accepted among post-communist economic reformers that the habits of seventy years of administrative control and restriction will take a long time to break. Post-Soviet economies will, however, never develop unless the central planning traditions of administrative control are addressed, since these administrative traditions represent an international competitive disadvantage. The habit of over-control will not be broken unless a strong start is made now to demonstrate that a more market-economy system of rationalised regulation brings positive results.

That requires strong political will, administrative cohesion, and incentives to change at all levels. Where these factors do not exist they have to be created.

Therein lies the heart of this political problem. Some will incorrectly assume that regulatory rationalisation will mean that the government, in a market economy, will withdraw from any involvement in the economy and create anarchy. Others may argue, equally incorrectly, that regulatory rationalisation will reduce the authority of the state.

But there is a further political problem in terms of incentives. Established

enterprises that have circumvented regulations and found a way to 'accommodate' them are now in a strong position. Meanwhile, burdensome and excessive regulations represent a barrier to entry for competitors and potential new market entrants, so political resistance at a policy level to regulatory rationalisation will be reinforced by resistance from administrators and many enterprises at the practical level.

Additionally, the rationalisation of regulations will result in the loss of power by many officials and specific central and regional government departments. For every regulation that is rationalised or removed, there will be pressures to create new ones to restore the power of those parts of government affected.

This means that a political approach to regulatory rationalisation must accompany an economic approach and an administrative approach. The compelling economic arguments and administrative arguments must be accompanied by the search for political support, particularly from those who will benefit at the practical level. Many practical businesspeople will be strongly in support of regulatory rationalisation and this support has to be mustered and channelled, if the enormous economic benefits of regulatory rationalisation are to be attained.

4.2 The need for a deregulation campaign

There is a need for a systematic approach to simplification and rationalisation of regulations as part of the process of transition to a market economy, and such a process is essential to economic development. Given the enormous effort being put into the revival of post-communist economies, factors which hinder this effort -- such as an increase in the burden of regulations -- need to be dealt with as a matter of urgency. In larger countries such as Russia, the structure and scope of the system of government across the whole of the country are such that an attempt to create a system of central control of all regulations would more likely add to the problems rather than solve them. Instead, it will be more productive to implement a programme which:

- * Gathers information on the extent of the regulatory problem, and provides this information to key organisations;
- * Provides guidance and persuasive evidence to authorities responsible for creating, eliminating or rationalising regulations to help minimise problems, and ensure that regulations are simple and non-contradictory;
- * Suggests legislation that applies to the development of regulations by different authorities, which prevents the worst of the problems from occurring in the future.

Before any detailed investigation is carried out, it is possible to lay down some

general principles:

- * State authorities should not have the power to reject registration of a new business. Registration should be made automatic, after production of the necessary documents. There should be 'one-stop-shopping' for registration: that is, anyone wishing to register a business should only need go to one location to do so;
- * There should not be any requirement to list specific activities in the charter of a business (and then to reapply if new activities are envisaged). Instead, businesses should be able to adopt large catch-all objectives in their charters (e.g. 'the provision of services of all sorts');
- * The process of registration should be standardised. There should not be different procedures in different localities, with different district governments applying different rules and procedures. One simple and national procedure should be adopted for the entire country;
- * Inspectorates currently have too much arbitrary power and have the power to close businesses without sufficient reason. Businesses need to be protected from the abuse of such power. An independent ombudsman's office should be created to which businesses can appeal against such decisions. Regulatory requirements should be simple and published openly, so there is no dispute as to their contents;
- * Local and regional governments should not have the power to levy their own taxes;
- * The number of different state authorities involved in the regulation of private business must be reduced;
- * Unnecessary licence requirements should be removed;
- * It is often difficult, in some post-communist countries, for private businesspeople to acquire products from the state. Barriers to trade between the private sector and direct producers should be removed. The number of goods subject to state orders and channelled through the state distribution system should be greatly reduced, preferably to zero.

If the over-regulation problem is not tackled and a healthy atmosphere for private sector growth created, the process of privatization will be stymied and the private sector will not be able to expand to take up the inevitable job losses from state enterprises.

5.0 A country example of flawed privatization

Here we provide examples of the flawed approach to privatization adopted by one post-Soviet republic (which shall remain nameless). These sadly typify many of the errors being adopted throughout the region. We examined this programme in some detail and present the following analysis in order to demonstrate the typical approach in many post-Soviet Republics.

The main problems of the programme were:

- i) lack of transparency in the methods of privatization used, namely the absence of use of vouchers and auctions, which led to non-competitive and arbitrary distribution of shares;
- ii) transfers of majority shares in most cases to labour collectives, without clear ownership rights for individual members of collectives;
- iii) the closed form of joint stock companies;
- iv) the provision in privatization contracts that constrained the business decisions of new owners, in particular holding them to continue existing business activities.

These problems are highlighted by examination of three examples of different types of privatized enterprise:

Example no. 1: A textile company -- A privatized joint stock company of the closed type.

Some 75% of the shares are owned by the workers, and of these 26% by the Director, (who is also a member of Parliament). The workers, apparently, unanimously voted that the Director should have a larger number of shares than other employees. The remaining 25% of the shares are owned by the state.

There are 6,500 employees, including those working on two farms which form part of the company. Some 91% of employees are shareholders, (9% joined after privatization). Employees do not have the right to sell their shares. When an employee leaves the company, he or she leaves his/her shares.

Products include clothes of most types, including underwear and everyday wear, in 100% wool, 100% cotton, synthetics and mixtures. The company involves the entire wool industry of the Republic, from raw wool processing through to finished product assembly and includes a chain of 100 textile shops.

75% of the company's production goes to the CIS, 3% outside the CIS, and 22% is consumed domestically.

The company holds 100% of the market inside the Republic, and, because of export and other restrictions, is a monopoly purchaser of its primary raw product, wool. The company itself requires a government licence to export its goods.

The company is profitable on paper, although it must pay a large number of taxes. It is questionable whether it is profitable in Western accounting terms.

Example no. 2: An electronics company -- A privatized joint stock company of the closed type.

The company was founded in 1973 to produce military computers. Although previously over 90% of its production was military, now less than 10% is. Early in 1993 it became a joint stock company and was privatized.

Now 35% of shares are owned by the labour collective, 55% by the state and 10% by a state-owned organisation.

There are officially 2,800 employees today, although unofficial enquiries revealed that around 1,500 of these are on permanent holiday without pay, and not all of the rest are full-time. A year ago there were 4,000 employees.

New products now being produced or planned include:

- * electricity meters;
- * fruit driers;
- * tape recorders;
- * solar collectors and batteries;
- * portable computers.

Despite its earnest efforts to produce new products for new markets, the company is not bringing in enough money to keep alive without bank loans on favourable terms.

In the first quarter of 1993 the company received a credit in roubles of the (then) equivalent of \$500,000 from the Promstroi Bank. They have until the end of 1994 to pay back this credit, at an interest rate of 8% rising to 14%. At current rates of inflation in the Republic (1000% annually) the money is, therefore, virtually a gift.

The company seeks the permission of the Ministry of Industry before it takes major decisions.

Example no. 3: A clothes shop

The shop was privatized by sale to its (8-person) labour collective in April 1993. The employees do not hold individual shares and do not understand how they can sell their shares. They signed a contract with the Government promising to sell the same range of products for 5 years. (Clothes, shoes, some food). They have improved the interior of the shop, installing new shelves and redecorating. They would like to develop a restaurant in the basement but cannot raise the necessary finance. They sell only goods that they obtain from the private sector, as they find it impossible to obtain suitable goods from state companies.

They received credit of the local equivalent of US\$30,000 for a term of 3 years at an interest rate of 53% from the bank of their previous sponsoring Ministry.

These examples highlight the requirement for a variety of policy actions. We outline below the most prominent actions which we believe should be taken to improve the situation in this case:

*** The need to break up monopolies prior to privatization**

The textile company, example no. 1, is a good example of a monopoly that has been transferred completely intact into the private sector. Export and import legislation reinforces its monopoly.

Such industries should be broken up prior to privatization into their component parts. This will require greater co-operation between the Privatization Ministry and the Competition Authority.

The question remains as to what should be done about those companies that already have been privatized as monopolies. The following are options:

- (a) Remove export (and import) barriers, which block foreign and other competition;
- (b) Implement measures to ensure that new competitors can enter the market;
- (c) Start the process of requiring some of the privatized monopolies to divest some of their component parts.

*** The need to sell remaining state shares**

In most cases of privatization to date in this country, the labour collective has received some 60-70% of the shares, with the state retaining the remaining 30-40%. There is considerable evidence that those companies in which the state retains a minority stake remain open to state influence and direction, usually from the ministry of which they previously formed part. It is therefore essential

that:

- (a) remaining state stakes in companies are sold;
- (b) ministries acquire a better understanding of their new role in a market economy.

*** Conversion of companies from closed to open type**

The privatization of companies as 'closed' joint stock companies preserves the power of the existing management and makes changes to the company more difficult. Two measures should be undertaken:

- (a) All companies sold in the future should be sold as open joint stock companies, with clauses preventing their subsequent conversion to closed form;
- (b) Existing companies with over 100 employees privatized as closed should be required to change their articles of association to 'open' form.

*** Provision of subsidised credit to state and privatized companies**

The practice of providing subsidised preferential credits to companies through the banking system should be discontinued. This makes it more and more difficult to restructure and privatize the banking system, something that is essential for the whole of the economy.

Insofar as the government views it as politically essential to keep certain companies alive, this should be done through direct budget transfers. Where subsidised credit is being provided by the government, it is preferable that this should be auctioned to eligible companies.

*** Removal of restrictions on business activities**

Those agreements which have been signed with companies restricting their business activities to a certain field (profiles), should be rescinded. The Privatization Ministry should write to all such companies with a legally binding guarantee that these provisions are no longer in force and will not be enforced.

The only possible exceptions to this rule should be those shops which are clearly the only food shops for a wide area. On the request of the municipality it should be permissible to retain the requirement that those shops carry certain items of essential food. However, they should not be prevented from entering other fields of commerce.

Similarly, there should be no restrictions in any new sale contracts.

*** Implement a mass privatization programme quickly**

The sale of enterprises at auction for vouchers will be the easiest method of privatizing a large number of shares quickly. It is therefore important to push ahead with the detailed formulation of a voucher programme.

This emphasises the need to proceed in the interim period with the privatization of shops and other small businesses by means of cash auctions, rather than sale to labour collectives.

Also in this interim period, much work can be done to prepare enterprises for privatization, particularly by splitting them up when they are of a monopolistic nature.

6.0 Conclusion

This report argues that privatization in many post-communist countries is failing because it is being implemented with insufficient regard to its ultimate objective of creating a competitive market economy. Attention is not being properly paid to the integration of competition and privatization policy, and to the creation of a favourable regulatory environment for privatized business. Undoubtedly, the situation is worse in the former Soviet countries than the East European ones, but the problems are by no means confined to the FSU.

Mass privatization appears to be the way ahead for countries to shift large quantities of enterprises from state ownership to the private sector, but in the vast majority of countries, there remain many unresolved questions as to how mass privatization programmes operate in practice. Many of these questions relate to how vouchers may be exchanged for shares and how vouchers may be combined to bid for shares. Much progress could be made if post-communist countries would draw from each others' experience to a greater extent.

Significant difficulties have been caused by the creation of unwieldy structures in government to take privatization forward, often with authority for privatization divided between different bodies, such as a Ministry and a State Property Fund. The reasons for this are political, often with Parliaments wishing to have some direct control over the process. This has generally caused additional problems and delays, and increased the role of special interests in the process.

Significant reforms both in the institutional frameworks and in policy are required if privatization is to be implemented effectively in a way which will increase competition and create a real market economy. However, the argument that some privatization is better than none at all - and if the approach is too complicated and intricate - then privatization won't occur at all, is a valid one. In difficult political circumstances, privatization Ministries often find it hard to make much progress in face of strong resistance from powerful directors of state enterprises. This means that some of the elements of a privatization programme need to be watered down or altered in order to accommodate those interests.

Nevertheless, the crucial question is how the necessary compromises are made. As in the British privatization programme, interest groups can be bought off with special concessions and privileges. For example, employees can be given discounts on shares, or shares on credit, and managers can be helped to retain their positions, with opportunities for salary enlargement.

In other words, state enterprise managers can be made rich within the context of a liberalised privatization programme. It isn't necessary to carry out phony privatization in order to retain their support. The pressure to privatize state enterprises in a closed, monopolistic form should be resisted. Instead, enterprises should be broken up if necessary, prior to sale. This actually provides the opportunity to enfranchise more managers as owners. All above a

minimum size should be sold as open joint stock companies, with company constitutions (memoranda and articles of association) that entrench the rights of all shareholders.

Managers may be encouraged to take substantial stakes in the context of a mass privatization programme, in which the majority of shares are taken up by outsiders, whether voucher investors only or combined with others. The widely dispersed share ownership that results from mass privatization should give managers the ability to retain their jobs, but only if their performance warrants it. The many new shareholders that result from a mass privatization programme will take time to get organised and exert their influence effectively, whether through investment funds or other means.

Clearly, the situation will differ from country to country, and different formulae will be required to suit different conditions. But if privatization is to achieve its true purpose - creating a competitive market economy - then a substantial reexamination of policy and practice is required along the lines we have set out in this report.