



Present at the confusion

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Abstract

By the fall of 1990 the economic position of the USSR had deteriorated to the point where the Gorbachev government sought the advice and assistance of the major Western international financial institutions: the International Monetary Fund, the Organisation for Economic Cooperation and Development, the European Bank for Reconstruction and Development, and the World Bank. These IFIs were asked to diagnose the situation and recommend measures to assist in the transition from plan to market. The reform of industrial and manufacturing enterprises was a key issue among the many analyzed. This article's author, from the World Bank, worked on the enterprise reform team. Drawing on extensive notes from 1990 and 1991 interviews with Soviet and Russian officials, reformers and enterprise managers, this article portrays in detail the extent of the economic—and political—dislocation of the Soviet Union in 1990, the acutely uncertain policy and legal environments in which enterprise managers and government overseers tried to function, and the various and sometimes desperate means by which those in the enterprise sector struggled to position themselves for survival in the newly emerging economy. A major theme is the widespread but ultimately fruitless effort on the part of the Soviet and then Russian reformers to find a gradualist, minimally painful way to carry out the transition of enterprises to market operations. One result of that failure was the much-criticized Russian privatization program. The conclusion is that for political as much as economic reasons, the pace of enterprise reform adopted was unavoidable. © 2016 Non-profit partnership “Voprosy Ekonomiki”. Hosting by Elsevier B.V. All rights reserved.

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1. Introduction

Following a meeting between Soviet and Western leaders in Houston, Texas, in July of 1990, the International Bank for Reconstruction and Development (the World

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Bank), the International Monetary Fund, the Organisation for Economic Cooperation and Development, and the then fledgling European Bank for Reconstruction and Development were jointly invited by the government of the USSR “to undertake a detailed study of the Soviet economy, make recommendations for its reform, and establish the criteria under which Western economic assistance could effectively support such reforms” (IMF et al., 1990, p. 1).

I was a member of the ensuing first mission of the World Bank to the then Soviet Union, in September/October, 1990. My remit was enterprise reform and the prospects of privatization. Our team visited the USSR (“All-Union”) Ministry of Justice and the State Planning Committee (*Gosplan*). We then met with officials in several All-Union industrial ministries (“branch ministries”): the Ministry of Light Industry, the Ministry of Electronics Industry, the Ministry of Metallurgy, and the Ministry of Machine Tool and Tool Industry.

We next conducted visits and detailed interviews in eight industrial enterprises in Moscow, Leningrad (as it was still then named), and Zelenograd.¹ We also held a round table discussion with managers from six other firms who were attending a course at the Leningrad Management Institute, met with the Economic Reform Committee of the Leningrad City Council, representatives of an equivalent body in the Moscow City Council, two Vice Presidents and a Board Member of the “Butek Peoples’ Concern” (an association promoting quasi-private production units in Moscow), staff of the Leningrad Management Institute, the Chairman and Financial Director of the Leningrad Lease Holders Association, Professor of Law V. Musin, who was working on the definition of property rights, the head of the Union of Cooperatives, Academician Vladimir Tikhonov, the head of the Tallinn (Estonia) School of Management, the Chairman of the Board of the Energomash Bank, the President of the Light Industry Commercial Bank, and a number of other persons interested in or working on liberalization.

I realized that this was a unique event and I took detailed notes on every discussion with every official met. Back in Washington I wrote a background paper on what I had found, stating what I thought could and should be done to improve Soviet enterprise performance. Parts of this paper were incorporated into the overall report (IMF et al., 1990). The whole of the background paper was published as a World Bank Discussion Paper (Nellis, 1991a).

In March of 2016, I rediscovered the extensive notes summarizing all the conversations held and adding details and reflections on the many visits, meetings and interviews conducted during the three and a half weeks spent in the Soviet Union. In re-reading these notes I was struck by the differences between what we outsiders thought we were seeing, and what we thought would most likely arise from what was then happening, and what was actually taking place and what eventually did occur. This is hardly surprising; “prediction is difficult, especially when dealing with the future.”

But what also comes out of the notes is how most of us on the team were poorly informed as to how the real sector functioned in the late Soviet period of

¹ These were: the *Krasny Proletari* (“Red Worker”) Machine Tool enterprise, the Three Mountains Textile Manufacturing Combine, the ZIL Industrial Amalgamation (truck making), a new Machine Tool “Service and Production Association,” the V. Sverdlov Machine Tool factory, the Reductor Gear enterprise, Textile Plant No. 42, and the Main Computer enterprise in Zelenograd.

perestroika. That is, how far, by 1990, enterprise operations had strayed from the central planning model, and how dysfunctional, chaotic and fundamentally unclear was the position of Soviet enterprises and their supporting units. Managers and administrators were caught in a position of acute uncertainty, where planning had mainly but not completely collapsed, and market thinking and mechanisms were embryonic.

Many—not all—of the Soviet managers, bankers, lawyers and ministerial officials we met were striving to determine what they could do to escape from what most of them regarded as a failed economic system. The search was daunting in itself. It was made exponentially more difficult by the fact that the Soviet political system was, in the fall of 1990, in an advanced state of disintegration. This political collapse was an over-riding central factor in all that was taking place—and a factor of which many of us outsiders had been insufficiently aware.

A re-reading of these notes 25 years later shows how much interesting detail was left out of the first report. It also reveals how much we missed. I now see that several respondents raised points and concerns that should have received more discussion and attention, then and in the period that followed. Thus, I here offer an interpretive summary of these notes in an attempt to illuminate a moment of intense socio-economic change. I conclude with a few observations on what subsequently happened.

This is not another in the long list of *post-mortems* on the Russian privatization program or the World Bank's or the international financial institutions' (IFIs) role in that process. I previously tried to assess whether we in the Bank got it right or wrong in Russian privatization, and I stand by the judgments reached then (see Nellis, 2008). These notes fall under the heading of not-so-ancient history, as a record of some revealing aspects of the last days of the Soviet Union.

2. First surprises

September 17, 1990: The World Bank's team first meeting was in the "All-Union" Ministry of Justice. Our counterparts were Deputy Director Golubov, Leonid Yefremov, Deputy Director of the Ministry's Department of International Relations, and several other staff. They said:

At present, there was a most complicated state of affairs. The established planning process was "in abeyance."² The entire economic scene was unsettled in the extreme. The political situation was worse. An economic "treaty" to determine the allocation of rights and responsibilities of the Union and Republican governments was being drafted, but important actors, particularly Russia and Ukraine, "were not cooperating." The Republics believed that all powers belonged to them, save for those few they might expressly concede to the Union. Golubov said these Republics are like "spoiled children, stamping their feet." Economic realities will soon bring them around to a more reasonable position.

A plan had been drafted—the Shatalin Plan, named after Professor Stanislav Shatalin, economic advisor to the Soviet leader Mikhail Gorbachev—to transform

² In summarizing the interviews, all words in quotation marks are taken directly from my notes. Words in quotation marks were spoken by Soviet participants, or, in a few noted instances, were my personal reflections on what was said. Names of Soviet officials met are rendered phonetically; few if any gave us business cards.

the system from plan to market in 500 days, starting, theoretically, on October 15. There existed an earlier, less radical, more evolutionary set of reform guidelines, formulated by a commission under the direction of academic economist Leonid Abalkin. It had not yet been decided which of these approaches would be official policy. Yefremov said that leaders of the Russian Republic favored the more radical Shatalin approach and were stating they would, come what may, launch the 500-day process on October 15.³

Golubov and Yefremov said there were many areas in which fundamental legislative, juridical and policy changes/decisions were urgently required to provide “the minimum legal requirements for transition to a market system.” The team expressed some skepticism that all this could be managed in 500 days, a view strengthened by Yefremov’s admission that there was an utter lack of knowledge within the ministry on most of these issues. “Everything is speculative,” he said.

Yefremov went on to say, wistfully, that he hoped that when the current dust settled the constituent parts of the USSR would retain an economic structure “a bit more consolidated than the European Economic Union.” He said the current negotiations must produce agreement that central authorities retained “absolute priority” on some key matters; otherwise, the Union could not exist. These statements took us aback; we hadn’t realized how advanced was the process of political tension and dissolution. The shock was heightened when we later spoke with officials of the Russian Republic and members of the Economic Reform Committee of the Leningrad City Council. They asked why we had bothered to speak with Union ministries: “They no longer had anything to say.”

Despite these signals, few on the team understood that the Soviet Union had but 15 months of remaining existence. How did we miss this? Perhaps we could not shake off the history of a bi-polar world and the myth of a powerful, expansive and enduring Soviet state. One Russian later told some of us (in the bar at the Hotel Cosmos) that the life of the USSR had been prolonged for a decade by the assessments of the US CIA that the Union was a great and wily power. “Even we believed it,” he said.⁴

2.1. Gosplan

A later meeting with senior officials of the famous *Gosplan* further revealed the precarious state of the Soviet system. We met with Messrs. Bezrukov, Head of the Main Computing Center; Ryzhov, Deputy Chief of the Financial Department, and Stepanov, Macro-planning and Modeling Department. The leader of the World Bank team, John Holsen, opened the session with a question: “We need to understand the future role of *Gosplan*; how will it evolve?” Following consultation the interpreter responded: “We would like to know too!”

³ In the week following this meeting, while the team was in Moscow, Gorbachev came down on the side of the Shatalin Plan. This decision was denounced by the then Prime Minister, Nikolai Ryzhkov, and by Abalkin himself (in his position as Soviet Vice Premier in charge of economic reform). Both claimed that the country was not prepared for such drastic measures and that disaster would surely follow. See Parks (1990).

⁴ It’s a cute line, but it was not true and we should have known it. By early 1990 the CIA was openly proclaiming that the USSR was in danger of economic and political disintegration. Perhaps this view had not yet been widely distributed, and perhaps the CIA was late in its appraisal and underestimated the speed at which the country could collapse. Nonetheless, had we been better prepared we would not have been so surprised at what we found.

The officials then tried to convince us, and themselves, that the Soviet Union, and *Gosplan*, would persist. Yes, at the moment many in the republics are “intoxicated” with the notion of full autonomy, but they will see reason: There “cannot and should not be any discussions on the point” that the USSR will continue.

Note that even here, in the principal basilica of socialist planning, no one questioned that the old system had failed and that a transition to the market, or something approximating a market, was urgently required. But those we met in *Gosplan*, and many of those we met in other Soviet ministries and central units, thought that the transition would be a gradual, lengthy affair, and that the outcome would be some sort of mixed approach. In this evolutionary process they thought (or hoped) that *Gosplan* would retain authority to forecast, analyze, assist, guide and even lead reform.

They anticipated that the remaining central state would be responsible for energy, railways, air and sea transportation, space activities, management of the defense complex, and communications and mass media. *Gosplan*, they said, was experienced in all the areas to be retained by the center; *Gosplan* (and they: a rational concern about one’s personal future was evident in every conversation we had throughout our stay) could not be dispensed with.

Still, *Gosplan* had initiated change to suit the new circumstances. *Gosplan* management was “deepening the function of economic analysis,” the new priority task; it would become the leading center for economic forecasting and prognosis. It would be responsible for dealing with the “social effects” of the shift to the market, including ecological issues, unemployment, pension matters; it would be the protector of those negatively affected by the transition. It would review and if necessary correct the new economic regulations and regulators. It would have a say regarding some prices. In sum, these officials were convinced that *Gosplan* would retain some operational role. We asked if they could see a point when *Gosplan*’s directive roles would vanish? No, was the response, not possible. “When scarcity is eliminated, the rules will be relaxed,” said Bezrukov.⁵

As for the future of the real sector, the officials’ evolutionary vision was that the massive, multi-divisional state enterprise/ministerial complexes would be broken down into “correctly sized” units. These would then go through a process of “corporatization” and would become joint stock companies, with all shares initially held by the state. These would then undertake a process of finding private partners (joint ventures with foreign partners were allowed by the 1987 Law on State Enterprises⁶), Soviet or foreign, who would bring in capital, technology, management expertise, and access to markets. Some percentage of shares would have to be turned over to these partners, but it would at first be a minority share, particularly for foreigners. These processes had just begun to start and, in their view, years would pass before substantial results were seen. Central organs such as *Gosplan* would guide and assist this evolution. Majority private ownership was a long-term prospect.

⁵ At the end of December 1991, *Gosplan*, and all other Soviet institutions ceased to exist.

⁶ This *perestroika*-inspired enterprise law decreed that henceforth consumer demand would partly replace planning. Enterprises would still have to fill state orders, but above quota production could, in theory, be disposed of as the firm wished. Enterprises were to be self-financing and cover their variable costs through revenues. Control of enterprises was to shift from ministries to elected “workers’ collectives.” Ministries and central units such as *Gosplan* were to provide guidelines, not production plans.

3. Ministries and enterprises in flux

As in *Gosplan*, ministerial officials were looking for ways to justify a continued existence and relevance in whatever system was forthcoming. Many we spoke to accepted or hoped for the evolutionary scenario offered by *Gosplan* personnel. But the more far-sighted ministerial officials realized that under the 1987 Law, and even more so under a proposed, autonomy-increasing enterprise decree scheduled to come into effect in 1991, they would receive financing only to the extent that enterprise managers found them useful.

Most enterprise managers we met welcomed the lighter directive mechanisms instituted under the 1987 Law. But, they said, these had proven partial and, ultimately, ineffective or counterproductive. They did not replace planning with a coherent, workable alternative. Planning had indeed largely vanished, but many autonomy-blocking vestiges remained, including price setting, hard currency controls, credit and capital allocations, restrictions on dealing with foreigners, and rigid rules on the use of labor. Indeed, the first results were the exact opposite of those anticipated. The semi-independent enterprises were finding it increasingly difficult to obtain inputs from their traditional suppliers (for reasons explained below). Output declined, shortages increased, enterprise debt was increasing, inputs requiring hard currency were out of reach, and retail prices had gone up for those products now partially produced outside the state order system. Consumer goods were everywhere in short supply. Enterprises that had for decades produced military goods were told to shift production, overnight, to consumer items—and they could not do it. The system was in crisis, and the need for solutions was urgent. Next steps remained unclear, however, and managers said little usable direction was coming from above.

3.1. Two responses

Ministry/enterprise complexes were responding in two main ways. The first group, typified by the reaction encountered in the Ministry of Machine Tool and Tool Industry and its constituent enterprises and the Ministry of Light Industry (textiles, leather, footwear, fabrics), recognized that the old system was not simply sick, but dead and buried. In these ministries officials realized they were largely on their own to find some way of surviving, both in the enterprises and in the guidance units. They had hopes and ideas, ideas galore, but were uncertain as to how to put them into practice. It was not clear that what they proposed to do was feasible or legal. Nor was it clear where they could get the resources to carry out their ambitious plans. But at least they had plans; they were not all waiting for someone to tell them what to do.

One saw in the more forward-looking ministries, and in the affiliated machine tool and textile firms visited, a feverish quest for ideas, money, foreign contacts and partners, external advice and training. Leases and cooperatives—the allowed quasi-private forms of production⁷—were common in the enterprises in these sectors. Several officials and managers said they were looking to privatize

⁷ The most radical *perestroika* decree was the 1988 Law on Cooperatives, which allowed, for the first time since Lenin's New Economic Policy of the early 1920s, small-scale private production.

machine tool firms as soon as possible, and they requested help on how to go about it. People were seizing opportunities, not waiting for orders.

A second group, exemplified by the behavior seen in the Ministry of Electronics and its Zelenograd Computer Enterprise, and even more so in the case of the Ministry of Metallurgy, was more passive and more nostalgic for the past “beauty of stability.” In these agencies we heard less about proposals to deal with the situation and much more about the problems, the difficulties of carrying out the reforms, and the need for central direction. “Long term problems require central planning,” said the Vice Minister of Metallurgy. He added: “We don’t want to go too far;” we must avoid “extremes,” we must retain the good features of the old system, and we should not transform enterprises into joint stock companies until policy is clarified and all the necessary laws are in place. We asked what reforms he would accept? He said his enterprises should be allowed to raise their sales prices—as long as the input prices remained fixed.

“I would like to know where I am,” said another bemused official in the Electronics ministry. A third said, “enterprises want freedom of direction, but they also want resources and assistance in time of need. They will come back to us.” What we’re seeing now is just “temporary euphoria.” How about privatization, we asked? The answer was that privatization “is not planned;” it is something for the far future.

Management in the Zelenograd Computer enterprise was unhappy about forthcoming changes in the tax regime. They deplored the “uncontrolled invasion” of computers and computer products from South East Asia. They said, “they simply did not know” how the coming changes in pricing would effect them. Whereas all the visited machine tool companies listed the steps already taken to distance themselves from central control, transform themselves into joint stock companies, and the joint ventures they had already concluded or were negotiating with foreign partners, the Zelenograd Computer manager said they had started thinking about such possibilities. He said he was “happy” to be a member of the Ministry of Electronics.

As our acquaintance deepened it emerged that there were plenty of problems even within the forward-looking group. The issue was that as central economic and political control eroded, a large and increasingly unsupervised group of entrepreneurial managers and administrators started seizing control of productive assets and using them primarily if not exclusively for their own ends. Just as we outsiders had not realized the essential fragility of the Soviet state, so too it took us some time to grasp that by the fall of 1990, the Soviet industrial complex had become a vast arena of wheeling, dealing and stealing.

3.2. How to do it

For example, at a meeting in Leningrad, we met with a Mr. Stryapin, “an enormous man, whose size is matched by his drive, energy and liveliness,” say my notes. Stryapin was General Director of a “Service and Production Association” being constructed to supply computers and numeric controls to the Soviet machine tool industry. An experienced manager, Stryapin said he regarded his recently acquired autonomy as both invigorating and perplexing. He now could obtain foreign machinery and technical materials superior to anything available

internally. Stryapin said enterprises now could, if they jumped through a large number of bureaucratic hoops, retain a percentage of any hard currency earned. They had gained access to foreign markets. He himself, he said with pride, had visited Chicago and several European centers to search for partners, ideas and customers. On the down side, the inputs and financing previously provided by the state had dried up. Enterprises were now starved of supplies, working and especially investment capital. He saw the irony of the situation: In the 1970s, when they had financial resources, enterprises were prohibited from dealing with Westerners; now they had permission to do so, but no way to pay.

With remarkable candor, Stryapin led us through the labyrinthine process of how he and his collaborators, starting in 1988, managed to get inputs and finance for his new enterprise under construction. We need to build our own computers for machine tools, he said, because those provided by the Ministry of Electronics were few in number and poor in quality. He said the producers in that ministry have “no incentive to change.” Recognizing the need, he and his Minister, Nikolai Panichev (see below), then began to plan this new-style venture.

In 1988, he obtained basic start-up funding from the traditional source, his parent ministry. He had hoped the ministry would provide all the finance needed. But the ministry itself was starting to feel the financial pinch. Despite strong personal support from the Minister, the amount secured was less than needed. Stryapin then went looking for credit to fund the 67 percent of the operation that could not be financed by the ministry.

In the past, loans to enterprises from the Vnesheconombank (the VEB, until 1987—Vneshtorgbank; a state agency) were more or less automatically guaranteed by the state. Post-87, this guarantee was granted less frequently, and the VEB became much more demanding with regard to repayment prospects. “We are now living in a wide-open bazaar,” said Stryapin.

It seems that part of his in-country costs were covered by a loan from the VEB, guaranteed by Western partners, perhaps from Germany. Precisely what these partners were receiving in return was unclear. Most probably, it was a combination of commitments to provide output, and a speculative bid by the partner to gain a foothold in a new market of considerable potential.

Less opaque was the method by which the plant was actually being built. Stryapin had signed an agreement with a Finnish firm to construct most of the new plant. Funds for the building came from loans from Soviet banks. Stryapin said it took 18 separate applications and many follow-up meetings with the VEB and other state funding agencies to secure money to pay the Finns. The builders, said Stryapin, had also obtained credits from a Finnish state export promotion agency. We pay the Finns with funds from our loan, and they then repay their loan with the Finnish agency, he said.

The Soviet enterprise then purchased from a Finnish machine tool maker, affiliated with the construction firm, machines that would eventually be used in the new plant. While the plant was under construction Stryapin leased space in Finland from the Finnish firm. The purchased machines were set up in this space. Stryapin and the Finnish firm somehow found a way to staff this leased space with Soviet workers from the machine tool sector. This labor used the machines to make finished products. The Finns sold the products in the West; the Soviets received training in use of the machines and Western business methods and procedures. The equipment

and the workers were to return to Leningrad in 1991. The new plant was supposed to open in June of 1991, but construction was behind schedule. The Soviet banks had several times delayed tranche releases of their loans, and called in Stryapin for additional reassurance about the nature of the proposed operation.

The many cloudy areas in this presentation led us to return to the central questions: What is the state getting out of its investment? Who is the owner, now and in the future, of the enterprise? We never did get an answer to the first question. Regarding the second, the answer was a simple “we don’t know.” His view, or hope, was that government, Union or Republican (he didn’t care which, but he had much higher hopes for the government of the Russian Federation), would eventually sell them, or better yet, give them the firm. And by “them” he meant the Workers’ Collective, led by management. Then all questions of ownership would just disappear. (This is not that far from what eventually happened in many enterprises.)

We asked, are all these arrangements legal? Stryapin cheerfully admitted that he was operating well outside of “Soviet norms.” He said he knew of no law covering many of his activities, and where there were laws, he was pretty sure he was breaking them. For example, he was concluding sales and barter deals with foreign firms without central knowledge or approval. He had sent Soviet workers to labor in Finland. If there was a crackdown, “I could go to Siberia, one way.” But “we don’t have a right not to do it,” the crisis situation demands it. The World Bank attorney on the team said to Mr. Stryapin, “you need a good lawyer.” “I don’t need a lawyer,” he said, “I have a fast car.”

Four days later the team held a second meeting with Mr. Stryapin. He presented us with a different business card, stating he was “President of the Leningrad Industrial Estates Association.” He also presented a less confident and more stressed demeanor. Minister Panichev had just informed him that his venture would receive no further funding of any sort from the ministry. And the VEB was refusing to advance any more funds to his or any plant in construction; it would henceforth only fund up-and-running operations in order to boost production and alleviate the growing shortages in consumer goods.

Stryapin said the cutoff of credit meant there was not enough money to meet his current costs. He had insufficient materials and inputs, “I’ve run out of finished product to barter,” I am working “furiously... in our crazy banking system to keep the firm going until some foreign partner—our only hope—arrives,” and there was no “coordination and policy” coming from Moscow. He did not know how he could make the next payment to his Finnish construction team. Indeed, if he couldn’t raise cash or a guarantee from a foreign partner immediately, the entire venture might collapse.⁸

3.3. *Things fall apart; the centre cannot hold....*

Interviews with officials of Stryapin’s parent ministry, and managers interviewed in other machine tool firms clarified, somewhat, what was happening.

⁸ I never learned what ultimately happened to this venture. Former World Bank staff member Igor Artemiev informs me that the energetic Mr. Stryapin is still active in several St. Petersburg business operations, mainly in the real estate and “self-regulatory organization” sectors. The latter are private firms that “are increasingly replacing government regulators” in fields such as construction. (Personal communication.)

On our first visit to the Ministry of Machine Tool and Tool Industry in Moscow the team met with Minister Nikolai Panichev. His Ministry comprised 14 specialized directorates, supervising 600,000 employees across the Soviet Union, working in 317 enterprises and units producing annually items worth nine billion rubles. Forty-five percent of production was machine tools. Only forty-five percent? Yes, he said, we also produce washing machines, toys, motor blocks and agricultural products.⁹

We've worked hard in the last two years to set this industry on the road to the market, said Mr. Panichev. The number of employees working in our central offices has fallen from 1450 to 500. We've studied foreign models, such as the Austrian state industrial holding company, General Motors and Ford. We think the ministry could transform into something like them. We're shifting to the function of "protecting the interests of our enterprises in their relations with the state." We're helping them obtain loans. We've helped firms introduce co-operatives, leases and joint ventures into their activities. We're directing the process of changing the enterprises into joint stock companies, with a view to eventual privatization. We've assisted our enterprises in making 62 transactions of various sorts with foreign makers or buyers of machine tools.

Nonetheless, he said, remaining problems are many. Our technology is old and obsolete. We produce small runs, with high production costs. All this is caused by excessive vertical integration. Our Soviet customers are complaining; they need improved machines. In particular, the consumer goods we produce are of poor quality. We need to improve the quality and quantity of production. We need financial and managerial resources. We've initiated many points of contact with Western firms and potential clients, but our joint ventures mostly remain at the idea stage; they are not funded. "We urgently need to conclude deals," he said; "we need \$500 million in refurbishment capital."

Panichev praised the great psychological shift underway in officials and especially managers in his sector. They are now "seizing opportunities, counting money, trying to make and increase profits..." This ministry started more quickly than others and we are starting to get results. But: The state supply system, run by *Gossnab* (state supply committee), was in tatters. Suppliers were refusing to follow its commands, and were—to maintain their own production—resorting to barter to obtain their essential inputs (thus partly explaining Stryapin's input problem). The State Arbitrage Commission had formerly resolved disputes with suppliers. This was now working sporadically. To make matters worse, *Goskomtsen*, the state price committee, was still setting a number of prices that make no sense for our semi-independent enterprises.

3.4. *Off to the enterprises*

Our team next visited nine enterprises. The two stylized cases already discussed present the essence of the issue: The Leningrad Machine Tool Association,

⁹ Every industrial unit we visited, no matter its primary field, was also making a range of consumer items, usually in sectors with little or no connection to their primary product (e.g., a gear-making enterprise also produced a line of children's toys). When asked why, the officials usually shrugged and said, we were given orders to do this. No manager or ministerial official we met in the USSR in 1990 suggested that these consumer product lines be dropped; on the contrary.

and the Zelenograd Computer enterprise. A more detailed flavor of what we were told is found in the following excerpts of the notes on a few of the more revealing enterprise visits.

3.5. *Three mountains textile manufacturing combine (Moscow)*

The plant sits on 9.3 hectares of prime Moscow real estate, on the Moscow River, very near the famous Ukraina Hotel (since 2009, the Moscow Radisson Royal hotel). It has a workforce of 3,500, of which 2,600 are women. The all-female management team struck us as very much on top of events. They deplored the old planning system. Now, they said, there was much more interaction with clients and response to their demands. Banks that formerly controlled us are now our partners. The “tons of paper” and special personal relations that previously determined if we would get credit have now been replaced with more business-like arrangements. We have direct and productive relations with our suppliers. We supply what our customers ask for. Most of the changes we’ve recently seen “are for the better.”

The huge remaining problem is obtaining inputs. If a supplier is within the Russian Federation we handle the process and this still, more or less, works. If the supplier is outside of Russia—which is the case for our principal input, cotton—an agency of the Russian government is supposed to manage the transaction for us. But inter-republic trade is breaking down. We are experiencing problems, and they are growing in number and intensity. The enterprise had one experienced manager working full time on obtaining inputs, mainly by barter deals.

To date, everything is sold at the same price. Through state orders? The response is that state orders are theoretically gone, but “nothing has changed in practice.” Next year, they’ve been told, the state order portion will fall to between 40–60 percent of production. That should be “very interesting,” says the Director.

“Inspired by the ideas of *perestroika*,” they have initiated discussions with their ministry with a view to leasing the entire enterprise. This is mainly a management idea, but the workers are going along with it. Managers believe that under a lease they will be better placed to produce higher quality goods at a lower cost. They also believe it will help them overcome the workers’ general “indifference” and lack of motivation. The workers, they say, are not interested in improving product quality or enterprise profitability and productivity; they are only interested “in increasing their personal incomes.”

They explain that under the old and still used pay system, bonuses went to enterprises that exceeded planned production amounts. The total number of workers divided the total bonus; all received the same amount. “Those who contributed and those who did not were rewarded equally.” It was impossible to dismiss anyone who showed up for work and was not overtly drunk, disorderly or defiant. It was impossible to deny the premium to anyone. A revised system started in May of 1990 will soon allow us to reward extraordinary workers—“and there are many”—and take into account differences in needed skills, time of shift, degree of difficulty and danger in the task, etc. The idea is to reduce absenteeism and link pay to production. Most workers favor the new system, but some are resisting.

We ask if the land on which the enterprise sits will transfer along with the lease. They think not, but they would love it if it did; they know they are sitting on a goldmine.

3.6. *Sverdlov machine tool enterprise (Leningrad)*

General Director Pokassyyuk said this was one of the oldest machine tool operations in Russia, dating from the 19th century. Twenty-five percent of output was exported, half of this to hard currency markets such as Japan, Argentina and Brazil, the other half to CMEA¹⁰ countries. This firm too had a consumer goods line, consisting of refrigerators, kayaks and garden tools. Despite its comparatively small size, the enterprise was vertically integrated and contained its own design unit, construction firm, transport section, etc.

In this enterprise the consumer goods line was linked to their core product: The enterprise made small saw-lathe woodworking shop combinations for handy-men; these were in very great demand. This activity had been hived off and was now being run by a cooperative within the framework of the enterprise. The cooperative “buys its inputs from the enterprise” and sells most of its finished goods back to the enterprise. The cooperative could sell above quota production, but only “at the state price.”

Director Pokassyyuk said he wanted to expand the consumer goods operations since demand was so high, and dissatisfaction so widespread with the poor quality of similar goods produced in other firms. “Yours is better?” we asked? “Yes, the workers in the cooperative receive a higher wage and work harder and better than those in the state owned section.” He would like to divide the entire enterprise into cooperative units. We ask, what prevents you from doing this? “We cannot get any more inputs,” he said. Lack of inputs and finance is the reason we do not break up the enterprise into many cooperative units. Banks want only to deal with ministries and large enterprises; cooperatives are new and small units of unsettled legality. Getting credit in these units is very difficult.

As in the textile firm, the manager said workers in the state-owned portion of his enterprise were not motivated or interested, and that his job was difficult because wages were not tied to performance. He and his management team had proposed to central officials an incentive-based scheme for the enterprise as a whole, but the idea had been rejected. Still today, he said, the national salary system overrides enterprise level suggestions. At the moment, “workers don’t care and management lacks the power to discipline them.” Pokassyyuk drew attention to a policy others mentioned: that if an enterprise’s wage bill exceeds a specified level of average pay per worker, the state imposes a tax equal to the whole of the excess. Central authorities could and did, by this means, prevent any state enterprise from trying to boost production through monetary incentives.

We asked, suppose government simply handed over the firm to the ownership of management and the Workers’ Collective; what would happen? His interesting reply, particularly in light of what later happened, was “we have had a long and

¹⁰ The Council for Mutual Economic Assistance (CMEA) was a Soviet sponsored trading bloc of Eastern European and a few other socialist/communist countries, in existence from 1949 to 1991. It was also known in English as COMECON.

negative experience with property that costs nothing.” He added that the need is to “organize the situation so that people are rewarded on the basis of their effort. We need to awaken the interest of workers.” Attitudes can and should be changed, said Pokassyyuk, but it needs management with personal capital at risk. He says the state is the owner of the enterprise, but a bad one since it consistently takes steps that work against the interest of the plant. In fact, he says, “I am the owner.”

Is there excess labor in your plants? “Yes,” was the answer. He estimated that if the operation were organized wholly in cooperatives one could manage well with 50 percent of the current workforce. “We had to employ more labor than needed;” plan fulfillment overrode all cost considerations.

3.7. *Reductor Gear Enterprise (Leningrad)*

This Leningrad enterprise employs 525 employees and produces 150,000 gear assemblies annually. Reductor also produces a line of children’s toys. The interesting aspect of Reductor is that it operates entirely as a lease, one of only three state-owned enterprises (SOEs) in Russia to do so, according to the managers. In 1987 the plant was in acute deficit and state inspectors had determined that the quality of its output was very poor. The plant closed. In 1988, in a last-gasp salvation measure, the Ministry of Machine Tool and Tool Industry leased, for a period of 12 years, the enterprise to its Workers’ Collective (WC). To assist Reductor, the enterprise was given a monopoly on the production of the type of gears it makes.

Reductor managers said that total Soviet demand for their gear assemblies is 500,000 units a year. We asked if Reductor makes 150,000 units annually, and has a monopoly, how is the rest of the demand fulfilled? The managers thought it was not being met, either by other producers or by imports. They said that the uptick in demand was recent. It stemmed from enterprises converting from military to civilian production, and which now used their type of assemblies. Will Reductor expand to meet this demand? No, they said, it cannot. “We are at the limits of production in our cramped space and with our old production machinery.” To meet demand they would need a new plant, money, foreign partners, etc.

We ask: If government were to allow imports would it be easy for competitors to enter the market? Oh yes, they say; the technology needed to produce these gear assemblies is simple.

We ask how Reductor gets its inputs? As a lease operation we have no normal state supply arrangements. Rather, Reductor has an “agreement” with the Ministry of Machine Tool and Tool Industry; it provides us with inputs at a set price. In turn, the Ministry takes all our output at a set price.

Reductor is nicely cushioned in other ways as well. We learn that the normal lease fee for an enterprise of this size is constructed as follows: One calculates the total historical (book) value of the assets. One then adds in a percentage of “profits” (quite differently defined from the GAAP process¹¹) of the operation, and a fee for any services rendered by the lessor, such as utilities. One then di-

¹¹ GAAP; generally accepted accounting practices, used in constructing financial statements. For example, we were told in some enterprises that “profit” was calculated as total revenues minus total variable costs, with no subtractions from revenues for taxes, depreciation or finance charges. In some cases it seemed that subtractions from total revenue might not include labor costs, thus boosting “profit” enormously.

vides this sum by the number of years of the lease to arrive at an annual lease payment. Applying this formula would result in Reductor paying an annual lease fee of about 500,000 rubles a year.

In Reductor's case however, the very poor physical and financial condition of the operation led the Ministry to reduce the lease fee to 150,000 for the first two years of operation, to exclude from the fee any portion of profits, and to accord to Reductor tax-free status for 24 months.¹²

The management team says that the number of workers has stayed the same after entering lease status, but managerial staff was reduced by 25 percent. Wages for all were doubled. The quality of output increased significantly, they claim, while the quantity showed only a slight gain.

How does the lease operate in practice? Here the Workers' Collective seems to be more active and involved than in any other enterprise we visited. They say the WC chooses the Director. There is strong competition for the post (my notes add: "which might make it likely that maintaining high pay for the workers will be a number one priority of management"). Representatives of the WC meet quarterly to set general policy, and a 15 person "executive committee" meets monthly, to "settle the question of how to allocate profits."

We ask who speaks for capital? What steps are being taken to see that the unit is not decapitalized, or run into debt in order to maintain the salaries of employees? Why are no funds set aside for needed future investment? From the responses, it is clear we are very far apart in our notions of how a production unit should operate. For them, the key is maintaining the incentive wages. They say it was the lack of these that led to the near-demise of the plant in 1987, and it is only the presence of these that keeps the operation afloat. Maintaining the comparatively high wages is their main concern, and our talking about subsidization, net welfare losses and distortions means little to them; it is just alien economic theory. Their solution to potential problems is to ask the authorities to extend the monopoly, the low lease fee and the tax holiday. Then all will be well.

3.8. ZIL truck enterprise

We visited the enormous ZIL plant in Moscow. Deputy General Director Borunov explained that ZIL ("*Zavod imeni Likhachova*," or "factory named after Likhachov," a former General Director) was an "industrial agglomeration" of fifteen factories. This one was the HQ and final assembly plant for the inputs produced in the other fourteen. The enterprise made 200,000 trucks a year. All inputs, save for the diesel engines to which they were converting, were made in the agglomeration. ZIL employed 160,000 people Soviet-wide. In addition to trucks "we make refrigerators, microwave ovens, compressors, candlesticks and other consumer goods." Why? Because ZIL "had the technical capacity to make these items" when the need was perceived. "We are thinking in terms of the needs of the people."

¹² This was but one of many examples we encountered of cooperatives and lessees paying comparatively little for the assets they used coming out of state-owned firms. We were told that government officials were calling for asset valuation based on some notion of market value, but that this was "simply impossible to calculate in the present circumstances."

The Ministry of Automotive Industry appoints ZIL's General Director and he, in turn, appoints the managers of the 14 subsidiary units. None of the 14 was self-financing or self-accounting; it was an entirely centralized operation. The enterprise is "subordinate to" the Ministry of Automotive Industry. ZIL HQ obtained from the state authorities all inputs and allocated them as needed to the sub-units. Prices for all transactions and payouts were fixed and immutable. This was still the process, "but change is coming." Relations with the governments of the various Republics containing ZIL input manufacturers were increasingly thorny. The Republics were now claiming taxes previously sent solely to the Union government. Still, the attitude here was less forward looking than in machine tool and textile units. "You cannot prepare for what you cannot foresee," is their thinking.

Goskomtsen officials had warned them of coming price changes. ZIL was still operating fully on state orders, but soon "we will be free to negotiate on these and all other matters." We asked what they were doing to prepare for these changes? The response was that the management team was discussing the implications of the likely changes, and consulting with the Workers' Collective as well. They noted that the WCs can recommend steps, "but final decisions rest with management." ZIL managers clearly considered the WC to be under their control.

As elsewhere, their most serious problem was that their relations with suppliers had broken down. Since many if not most Soviet producers were *de facto* monopolies, all feared that a shift to supply and demand pricing would lead to the "anarchy" of surging prices. As the fixed price system collapses, suppliers were ignoring *Gossnab* and insisting that ZIL barter with them directly to exchange finished trucks for more inputs. Borunov said this was "a big racket." But it was a game that ZIL, as an oligopolistic supplier, could play as well. Management used ZIL's status as maker of a desired product to get what they needed "by hook or by crook," said the interpreter. "*Gossnab* is dying," added the General Director.

How is this mixed system working, we asked? In essence: *Gosplan*, despite the 1987 Law, and despite the increasing irrelevance of *Gossnab*, still gives ZIL the names of buyers and tells management to contact them and arrange the transactions. The Council of Ministers also gives ZIL names of customers it must satisfy, who are not on *Gosplan*'s list. What is new is that if anything is left over after fulfilling these orders, ZIL supposedly can sell it to whatever Soviet, or even foreign, customer it wants. In theory, 10 to 20 percent of ZIL production is unplanned. But it doesn't work that way in practice, say the managers. They claim that *Gossnab* still tries to distribute 100 percent of ZIL's production according to its priorities. So far, the amount they have to sell or barter on their own remains quite small.

In addition, they face unanticipated major problems with selling any trucks in excess of state orders. Foremost among them is the poor level of internal communications technology in the USSR. The telephone system is overloaded (we noted that the higher the official, the more phones on his, and rarely her, desk; ministers with six or seven or more; managers with three to five). Fax and telex are helping but they are fairly new and their networks spotty. Second, since government insists that all trucks, state order or non-state order, be sold at the same price, ZIL's ability to negotiate deals is severely limited. Third, the State Arbitrage Commission tries to resolve disputes between government owned and operated

entities, but has no authority to arbitrate problems between a state seller and a non-state buyer, or vice versa. There is no law or agency to deal with this.

Could ZIL compete against exports, is the next question? Yes, they say. True, foreign trucks offer better quality. But they cannot match ZIL's ruggedness, the company's distribution and spare parts network, and the knowledge of Soviet mechanics and citizens about how to work and maintain a ZIL.¹³

We ask, how will the proposed Enterprise Law of 1991 affect ZIL? They say, the new law favors the creation of smaller, quasi-private units. We will form a number of these within ZIL to take advantage of the increased autonomy and incentives offered. These will take the form of leases, considered to be "the only legal form." ZIL will be the lessor; the Workers' Collective will be the lessee. All of the Workers' Collective or just those workers involved in the leasehold? They were not yet sure how this would work; they seem to be waiting for instructions before reacting. Concerning the mid-term future, managers seemed both resigned and cynical.

They were more enthusiastic and positive describing how the lease fee would be arranged. As elsewhere, the amount of the fee would be derived from the depreciated historical value of the assets. In theory, the fee would be determined by (a) the time length of the lease, (b) plus a percentage of the profits of the leased unit, (c) plus the cost of services provided to the lease by ZIL (e.g., utilities, floor space). When a lease came into being, they would make the final calculation of the fee. The lessees will be allowed to buy new assets and dispose of the old. Their idea was that as the payments accumulate the amount transferred to the enterprise would eventually equal the total value of the transferred assets, and the unit would pass into purely private hands. We ask, what if the lessee performs poorly or does not pay the annual fee? Lessees persistently in non-compliance could have the assets removed and returned to the enterprise. Other penalties, perhaps including issuing a new lease, might be imposed.

4. What is to be done?

Armed now with some knowledge of what ministries and managers were thinking— and hoping—we set off to talk to those who were leading the reforms, or were said to be leading the reforms: promoters of the cooperatives and lease movements, managers of the recently established commercial banks, and officials in the economic reform commissions of the Leningrad and Moscow City Councils.

4.1. Academician Vladimir Tikhonov (Head of the Union of Cooperatives)

As a researcher at the Leningrad Academy of Agricultural Sciences, Professor Tikhonov had studied the cooperative movement in the West, and written on

¹³ The team is later told by a Russian that Soviets are the best auto and truck mechanics in the world. Why? Because each time a Soviet citizen takes possession of a new ZIL, LADA or KAMAZ, the first thing he does is disassemble it completely, to see what the factory forgot to put in. He thus knows the vehicle top to bottom. This story is facetious, but it is based on the real issue of poor quality control. At the end of our visit, after walking the assembly line, the team was taken to the roof of the plant. A huge parking lot stretched out behind the plant. In it, hundreds if not thousands of ZILs sat silent. We observed to the Deputy General Director, "you have a very large inventory." "Those are not inventory," came the answer, "those are the mistakes."

the need for land reform in the USSR. He became a Deputy in the Gorbachev-created Congress of Peoples' Deputies in 1989, and used his position to push for implementation of the 1988 cooperatives law. According to Anders Aslund he was a "radical economist...who had gained political prominence" (Aslund, 1991, p. 102).

Professor Tikhonov told us that cooperatives in the USSR differed from cooperatives in other countries. Here, they are not based on collective ownership; they are purely private firms. "It is the only way that private forms (sic!) can legally exist here," he said. The initial capitalization of cooperatives comes from contributions of private persons. The Union of Cooperatives exists to assist in the formation and expansion of cooperatives, and to protect their owners' and workers' interests.

He said: Cooperatives were legally allowed starting in 1988. As of October 1990, there were 250,000 cooperatives in the USSR, with 5.2 million employees (65 percent cooperative members and 35 percent hired help). One-third of cooperatives are in production of one sort or another, two-thirds in services. He claimed that the two percent of the Soviet workforce in cooperatives accounted for five percent of national economic output in 1989. The growth of cooperatives has been astonishingly fast, "offsetting the decline in production in state-owned enterprises." As the higher quantity and better quality of goods made in cooperatives becomes increasingly evident, more and more sectors are being opened to cooperatives. Cooperatives are now found in all forms of production, manufacturing, services and foodstuffs. Their numbers are growing within SOEs. Soon newly formed small and medium firms will be able to join our Union.

There have been three stages in the evolution of attitudes towards cooperatives. Following the passage of the enabling 1988 Law, the "initial attitude was neutral but tending toward favorable." Both officials and the public exhibited a "wait and see" attitude. The initial growth rate was explosive; 140,000 cooperatives came into existence in the first 12 months following the passage of the Law; the number of employees in cooperatives quickly exceeded 1.5 million.

Officials and consumers were pleased to see cooperative-made goods coming into the market and relieving scarcity. But they were "shocked" that the prices were, most often, substantially higher than those set by government (elsewhere we heard estimates of three to five times the official price). Officials began to criticize the cooperatives as "gougers." By mid 1989, reacting to many public complaints of the cooperatives' unfair pricing practices, government introduced restrictions, including a higher tax rate, and a discriminatory increase in cooperative input prices to 2.5 times those paid by state-owned enterprises. Government also raised taxes on all cooperative imports, leading most of them to exit from any field requiring foreign inputs. A major additional blow was the Communist Party's official statement saying cooperatives were not socialist. About 18,000 cooperatives disbanded in late 1989.

However, continuing stagnation in SOEs production, the ever-increasing shortages in consumer goods, and the vocal support of a number of pro-*perestroika* officials led to change. Cooperatives "started being treated with respect." Liberalization in the 2nd quarter of 1990 equalized tax rates for cooperatives and SOEs. This helped considerably. But cooperatives still pay much higher than SOEs prices for the same input. Moreover, cooperatives find it very difficult to obtain bank credit

(confirmed by interviews with bankers in both Moscow and Leningrad), and many inputs can be obtained only through long and costly barter arrangements. SOEs use their clout to deprive cooperatives of resources and customers. Fortunately, despite all the problems, we will win out because SOEs really cannot compete against our “much higher productivity and better quality output.”

As an example of cooperative success, Tikhonov cites the case of a unit called “Builder” in the Karelia region near Leningrad. This cooperative has 600 employees working on construction projects. Its output is valued at 20 million rubles. A nearby SOE with 1300 employees, working in the same field, has output valued at 11 million rubles. This suggests, *ceteris paribus*, that the average cooperative worker out-produces his SOE counterpart by a factor of 3.9 times. In this particular instance, says Tikhonov, the input prices are the same. He claims that cooperative production costs are 30 percent less on average than those of SOEs, despite often having to pay higher prices for inputs.

Production improves in cooperatives because cooperative members work more days per week, says Tikhonov. Second, they work more hours per day. They do this because of better pay, better benefits, less bureaucracy and less outside interference. Cooperative workers take pride in their efforts. Qualified workers are “flocking” to cooperatives, and SOEs are complaining.

Cooperatives have so far had limited success in the agricultural sector, he admits. People in the rural areas are more conservative and fearful; state farms prevail. Most land is still owned collectively and most farmers are unwilling to break up the collectives and go off on their own. They are “not ready to use cooperatives.” While there is no legal barrier to the entry of cooperatives in the agricultural sector, there has been little success to date. We have great hopes for the new policies on the agricultural sector that are being planned by Boris Yeltsin and the Russian Federation. Yeltsin “is very positive about private enterprise in all spheres.”

In sum, cooperatives “are infants; we are taking the first steps.” Only two years have passed since the first cooperatives were allowed, and many in the public and some officials are still very antagonistic. For example, the Russian (fewer and fewer people are saying “Soviet”) consumer has been accustomed for years to meat priced at 8–9 rubles a kilo. He now sees cooperative-produced meat at 12–13 rubles a kilo or more, and cannot understand how this can be. There is no meat in the shops at the old price. But that is nonetheless the price the consumer is used to paying and still wants to pay. Anything higher is seen as robbery.¹⁴

Eventually the anti-cooperative attitude will disappear, concludes Tikhonov, partly because there will never again be an adequate supply of basics at the old prices, and partly because pro-reformers are speaking out to explain and support the changes. He quotes Gorbachev as saying that “private property and private enterprise are not in contradiction with socialism but promote and strengthen it.” The outspoken opposition of the party and Soviet officials is declining. Why? Because, says Tikhonov, “the substantial accumulated capital of the communist

¹⁴ Evidence of the prevalence of an anti-coop sentiment was found even among reform-minded members of the Leningrad Economic Reform Commission, who said cooperatives had been given unfair rights and access to government goods, did not operate on a level playing field with other economic actors, and were “a rotten aspect of an excessively centralized system.” They admitted that cooperatives are more flexible and people in them have more initiative, but that may be because “people in SOEs don’t try so hard to steal.”

party machine is now being invested in all sorts of private enterprises and ventures, including banks.”

My notes on this meeting conclude: “Here is a breath of fresh air; here is a force concretely and practically pushing to enter and expand a market.” We did ask from where were cooperatives obtaining inputs? It was clear that, despite their complaints about discrimination, in many cases the answer was SOEs or other state-owned sources, at very low or even zero prices. Here and elsewhere, the quick and the agile were privatizing assets, while the liabilities remained in state hands. “But: they are putting the assets to productive use; they are paying incentive wages; they are putting people to work and putting goods and services into the economy. They—with leases, SMEs and collective enterprises—are the only game in town.”¹⁵

4.2. Moscow City Council reform group

We met with Sergei Shatalov, Ian Melkumov,¹⁶ and a five-person group working on privatization—Messrs. Glushetz, Vishnikof, Chernyak, Lazarevski and Fituni. We discussed privatization, ownership issues, banking, accounting and the possible ways forward.

My notes read: They perceive Moscow today as “an overcrowded city, with an inadequate and decaying infrastructure, woefully insufficient housing stock, a center of polluting primary processing industries, with rising crime rates and declining living and health standards.” Their first wish is to create a “Moscow Business Center” to lay the foundations for market structures. They complain that 85 percent of all economic activity, of any sort down to the smallest shop, is centrally controlled. They wish to introduce, as rapidly as possible, private sector operations and ownership to alleviate the “dire” social situation, especially inadequate food supplies. They acknowledge that the largest obstacle is the ingrained negative attitude of the bulk of the local population to private activities.

They say the next most important barrier to private operations is the total lack of real estate and storefronts in which private business can operate. “No adequate procedures exist for the valuation of real estate assets; we do not know where to begin.” Existing law says that the forms of transformation allowed to date (cooperatives, leases) exclude the transfer of real estate and land. When a part or all of an enterprise is hived off, the land remains with the state. This leads to abuses both by the parent firm, and by regulating officials.

These Moscow reformers are for rapid ownership change, but they warn “prices are now meaningless; ownership change won’t solve all problems by itself.” The situation is “eventually correctable, but a long period of adjustment is necessary.” “We have no real knowledge of real functioning of a market system,” remarks another participant in the meeting.

They are worried about the recent “multiplication of conflicting legislative actions” from the Union, the Republics, and local authorities, all claiming that they are the responsible parties for economic activity, “But,” they say, “none want

¹⁵ Igor Artemiev informs me that Academician Tikhonov died shortly after the mission was in Russia.

¹⁶ Sergei Shatalov later became a staff member of the World Bank; Ian Melkumov is today a well-known financial analyst and commentator in Moscow.

to pay for the upkeep of enterprises.” Two participants start to argue about how to interpret a recent decree on enterprise accounting. A third person says to us, “This is not the only crazy document adopted recently by central government.” A fourth participant says, “we have here belligerent incompetence; everybody wants to make laws and nobody wants to work.”

The participants confirm that SOEs are complaining of a loss of their good workers to cooperatives and leases. They think this will only accelerate unless enterprises are given the freedom and means to pay incentive wages. At the same time, they are concerned about the effects of rising prices and wages on pensioners. Development of a social safety net is an urgent matter.

The speakers on privatization are agreed: It is “clearly understood that the only way out of the critical situation is privatization.” But they see great obstacles to its implementation. First, the population has no money to buy assets or shares. Second, there are no settled privatization procedures, but only bitter conflict between various levels and persons as to what to do. And who is in charge. Third, they are all very concerned about the privatization of state monopoly producers of basic goods. There will be a need to control prices. Such as, we ask? Bread. Why bread? Because, it appears, there is a single massive SOE producing bread for the entire Moscow region.

A Bank economist says bread is not a natural monopoly. Bread baking is a contestable market; it should be easy to allow other bakers to enter this market, and the problem will be solved, without regulation, by competition. Puzzlement. “What do you mean by a natural monopoly and what are contestable markets,” they ask?

Shatalov, supported by others, says that, ultimately, the Moscow City Council wishes to privatize SOEs by means of employee buyouts. Given the fact that most people have little or no money, present thinking is to involve banks in the process. Perhaps banks could fund the buyouts in return for shares in the enterprises? (This strikes one as something of an embryonic forerunner to the famous, or infamous, 1995 “Loans-for-Shares” scheme.) They speak of prioritizing buyers, with Moscow units being offered first to Muscovites, then Russians, then Soviet citizens, then to any resident of the USSR. Foreigners? Only in partnership with a Russian, they say, and only with the approval of the Workers’ Collective.

The meeting ends with several participants stressing that policies must take into account “the mood of the people and observe the concept of social justice,” which seems to mean that “the accumulated national income be equitably distributed among all citizens.” The rationale is that over the past 70 years the state took for itself “6/7 of the production of enterprises.” All contributed to this wealth, and “all want something back.” Only one participant, Mr. Chernyak, disagrees: We should sell to investors, regardless of nationality. We want experienced, moneyed owners; “we must teach ourselves how to act in a market.”

Most of the others reject this view. They offer the idea that any enterprise, public or private that controls over 65 percent of a product market will be subjected to price controls. Firms with between 30 and 50 percent of a market will require regulation on price “and rules on who to sell to.” One of the group says, “If a price results in excessive profitability, then we will raise their taxes.” Lazarevski ends this part of the discussion with a plea for a gradual approach to privatization. He says, “If we dismantle the old systems instantly it will only be worse.”

Someone on the Bank team notes that even among a group of reformers there remains a great deal of interventionist sentiment. But several in the Moscow group remind us that in the Soviet context, they are radical reformers, attempting to introduce free markets and full democracy. These are totally new objectives. If the old guard returns to power we will be ousted or exiled—“or executed,” someone says. They argue that their lack of knowledge on the mechanics of what they want should not blind us to the fact that they are facing desperate, immediate problems, and have had little guidance and no theory on which to operate. It is not surprising that they think of solutions in terms of measures they are familiar with, such as intervention and control.

My notes conclude: “They are uninformed, not unintelligent, and they need and deserve help.”

4.3. Banks: *Energomash Bank, Leningrad Industrial and Commercial Bank (LICB)*

In Leningrad we met with Leonid Talmach, Chairman of the Board of the Energomash Bank, and in Moscow with V. G. Semenov, President of the Light Industry Commercial Bank (LICB).

Talmach claims that his bank, founded in May of 1988, was the first true commercial bank in the Soviet Union. The registration process with *Gosbank* was tedious, repetitive and painful. *Gosbank* saw its role as obstruction rather than assistance. Nonetheless, there are now, he says, 300 commercial banks in the USSR, 12 in Leningrad alone. His bank has 38 employees and 1.5 billion rubles in “annual monetary circulation” (a sort of turnover?).

His goal is to create a full-service, universal bank on the Western model. He admits Energomash is not there yet. The bank presently offers credit, short and long-term deposits, and savings accounts. Savings accounts are only for shareholders in the bank. Who are the shareholders? A number of “concerns”—formerly branch ministries or sub-sections of these ministries; about three-quarters of them in the energy sector. Can anyone buy your shares? No, government had decreed that private citizens are not allowed to buy shares in commercial banks.

Why do concerns invest in your bank rather than in their own enterprises? First, we’re a good investment. We’re a well-run bank, managing to get a 20 percent return on equity, which we are required by law to split in two; half to dividends, half to a reserve fund. Thus, we pay a 10 percent dividend. Second, concerns get borrowing rights from Energomash, “in some cases far above their capital allocation.” The shareholders thus get leverage, though we do have a 35 million-ruble limit on the amount of loan to any single customer. Why borrow from Energomash rather than a state finance institution? We are easier to deal with; with us there is much less red tape, delays and “headaches.” “We’re here to assist the client, not treat him suspiciously when a demand for capital is made.” The customer encounters a different service mentality in Energomash. Moreover, state banks are now severely short of lending capital.

Expansion of plant is the basic use of most funds lent, he said. Interest rates on deposits are set by government and are the same for all banks, state or commercial. We compete mainly on service, “and we win.” Interest rates on loans do

vary; seven percent is the average interest rate at the moment, but Energomash has a number of loans out to enterprises at 15 percent—and a very few “social loans” at one percent interest. These last are a public relations measure to placate *Gosbank* authorities.

Nonetheless, state-owned banks still have special powers and privileges and an inside track with many of the largest state enterprises. We have run into “sabotage” by state-owned banks of our efforts to attract new clients. However, as liberalization unfolds the state banks’ special circumstances will vanish; it’s just a matter of time.

Regarding appraisal, he and his staff carefully assess the borrower, the operation and the client’s business plan. “You must persuade us of the quality of your proposal.” We negotiate a sensible maturity. We demand collateral. If the applicant has no property and no assets, then there will be no loan. We are not allowed to seize personal property, but if a shareholder’s loan is not performing, we can “negotiate to remove profit from his account.” (And we later learned from the LICB that there are limits on how much of his “deposits” any shareholder may withdraw on demand.) “We want to protect ourselves and minimize risk, but serve the client.”

What about bad loans? In the case of a shareholder with sums in his account, there is no difficulty in recovering some or most of the loss, though even here we have to negotiate. Recovery is more difficult with non-shareholders, “but we get something back.” In general, our powers are limited and property rights are ill defined. We have no right to impose bankruptcy, for example. There have only been a few test court cases regarding bad business debts and they have not gone in favor of the lender. So we have to be careful.

The legal framework on debt will evolve in our favor. The bigger problem is the absence of a modern financial infrastructure: logical, modern banking laws and regulatory structures, deposit insurance, re-insurance, wider share-holding, a real estate market, intermediaries, brokers, etc. We are not even allowed to advertise and “we don’t know who has money.”

Talmach concluded by noting that many are surprised that competition is coming to the banking sector. No matter how many and important the signs that the old system has ended, many people, even those who should know better, are amazed when they see what is coming next. He admits that many early Soviet entrants into market or market-like operations were “gray elements, thieves and hooligans.” But honest people are following the leaders. More entrants and more competition are needed, and these will lead to lower prices. As that happens, the public will accept the transition.¹⁷

President Semenov too claims that his bank was the first to take advantage of the new legal framework and become a commercial bank (perhaps each means that they were the first in their respective cities). He states that he has 15,000 clients. In addition to “many large enterprises” he says his bank serves 5,000 cooperatives, associations and small and medium enterprises. He notes that loans to cooperatives make up about 15 percent of LICB’s total lending. Semenov estimates that 10–15 percent of LICB’s loans to cooperatives went into default in

¹⁷ Later in the 1990s, Mr. Talmach moved to the Republic of Moldova. He served as President of the National Bank of Moldova from 1995 to 2009. The latest I can find on him is a 2012 mention that he had been put forward as a candidate for the Presidency of Moldova. He was not elected to the post.

1989; LICB's cooperative portfolio ran a loss. Cooperatives, he said, come into and go out of existence very rapidly. The law allows them to form "without individual contributions" (meaning, we think, that there are no resources belonging legally to the cooperative), and the courts have so far "resisted serious corrective action on defaulters." This is a concern; "we must be much more careful in dealing with cooperatives' loan applications than with SOEs."

Semenov says the LICB makes money on what amounts to a factoring operation. That is, the LICB buys at a discount the non-performing debts owed to enterprises and takes up the collection effort. How can you collect on the debt when the enterprise cannot? Banks are more feared and respected than enterprises, he says. Plus, we have a network of corresponding banks across the Russian Federation, and they can exert pressure over suppliers and clients of the defaulter. He claims that this is a lucrative business line.

He agrees with Talmach that the absence of legislation on banking is a serious deficiency. Government, he says, was very late in initiating reform in this crucial area; the shortcoming now poses a major blockage to all other reform.

Our team had many other interviews, but the information obtained elsewhere mainly reiterated and deepened themes already covered: The loss of control by central authorities, the depth and costs of the pervasive uncertainty, the search for relevance and indeed survival among elements of the collapsing planning system, the quest for private foreign partners and money, the struggle to construct new economic and financial mechanisms that would be both productive and socially acceptable, and the deep concern raised by the overarching political questions.

5. Then what?

The final joint IFI report—incorporating the findings and suggestions of the various teams of all four international organizations—was compiled, reconciled, distilled and published in December of 1990 (IMF et al., 1990), just two short months after our time in the USSR.

5.1. Short-term Outcomes

The final report was mercifully succinct (50 pages), surgical in its dissection of the causes of Soviet economic decline and the depth of the crisis facing the country, and loaded with reasonable, imperative tense ("the Government should...") suggestions on what should next be done in areas ranging from macro-economic policy and management to seven different "systemic" policies (of which enterprise reform was one) and seven different sectoral issues (e.g., environment, agriculture, housing, transportation, etc.).

With regard to the overall strategy of launching the transition, or to be more accurate, the strategy of deepening and carrying the transition forward, the report considered a "conservative", or gradualist, and then a "more radical" approach. To no one's surprise, the report recommended the more radical option. But what "radical" meant was rapid price decontrol and macroeconomic stabilization measures. Measures proposed for the enterprise sector did include the introduction of a bankruptcy regime for persistent loss-makers, which would have been a radical

step, but it was not enacted. The report did *not* call for wholesale, mass and rapid privatization.

True, the report said “the ultimate goal of ownership reform is to privatize almost all enterprises in the USSR.” It acknowledged “...the desirability of moving rapidly...” But it then stated “...doing so effectively on a large scale...” was “...a practical impossibility” (IMF et al., 1990, p. 26). The report thus devoted seven paragraphs to the issue of how to privatize, but spent four full pages on the question of how to reform and manage evolving state enterprises (IMF et al., 1990, pp. 27–31). (Few of these proposed recommendations were ever enacted.) Despite the lip service paid to the need for speed, the recommended path to ownership change was distinctly gradualist. We did not anticipate what was coming in 1992.

5.2. *In the medium-term...*

1991 was a tumultuous year in the Soviet Union. In March, a majority in nine of the 15 republics voted to keep the Union, albeit in a changed, more truly federal form. Citizens in six republics boycotted the vote. In June, Boris Yeltsin was elected head of the Russian Federation, easily overcoming pro-Union opponents. Dissolutionist pressures strengthened. Fracture lines were based on nationality and economic philosophy: Those hoping to retain the Union tended to be gradualist in economic approach; those favoring the complete independence of the republics also wanted full-speed economic transition to the market—and many did not care if adoption of those policies would entail the breakdown of the Soviet Union.

On August 19, the day before the republics were to meet to ratify a new, looser Union arrangement, a group of senior Soviet officials ordered the arrest of Gorbachev, who was vacationing in Crimea. They then banned all political activity, and the publication of most newspapers. The expected public support for the coup failed to materialize. Russians flocked to support Yeltsin (who had his moment of undying glory, standing on a tank outside the parliament, defying the coup plotters). The putsch collapsed in three days, and Gorbachev—much diminished by the events—was released.

The coup had failed, but the fear of a repetition galvanized the separatists and economic radicals, and spurred the political dissolution. The Baltic states' independence was recognized in September. Through the fall, more and more Union ministry powers and resources were assumed by the Russian Federation. The final blow came on December 1, with a 90 percent “yes” vote for independence in Ukraine. The USSR and the Communist Party of the Soviet Union were officially dissolved; Gorbachev resigned, and by the end of the year all official Soviet functions ceased.

The point is that the Soviet/Russian political situation pushed all else to the rear for most of 1991. Only in the late fall of that year, with the consolidation of the Yeltsin government, could the full attention of officials turn to the details of market-oriented reform in general, and enterprise reform in particular. World Bank and other IFI assistance was then requested.

In November, a World Bank mission returned to Russia in part to “learn the state, and advance the development of privatization.” In the year between

the joint mission and the second trip to Moscow many of us in the Bank working on enterprise reform had generally become much more persuaded of the correctness of a mass and rapid approach to ownership change. Partly this was because the Czechs were pushing ahead with an innovative voucher scheme that promised to divest quickly, and, it appeared, fairly, a large portion of state-owned enterprises. There were other rapid-action approaches underway, in Poland, in the former East Germany, and in Lithuania. Above all, the attempted coup in Russia had given weight to the argument that unless one acted rapidly to create a large group of private property owners and operators who possessed a substantial material interest in maintaining the new system, then the communists might try again, and this time meet success. The perspective had changed.

Back in Moscow, we found a country “in ferment.” The Back to Office Report (BTOR) noted: “There is underway in Russia an increasingly open, faction-ridden and dangerous struggle to appropriate the property rights formerly vested in ‘the people’ as a whole” (Nellis, 1991b, p. 1). The actors in this struggle were:

- *The Russian Federation government*, acting through its newly formed State Committee on Property Management (or GKI, from its Russian initials). Its mandate was to privatize rapidly, transparently and fairly. We met and talked with the just appointed Chairman of the GKI, Anatoly Chubais (“he seems good,” read the BTOR).
- *The workers in enterprises*. For 70 years they had been told their labor was the major factor in determining value, and that the means of production were theirs. A Federation law on privatization, passed in July 1991, partly supported this view.
- *The managers in enterprises*. The processes of leasing and the formation of cooperatives had steadily advanced through 1991. We concluded that “In the present murk of undefined property rights, managers are rapidly becoming quasi-owners of enterprise assets through spontaneous privatization, that is, management and employee buyouts. The process is non-transparent and appears to be taking place on a scale far greater than in other countries” (Nellis, 1991b, p. 1).

To this normal mix of claimants was added the diverse regional governments of the Russian Federation, many of which were insisting that all resources and enterprises in their territories were their property, to dispose of as they wished. And the remnants of the branch ministries, though weakened, were still using their contacts and remaining resources to secure some position of ownership or at least influence in the coming divestitures.¹⁸

The BTOR then stated:

“The result is a colossal mess. The Russian Supreme Council passed a (privatization) law on 3 July 1991 in an early effort to sort it out; but many Russian officials and all foreign lawyers and observers agree that the law adds to rather

¹⁸ Some of the officials in these ministries did succeed in turning themselves into private and enduring entities. Nikolai Panichev, for example, last mentioned as Minister of Machine Tool and Tool Industry, became President of RossStankoInstrument Holding Company, an import/export group servicing the machine tool industry. He still held that post as of 2012. While private, the firm’s public notices prominently mention its former ministerial status.

than resolves the confusion. Its faults: (1) It says almost nothing about foreign investment; (2) an accompanying act establishes ‘investment certificates’ that will be given to the public; the people think this will result in a distribution of wealth; officials don’t have the slightest notion of the legislators’ intent or what to do with this concept; (3) the law created a plethora of over-lapping, decentralized, competing institutions to manage parts of the process; in the few major cities where they have come into existence they are fighting with each other, and the local elected officials, over who controls privatization; (4) the law does not say whether the old branch ministries are dead and disbanded, or whether their present strenuous efforts to maintain themselves are legal; and most ominously, (5) the law gives the workers’ collectives in the enterprises the power to approve or reject (or at least seriously delay) privatization proposals” (Nellis, 1991b, p. 2).

At this time Moscow was alive with ideas and proposals for what the Russians should do next in privatization, from Russians in- and outside government, from within the World Bank and other IFIs, and from the growing number of advisors, private operators, privatizing politicians from other countries and academics — e.g., Jeffrey Sachs, David Lipton, Andrei Shleifer, Enrico Prodi of Italy and Roger Douglas of New Zealand — who were turning up in droves. The brand new GKI team promised speedy early action, but — reasonably enough — was not yet able to offer details. Most interesting, in light of the program later adopted, the number two man in the GKI, Dmitri Vasiliev, told us that neither he nor Chubais thought much of the promised ‘investment certificates,’ or vouchers.

At the end of this mission the World Bank’s Manuel Hinds strongly recommended that all the past spontaneous privatizations and outright grabbing just be legalized. His view was that managers knew the enterprises better than anyone. If properly incentivized, they would be in the best position to make something of them. Give them the companies, impose a hard budget constraint and end subsidies, and let the market sort out winners and losers, he said.¹⁹

This ‘let it rip’ approach was too much for many others, who wished the GKI, with assistance, to become something like the German Treuhandanstalt. This body was then rapidly privatizing thousands of firms in the former DDR, mainly by selling assets to more or less qualified buyers. But many of the buyers were West Germans. And the Treuhand was spending literally billions of Deutschmarks maintaining moribund enterprises until some buyer for the residual assets could be found. Where were buyers of this sort to be found for Russia? Where were survival funds of this magnitude to be found? Too bad, said someone on the Bank team, there is no West Russia.

Variations on the themes of ‘get it done’ and ‘find good owners’ abounded, but by the end of 1991 no single notion had yet won the day.

5.3. *And in the long run?*

After this, the Russian privatization story becomes well known, well analyzed and well outside the scope of this historical note. The briefest of summaries: Perhaps partly influenced by outside views, but mainly based on their own assessment of the situation — and above all, by their overriding fear that the com-

¹⁹ Hinds had staked out this position in a paper written earlier; see Hinds (1990).

munists might try again to regain power—starting early in 1992 GKI officials opted for a mass and extremely rapid privatization approach, using vouchers. These vouchers or coupons could be sold for cash or used in upcoming auctions to obtain shares in a privatized firm. GKI leaders decided to employ this difficult and untested voucher method because they had been persuaded that the public would not tolerate a simple sale of enterprises to the former *nomenklatura* or to foreigners, or some combination thereof. They concluded it was essential to find a way of obtaining the involvement and the acquiescence, if not the enthusiastic support of the population. Vouchers, they claimed, appeared to be the only practicable way to do this.

The World Bank and other donors provided heavy and sustained assistance for this program. Bank staff member Ira Lieberman tirelessly led a Bank team that, over the next three years, helped the Russians transfer to private ownership between twelve and fourteen thousand large and complex companies, employing half the total Russian workforce. Moreover, through the voucher program, this unprecedented transformation made shareholders of 40 million Russia citizens. By the middle of 1994, the general assessment was that this was an amazing and generally positive accomplishment.²⁰

The Russian privatization program went disastrously wrong after 1995. There are critics who argued that the preceding, Bank-supported mass privatization program had set the scene for the later major failings. They²¹ thought that Bank staff and other foreign advisors should have seen the negative potential of the mass privatization approach. Western advisors, they reasoned, should have seen that the trumpeted anti-communism of the privatizers was a smokescreen to hide the enrichment of themselves and their allies. The advisors should have supported a more gradualist approach, based on building the institutions needed for a broadly beneficial sort of capitalism to flourish.

Others said nonsense; the accomplishments of the first three years of the program laid a solid foundation that was squandered by post-1994 decisions and actions of the Russian government. Members of the coterie surrounding Yeltsin knew what they wanted and how to get it. They took advice and assistance regarding the mechanics of privatization, but they never allowed any external voice to influence their underlying policies and goals. Had anyone given them advice to move gradually, they would have ignored it. And given the political circumstances prevailing in the mid-1990s, they might well have been right to do so (Shleifer and Treisman, 2000).²²

In any event, rehashing this old debate is not the purpose here. It has been done and redone (see Nellis, 2008).

The sole remaining issue to address in this historical note is this: Why did the 1990 joint IFI mission not get a glimpse of the coming emphasis on mass privatization? How did it—we—miss the fact that the government of the Russian Federation would opt for audacity? The answer, I think, is not so hard to grasp:

²⁰ For a generally positive assessment of the program as of 1994, see Lieberman and Nellis (1994).

²¹ The most prominent of the “they” was Joseph Stiglitz. He became Chief Economist of the World Bank in February 1997. He then began to take an interest in privatization in formerly communist countries. In 1999 he published two papers criticizing the advice given by Western observers of the process, including those from the World Bank. See Stiglitz (1999a, 1999b).

²² Note that Shleifer advised the GKI on its program.

In September/October of 1990 the Soviet Union was shaky, but still in existence. The coup to keep it in existence, and which (after it failed) would energize radicals to do what they could, while they could, had not yet taken place. The Russian Federation government was not yet in a position to determine fully its own fate, or the methods it would chose to effect that fate. The individuals who would later lead the Russian Federation's mass and rapid privatization program were in secondary positions, mainly in Leningrad. At the time, even they had little clear idea as to precisely what they would later espouse. Outside Russia, mass privatization programs were still in the planning stage.

The overwhelming majority of persons we spoke to in 1990 were gradualists. They wanted to effect as painlessly and politically acceptable as possible a transition to the market. The sad truth of the matter is that this proved impossible in the Russian circumstances.

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