

1998

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Citation of this paper:

Wintrobe, Ronald. "Privatization, the Market for Corporate Control, and Capital Flight from Russia." Transition Economics Research Forum Reports (TERF), 1998-2. London, ON: Department of Economics, University of Western Ontario (1998).

5 0 1 5 6

ISSN:0318-725X

ISBN:0-7714-2080-3

**RESEARCH REPORT 9804
(TERF REPORT 1998-2)**

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And Capital Flight From Russia**

by **ECONOMICS REFERENCE CENTRE**

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MAY 2 1 1998

UNIVERSITY OF WESTERN ONTARIO

March 1998

Transition Economics Research Forum

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PRIVATIZATION, THE MARKET FOR CORPORATE CONTROL, AND CAPITAL FLIGHT FROM RUSSIA

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1. *Introduction*

While the data are ambiguous and estimates vary considerably, there seems to be a general consensus that some, perhaps a substantial amount¹, of capital has left Russia, and that investing in Russia is insufficiently attractive either to domestic or foreign investors to motivate domestic investors to return, or foreign investors to enter at a sufficient level to adequately finance the development of the Russian economy. Many reasons can be suggested for this situation. These include, most obviously, political uncertainty--the prospect of unfavorable political developments such as the election of communists or of a victory of nationalism over neo-liberal reform; bureaucratic obstacles to investing there; unfavorable tax treatment; the possible return of high inflation, and so forth. This paper will argue that the basic reason for the

¹The estimates of the amount of capital flight vary widely, ranging from a low of \$30 billion to a high of \$300 billion.

flight of capital from Russia over the last few years is the neglect, during the transition, of property rights issues, and in particular of the property rights environment necessary to ensure adequate corporate governance and the resulting "incomplete" ownership structure typical of the Russian firm. This neglect has been common in the analysis of transition. Despite all of the work in the new institutional economics on property rights and despite the (admittedly crude) evidence of Wallis and North (1986) that about *one-half* of GNP is spent on "transactions services", theorists of the transition typically write as if, once freed from the government, enterprise managers will automatically be motivated to maximize profits, and markets will spontaneously arise to coordinate production.

The emphasis during the transition was to remove enterprises from government control, that is, to *privatize* companies. The basic rationale for this was set out in *Privatizing Russia* (1995) and in other publications by the privatization team and advisers to it. In this and other publications, the focus was on the contrast between political control and control by private owners. Little emphasis was paid to the question of how to design appropriate institutions to ensure the transferability of ownership and how to discipline managers so that they would manage corporations in such a way as to breed investor confidence. The result has been a form of capitalism aptly dubbed "Weird Russian Capitalism" by Cottrell (1997) in which managers are entrenched in power in the enterprises in a way that they never were under the old central planning system, and it is not obvious how the system can ever be changed to breed investor confidence. Under the circumstances, I suggest that a more appropriate focus for policy is on developing rights for employee- shareholders to undermine the power of management and to look to alternative industrial systems such as the German or the Polish one, rather than to attempt to adapt the Russian ownership structure to the American model of widespread outsider ownership to which it

is, as the result of the privatization process, completely unsuited.

2. *Goals of privatization and the Russian privatization program*

The theoretical rationale for the way privatization was carried in Russia consists of two propositions:

1. Political control of enterprises is economically inefficient. The basic aim of the privatization program was therefore to remove political control over both cash flows and enterprise decisions of enterprises (See Boycko, Shleifer and Vishny's *Privatizing Russia* (1995), or Shleifer and Vishny (1994) for a more comprehensive theoretical statement).

2. Firms consist of stakeholders: managers, workers, and others. The privatization program was explicitly designed to accommodate the interests of these groups. In any case, these groups were politically powerful in Russia, and in order for the privatization to be accomplished, they had to be appeased.

Some other, oft-cited benefits of privatization are:

3. Privatization is necessary if the transition from socialism to capitalism is to be made (Brada (1996)).

4. Privatization permits the replacement of soft with hard budget constraints (Stiglitz (1994), p. 180).

5. Privatization permits more flexible executive compensation than is possible under civil service rules (Stiglitz (1994), p. 180).

6. Privatization in a socialist economy breaks the state's monopoly over the bases of political power so that other sources of power can emerge and thus creates a nascent middle class

(Lipton and Sachs (1990), Berger (1992).

3. *Problems with the theory and practise of privatization: How the way privatization was carried out hampers the functioning of the Russian economy and leads to capital flight*

1. To begin with, the argument about the inefficiency of political control is presumably very different, and much more compelling, when the government in question is a dictatorship than when it is a democracy. It is interesting that the distinction is barely made by Shleifer and Vishny in all of their work on the difference between public and private enterprise. And, when it is made, (Shleifer and Vishny (1994), p. 1013, improved political competition is said to create *inefficiency*.

2. Privatization creates corruption.

3. Privatization does not solve the problem of ensuring that firms are well managed. To understand this point, we have to discuss the theory of property rights in corporate control in more detail.

As is well known, in order to raise capital on a reasonable scale, firms have to have limited liability. This, in turn, implies that owners will want to diversify their holdings in order to optimize their portfolio choices. So companies will typically be widely held, and managers of the firm are "separated" from their owners. Under these circumstances, what disciplines the manager to act in the interests of shareholders? The boards of directors are typically weak and under the control of the manager (Shleifer and Vishny 1988), and cannot be counted on to perform this task. Three mechanisms have been widely discussed in the literature: executive compensation, the threat of a hostile takeover, and managerial competition. Of these, the most important is and widely discussed is the second mechanism, the "market for corporate control": firms which are badly managed will fall in value. This provides an opportunity for an outsider to buy a controlling interest in this firm,

replace the inefficient management with efficient management and profit as the stock price rises to reflect this improvement. In the original literature, the only question was how far the actual value of the firm could diverge from its potential value before a takeover bid would be launched.

However, there is a flaw in this story, as was originally pointed out by Grossman and Hart (1980). To see it, the reader should suppose that he or she owns shares in a firm which is badly managed, and that a well-known takeover artist like Carl Icahn launches a bid for the firm. Suppose the original value of the shares is \$10, and that Icahn bids \$15. Should the reader sell? The astute shareholder will realize that if Icahn is bidding \$15, he is obviously hoping that the stock will eventually rise higher than this. So the shareholder holds on, hoping to profit even more by the improvement to be made by Icahn's management, and hoping that others sell so that the takeover goes through. However, since all shareholders reason this way, hoping to "free ride" on the stupidity of others, the takeover fails to go through. The only price at which people will be willing to sell is that which capitalizes the entire value of the improvements into the share price. But in that case, the bidder cannot profit in the way that Manne originally suggested, through replacing and improving the management of the firm. The evidence on this market fully supports this prediction: a substantial premium of 20% or more over the original value of the target's shares is necessary for takeovers to take place (Jensen and Ruback (1983), Mueller (1992)). In short, this mechanism cannot be relied on to replace inefficient management.

Nevertheless, takeovers do take place, and two alternative theories have been suggested to explain them: one is Roll's (1986) "hubris" theory, in which bidders buy firms because they mistakenly value them more than the market does, and the other is Shleifer and Summers' (1988) idea that takeovers are a way for shareholders to ratify a "breach of trust" with the firm's employees: In this theory, it may have originally been in the shareholders' interest to find or agree

to a manager who was capable of establishing trust with workers; however, under some circumstances, this trust becomes dysfunctional and the implicit contract between managers and workers should be broken. However, the original and now existing manager cannot do this, so a new manager is needed in order to breach the implicit contract between managers and workers, and allow shareholders to appropriate the rents of the firm's employees. Neither on this nor on Roll's theories does the takeover process create any economic value. And on neither does it provide a mechanism which transfers ownership in such a way that it ends up in the hands of those who will maximize the value of the firm.²

It follows that there is no reliable mechanism to discipline firm managers who do not act in the interests of shareholders and there is no mechanism which acts to transfer control rights in firms to those who are best able to use them. Nevertheless, in countries with sophisticated capital markets, firms will indeed be valued correctly, and the first and third mechanisms mentioned above do provide an incentive to managers: executive compensation schemes ensure that managers who do act in shareholders' interests are rewarded for doing so; and competition in the market for managers (Alchian (1969), Fama (1980)) ensures that "good" and "bad" managers develop appropriate reputations which are capitalized into their compensation. Finally, product market competition ensures that firms which are well managed will enlarge their market share at the expense of those which are not. So other institutions can compensate for the weakness of the

²Many have suggested that, when property rights are weak, "trust" may arise to substitute for the missing legal authority. But note that, in the market for corporate control, *lack of trust* is what is required: to the extent that shareholders in target firms do not trust the takeover artist to increase the value of the firm but suspect that he may in fact be planning to dilute the firm's value, e.g., by transferring some of its assets to another firm that he owns, they will be tempted to sell, thus solving the free rider problem. Similarly, the explanation of takeovers stressed by Shleifer and Vishny (1988) stresses the desirability of being able to break implicit contracts under certain circumstances.

mechanism for transferring ownership. If these other institutions are weak, the initial allocation of control over firms is obviously of great importance, as the transfer mechanism cannot be counted on to reallocate control to any great degree even in a well-developed market economy.

However, this problem was paid lip service at best in the design of the privatization program, where it was felt that speed and the overriding importance of getting the government out were the most important objectives. Thus, while Boycko, Shleifer and Vishny admitted that

This agency problem has been the focus of extensive analysis of publicly held corporations in market economies. It is much more severe in Russia, where many managers are not fit for the job and need to be replaced..The agency problem between managers and shareholders suggests that privatization is only the first step in getting cash flow and control rights aligned. The next step is ensuring effective corporate governance by transferring control rights from the managers to the outside shareholders who have the cash flow rights. Since outside shareholders are only interested in maximizing profits, the ownership structure that gives them both cash flow and control rights is truly efficient.Many writers on privatization in Eastern Europe and Russia have not viewed depoliticization as the primary goal of privatization, and have instead focused on establishing effective governance as the key objective. *In our view, controlling managers is not nearly as important as controlling politicians, since managers' interests are generally much closer to economic efficiency than those of the politicians. Once depoliticization is accomplished, the secondary goal of establishing effective corporate governance can be addressed.....*"(Boycko, Shleifer and Vishny (1995), italics added, p. 65).

5. The result was a Russian privatization which solidified the control of insiders. As Blasi, *et.al.* (1997) admitted, "To get the job done quickly, the process was designed to transfer ownership mainly to employees and managers" who had the option of purchasing shares in the firm valued at 1.7 times book value, where these values were unadjusted for inflation. The result was that "Russia leads the world in employee ownership" (Blasi, *et.al.*, 152).... "But the workers themselves are firmly under the thumb of management and possess no real power" (Blasi, *et.al.* p. 58, 169). Of course, the takeover of the firms by the managers had begun much earlier, with Gorbachev's decentralization schemes, which largely removed the managers from the control of the branch ministries (Blasi, *et al.* (1997) pp. 33, 45, Boycko, Shleifer and Vishny (1995), p.39). The result was the consolidation of power by the old elite, in a way that ensures its continuance better than under communism, where the rights were held but could be taken away. Boycko, Shleifer and Vishny admitted this but viewed it as a necessary step to ensure depoliticization. Others, however, saw the program as a victory for the old *nomenklatura* (see McFaul). So, as a device for breaking the power of the state, privatization may have succeeded in some ways, but the hold of the managers over the assets of the country was strengthened rather than weakened by the program. Indeed, Blasi, *et al.* report that "The depth of management entrenchment began to terrify observers of the privatization process, particularly Dmitry Vasiliev, then [1996] deputy chairman of the privatization ministry" (Blasi, *et.al.* (1997), p. 97)

6. The firms were sold at rock bottom prices. Boycko, Shleifer and Vishny (1995, p. 118) reported that while U.S. manufacturing firms have market values of about \$100,000 per employee; Russian manufacturing firms were sold for between \$100 and \$500 per employee. For example, in 1997, the stock value of one Russian bank's branches amounted to \$5,000 per branch, bricks and mortar included, and figuring out that this company was undervalued was "not rocket science"

according to the head of one Western mutual fund specializing in Russia (Andrews 1997), p. 10. The general directors surveyed by Blasi, et.al., said that they paid 40 times less for their shares than the enterprises were worth.

To understand the implications, suppose the managers were exaggerating, and they paid only 20 times less for their shares than their "true" value. What difference does this make? It is often stated that, while excessive wages can hamper an enterprise, excessive profits do not matter. For example, Leszek Balcerowicz, a chief architect of the Polish privatization stated, with respect to the bad effects of granting too high wages to workers in East Germany, that ".. what happened in East Germany was the peaceful bombardment of enterprises with explosive wage increases far ahead of productivity growth. This destroyed the economic value of the enterprises, i.e., their stream of future profits. An economic effect of this kind is almost as devastating as the physical destruction of machinery and buildings. To compensate for either requires huge amounts of investment." (Balcerowicz (1994), p. 37).

On the other hand, it is not usually held that bad economic effects arise from windfall profits. But this neglects the problem of transferring ownership discussed above. If it is difficult to transfer a company's ownership when that company is 20% undervalued, how can transfer ownership of a company which was purchased for one-twentieth of its value? Suppose first that the assets are widely held. Since the current owners must be assumed to be rational, they should hold out until the entire value of the profits from restructuring (discounted for risk) are capitalized into its price. But who would pay twenty times its going value for a Russian firm? On the other hand, most Russian firms are not widely held. The managers of these firms do not want to sell their shares either, for the simple reason that if they do so, they might be out of a job (Blasi, et.al.,

p. 135). Employees do not want to sell for the same reason.³

The fundamental problem, then, is that transferring ownership and control of an enterprise in a transition economy is particularly difficult, and this difficulty increases directly with the extent to which the company was undervalued during the initial privatization. Because of this, insiders are firmly in charge, and outsiders are naturally reluctant to invest. Hence the problem of capital flight in Russia. The behaviour of the firm managers, in turn, results from this difference between the likely "bid" and "ask" prices of Russian firms. With little possibility of raising capital, the strategies of asset stripping, of paying workers late or not at all, of repurchasing shares of outsiders, and so forth, represent nothing more than rational responses to a bleak situation. Moreover, as long as the market continues to expect managers to manage in their private interest on average, any particular manager is caught in a trap, which is exactly analogous to the statistical discrimination trap in which some minorities are alleged to be in (see Arrow (1972)): only widespread improvement in the general behaviour of the managers, not individual improvement, can be expected to make investment in Russian firms attractive to outside investors.

³Blasi, et.al., present evidence that, when outsiders do assume control, the likelihood of replacement of the manager increases substantially. Indeed, they show that managers often go to extraordinary lengths to reduce the possibility of outsider control, sometimes issuing shares and then buying them back with company funds. Moreover, managers have also put extreme pressure on employees not to sell their shares, regarding such actions as betrayal except when they are sold to management.

In the meantime, this behaviour of the managers has had predictable consequences for the Russian economy, as summarized by Cottrell:

Between January 1993 and January 1996 Russia's industrial output fell by roughly a third-even though the country's total consumption of goods and services rose slightly over the same period. The privatized firms tracked by the Russian National Survey got rid of 23 percent of their employees between 1993 and 1996, but the slump in output left them operating at barely half capacity. In the course of shrinking, therefore, they tended to grow still less efficient. As for labor relations under the new dispensation, millions of workers found that any changes were for the worse. It became commonplace for managers to pay wages late, or not at all, knowing that employees had nowhere else to turn. (Cottrell (1997), p.27.

4. *Policy Implications*

Under communist central planning, enterprise managers were firmly under the supervision of the government ministries, in turn controlled by the Communist Party. Enterprise managers could be dismissed from their posts for malfeasance, purged from the Party and sometimes subject to more severe sanctions. The system, as it turned out, was cumbersome and overcentralized, and in the end inefficient, but it was not illogical, given the objective that political forces, not market forces, should guide the economy⁴. In the end, the system could count only one success: the high

⁴Brada (1997) suggests that plain inefficiency was the main reason for privatization. Wintrobe (forthcoming) provides a detailed account of the logic of communist economics and explains why the enterprises became increasingly inefficient over time.

level of economic security it provided its workforce (Aslund (1989), p. 21). Indeed, in Russia under communism, enterprises not only provide workers with security, they paid huge social expenses for employees (housing, day care, kindergartens, medical facilities) as part of their social contract with workers (Blasi, et.al. p. 142). One of the reasons that Russian firms sold for such low prices is that the hierarchical links which substituted for legal, transferable property rights in controlling managerial discretion were broken, initially by Gorbachev's decentralization schemes, and then finally and decisively through the privatization program which entrenched managerial control. In the absence of a properly functioning market for corporate control, there simply is no pressure on managers to restructure other than that from (still weak) product market competition, and, with capital markets weak, no means by which the firms could raise the necessary capital if they wished to do so.

Since most shares are owned, technically at least, by employees, and since markets do not provide security, this suggests that one barrier to restructuring could be reduced through bold social welfare legislation which would shift this function from enterprises to the state. With their dependence on the firms reduced, employees might then be more willing and able to part with their shares to outsiders than they are at present. More generally, although it was not the explicit purpose of the privatization program to make Russia the world leader in employee shareholding, that is undoubtedly the result of the program, and other steps could be taken to reduce the dependency of employees on management by enhancing the protection of employee-shareholders' rights. This suggests looking to other industrial relations systems besides that of the U.S. model of widespread outsider shareholding, the attainment of which was one of the objectives of the privatization program, but which now looks very remote indeed, and, on the basis of the analysis summarized in this paper, not all that desirable in any case. The German system of important

worker involvement in enterprise decisions, the Japanese *keiretsu* cartels, the Korean *chaebols* or, closer to home, the Polish and Czech privatizations, with their extensive involvement by governments and banks, might all provide models, any of which will allow capitalism to develop better in the environment of the post-privatization ownership structure in Russia more closely than the market for corporate control.

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