LESSONS FROM CORPORATIZATION AND CORPORATE GOVERNANCE REFORM IN RUSSIA AND CHINA

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History of Russian Corporatization and Privatization

- Corporatization and privatization more rapid than other EE/CEE/CIS countries

- Three stages

- **<u>1993-1995</u>**: Shares of 2/3 of all large and medium firms transferred completely or partially from state to private hands; 80% of all small firms divested

  - Mass Privatization Program (MPP): ownership vouchers given to entire population for sale/trade; majority of firms turned into joint-stock companies

    - Effectively created >41 million private Russian shareholders via direct shareholdings in individual firms or in voucher investment funds

    - 70% of the 76,000 privatizations under the MPP were sales of majority shares (51%) mostly to workers and other "insiders" (MEBOs)

    - Mass privatization conducted quickly despite nascent institutional reforms—corporate governance, competition policy, accounting, capital market—to "lock in" transition to a private enterprise-based economy

History of Russian Corporatization and Privatization (cont'd)

- **<u>1995-1996</u>**: Government sells much of remaining minority and majority share packages in thousands of other enterprises through cash-based and other auctions

- Enterprise managers also gain dominant insider control of privatized firms from workers and citizen shareholders (legally or via coercion)

    - Managerial dominance of ownership and control—combined with "soft budget constraints"—foster asset stripping and limit outside investors' entry

- Government gives controlling shares in largest/most attractive firms as collateral to financial industrial groups (FIGs) in exchange for loans to budget: LFS scheme

    - Lack of transparency raises serious concerns about equity, concentration of market power, corporate governance incentives

    - Lack of competition in the transaction lowered government revenues

- Greater insider control and LFS scheme diminish credibility of corporatization process and parliament's appetite for further privatization

History of Russian Corporatization and Privatization (cont'd)

- **<u>1997- present</u>**: "Case-by-case" privatization (international best practice)
  - Targeted at largest enterprises (ideally sales of controlling share packages)
  - Pursuit of strategic investors
  - Competitive tenders and auctions or negotiated sales
  - Transparent procedures
  - Independent financial advisers chosen competitively to (i) prepare firm for bid and (ii) conduct sale for State
- Russian CBC legal framework sound; but implementation record mixed
  - "Most Successful" *Svyazinvest* [telecoms]: first real CBC; *Onako* [oil]: sales price 2x starting price
  - "Least Successful" *Rosneft* [oil]: inadequate preparation, assets stripped, ultimately failed); *TNK* [oil]: priced below market; insider deal(?)

Corporatization of Russian Enterprises Today

- Cumulatively more than 140,000 enterprises privatized since 1992

- Official statistics indicate private sector accounts for at least 70% of GDP

I. Corporatized State Firms

- State is a shareholder of ≥25% shares in about 2500 joint stock companies
  - in 382 firms, state share is 100%; in 470 firms, state share is >50%
  - "golden share" retained in 580 companies

- Top management of SOEs carried out directly by officials in federal agencies

- Management under trust by professionals is the exception

- State management of corporate assets widely recognized as inefficient
  - absence of clear corporate objectives
  - lack of personal accountability
  - limited disincentives for failure to adequately represent state interests
  - misconduct and corruption

Corporatization of Russian Enterprises Today (cont'd)

I. Corporatized State Firms (cont'd)

- Government uses a variety of methods to ensure better performance
  - personal trust agreements with management in strategic firms (35% ownership of *Gazprom*)
  - formation of holding companies, grouping several ownership stakes
  - entrusting share management to FIGs
  - issuing Presidential Decrees or enacting laws specifying appointments and voting instructions
- "Concept of State Property Management and Privatisation in the Russian Federation" approved in 1999 articulates current and future policy

Corporatization of Russian Enterprises Today (cont’d)

II. Non-Corporatized State Firms

- Approximately 14,000 “unitary state enterprises” remain
- Corporate governance strategies for these firms not yet formulated
- Transformation into joint stock companies resisted by incumbent directors
- Government has lack of accurate financial information about these firms
- Lack of accountability and liability for incumbent managers, protected by current labor code
- Confusing and unstable division of functions among authorities responsible for management of state assets

Impact of Mass Privatization, LFS on Corporatization & Governance

- Russia's corporate governance *legal-institutional framework* becoming sound
  - joint stock company law
  - securities law regarding protection of minority shareholder rights
  - penalties on insider trading
  - operation of Federal Securities Commission

- But legacy of rent-seeking incentives mean corporate governance *practices* weak
  - share dilution/share swaps: reduce minority shareholders' voting rights
  - asset stripping/transfer price abuses: asset/product sales to firms controlled by related parties/friends/family at below-market prices
  - financial information disclosure: sporadic, often not public; not in compliance with international accounting and auditing standards

- <u>Result</u>: equity shares of 21 largest firms trade at 6% of potential market value

- <u>Result</u>: inability to attract equity investors (domestic and foreign); excessive reliance on reinvestment of profits; some debt financing; FDI very low

- <u>Result</u>: new domestic business entry strikingly low and skewed in Russia

Did 1998 Crisis Finally Usher in Russian Corporate Reform?

- Devaluation fostering substantial import-substitution and export-promotion opportunities for Russian firms; indeed, corporate drive for finance prompting reform in corporate governance more effectively than past government programs
  - increase use of independent directors on corporate boards
  - regular publication of financial accounts
  - availability of company charters
  - payment of dividends
  - voluntary adoption of int'l shareholder protection principles (OECD-IBRD)

- Evidence that market incentives work. Still, complementary government reforms essential to instill deeper behavioral changes and broader application
  - Corporate Governance Code and amendments to core laws
  - Competition policy: abuse of horizontal and structural dominance; mergers
  - Competition policy: reduce structural barriers to entry for new firms
  - Bankruptcy policy: weak court systems; lack of professional trustees
  - Banking reform: lack of intermediation for investment; limited competition
  - Accounting and auditing reform
  - FDI policy: weak national treatment, dispute resolution, gov't rule uniformity

China’s State Enterprise Sector

- SOE sector has been the Achilles heel of China’s otherwise remarkable economic performance over past two decades

- Since 1978 innovative, if often administrative, institutional reforms have begun to achieve Chinese goal of “separating government from businesses”

- Privatization and corporatization of SOEs occurring: mostly small and medium sized firms; and decentralization has engendered discretion to localities

- But the Chinese State still maintains ownership/control of key enterprises

- Under the “socialist market economy” government agencies attempt to carry out shareholder functions typically performed by private owners in a market economy

- For largest businesses, creation of holding groups the main form of restructuring

- Real progress in some areas, but portions of strategy contradictory: produces unanticipated distortions and resource drains, spilling over to financial and social sectors, jeopardizing core elements of the overall economic reform program

China’s SOE Sector Has Declined in Size

- While China’s SOEs account for one-quarter of national production …

Ownership Structure of Chinese Enterprises (Number of enterprises)							
	1993	**1994**	**1995**	**1996**	**1997**	**1998**	**1999**
Total	9.91mn	10.00mn	7.34mn	7.99mn	7.93mn	7.97mn	7.93mn
SOEs	100.5th	102.2th	118.0th	127.6th	110.0th	64.7th	61.3th
Collectives	1.80mn	1.86mn	1.48mn	1.59mn	1.77mn	1.80mn	1.66mn
Individually Owned	7.97mn	8.01mn	5.69mn	6.21mn	5.97mn	6.03mn	6.13mn
“Other” †	32.1th	44.5th	60.3th	70.2th	77.3th	85.7th	91.8th

Share of National Gross Output Value of Chinese Industrial Enterprises							
	1993	**1994**	**1995**	**1996**	**1997**	**1998**	**1999**
SOEs	47%	37%	34%	36%	32%	28%	28%
Collectives	34%	38%	37%	39%	38%	38%	35%
Individually Owned	8%	10%	13%	15%	18%	17%	18%
“Other” †	11%	15%	17%	17%	18%	23%	26%
Total	100%	100%	100%	100%	100%	100%	100%

† “Other” refers to private firms with more than 7 employees; Sino-foreign joint ventures; fully foreign-funded firms.

Source: Broadman “The Business(es) of the Chinese State”, *The World Economy* (2001) based on data from the *China Statistical Yearbook*

China's 'SOE Problem' Remains

- … they still comprise two-thirds of total assets, employ more than half of urban workers, account for three-quarters of investment, and absorb ¾ of bank credit

- Factory capacity utilization rates for SOE products low; sizeable inventories

- Most SOEs remain obligated to provide "cradle-to-grave" social services

Employment In Chinese Industrial Enterprises

	1993	**1995**	**1997**	**1998**	**1999**
SOEs	45.0m	44.0m	40.4m	27.2	24.1
Share	*68%*	*67%*	*65%*	*57%*	*55%*
Collectives	17.0m	15.0m	13.3m	8.0	6.7
Share	*26%*	*23%*	*21%*	*17%*	15%
"Others" *	4.3m	7.1m	8.5m	12.3	13.4
Share	*6%*	*10%*	*14%*	*26%*	*30%*
Total	66.3m	66.1m	62.2m	47.5	44.2
Share	*100%*	*100%*	*100%*	*100%*	*100%*

*"Other" is *all* private firms: "individually owned"; firms with more than 7 employees; Sino-foreign ventures; fully foreign-funded firms.
Source: Broadman "The Business(es) of the Chinese State", *The World Economy* (2001) based on data from the *China Statistical Yearbook*

China's 'SOE Problem' Remains (cont'd)

- While direct budgetary subsidies to SOEs have declined, implicit subsidies prop up loss-making SOEs through an already weak financial system (> 25% NPLs)

- Crowds out non-state entrants—the real engines of China's growth

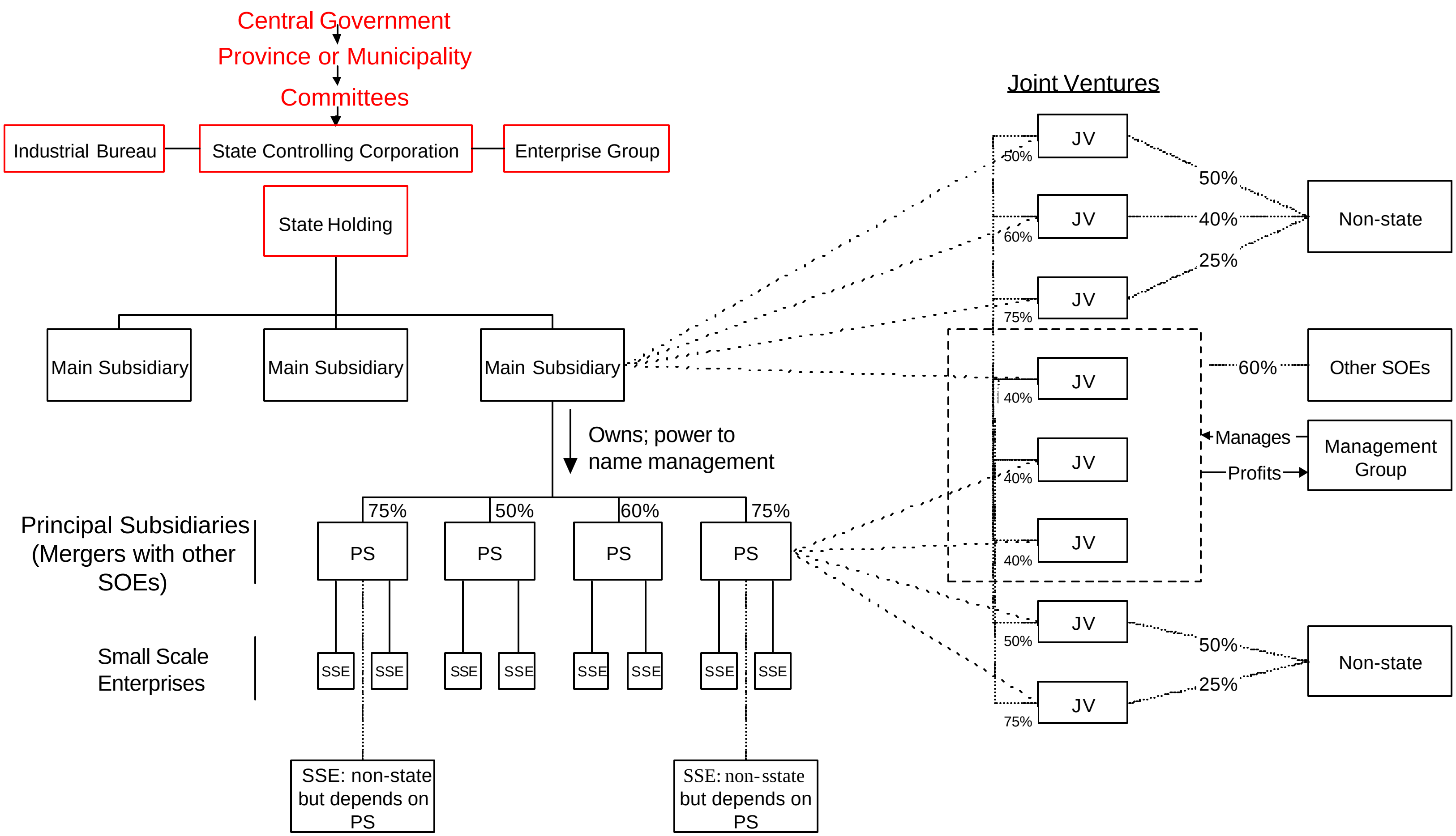
Losses and Profits of Chinese Industrial State Owned Enterprises*							
	1993	**1994**	**1995**	**1996**	**1997**	**1998**	**1999**
Losses (Yuan) *As a Share of GDP*	45.3 bn *1.3 %*	48.3 bn *1.0%*	64.0 bn *1.1%*	79.1 bn *1.1%*	83.1 bn *1.1%*	85.1 bn *1.1%*	76.9 bn *0.9%*
Pre-Tax Profits (Yuan) *As a Share of GDP*	245.4 bn *7.1 %*	287.6 bn *6.2%*	287.4 bn *4.9%*	273.7 bn *4.0%*	290.7 bn *3.9%*	337.1 bn *4.3%*	407.9 bn *5.0%*

*Officially reported losses and pre-tax profits. "Pre-tax profits" is the sum of what the Chinese statistical authorities define as "total profits", sales taxes, sales tax surcharges, and value-added taxes (since "total profits" is net of all such taxes but gross of income of taxes).

Budgetary Subsidies To Loss-Making Chinese Industrial Enterprises							
	1993	**1994**	**1995**	**1996**	**1997**	**1998**	**1999**
Subsidies (Yuan)	41.1 bn	36.6 bn	32.8 bn	33.7 bn	36.9 bn	33.4 bn	29.0 bn
As a Share of GDP	1.2%	0.8%	0.6%	0.5%	0.5%	0.4%	0.4%
As a Share of Government Expenditures	8.9%	6.3%	4.8%	4.2%	4.0%	3.1%	2.2%

Source: Broadman "The Business(es) of the Chinese State", *The World Economy* (2001) based on data from *China Statistical Yearbook* (various years); *2000 Statistical Communique; China Statistical Information Network* (December 2000)

China's Enterprise Groups Are Unduly Complex in Structure



China’s Approach to Corporatization and Corporate Governance

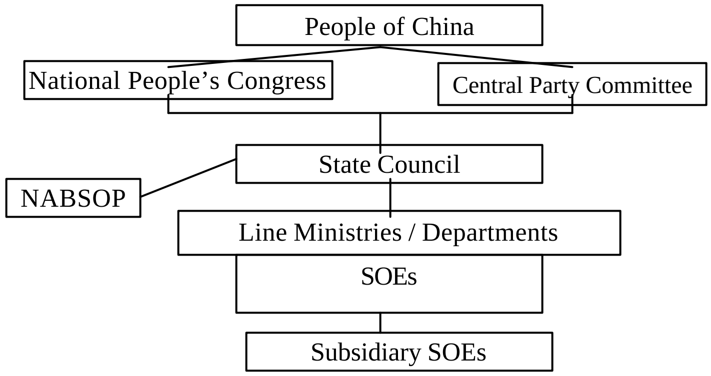
- Creating the “Modern Enterprise System”
  - Liberalizing prices and production
  - Incentive contracting (Contract Responsibility System)
  - Given managers autonomy (14 Autonomous Management Rights)
  - Transforming firms into joint stock companies under the Company Law
  - TVEs and other non-state competitors
  - Creating large holding groups and state asset management companies
  - “Grabbing the large and letting the little ones go”

- Partly ad hoc, partly systematic, the reforms have yielded some positive results …
  - SOE total factory productivity rose
  - Greater competition (yet regional autarky)

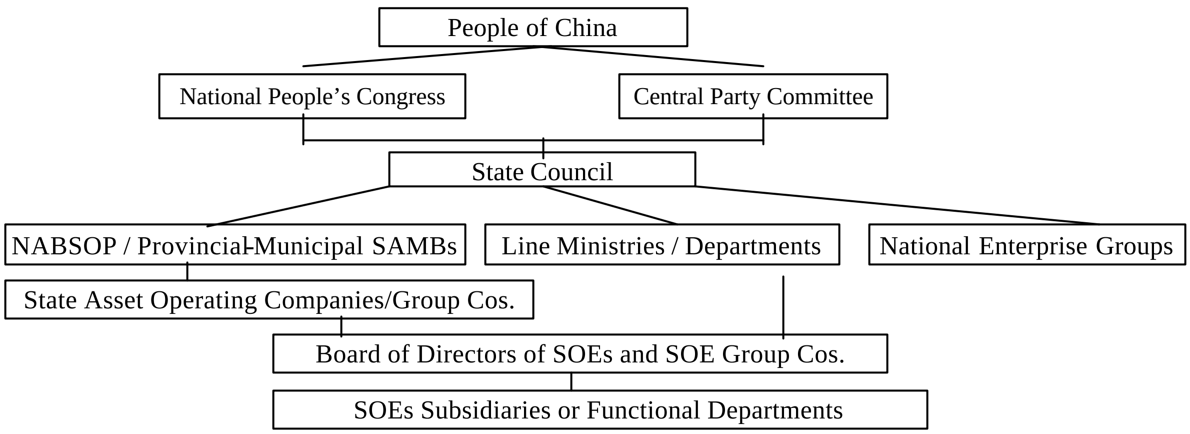
- … but the strategy also produced distortions and resource misallocation
  - Fuzzy property rights (who is the owner-investor?)
  - Managerial discretion, but governance vacuum (weak checks & balances)
  - Conflicts of interest (regulatory / commercial / social functions blurred)
  - Unduly complex organizational structures (horizontal and vertically)
  - Privatization of assets but socialization of liabilities

Reform of China's State Asset Management System

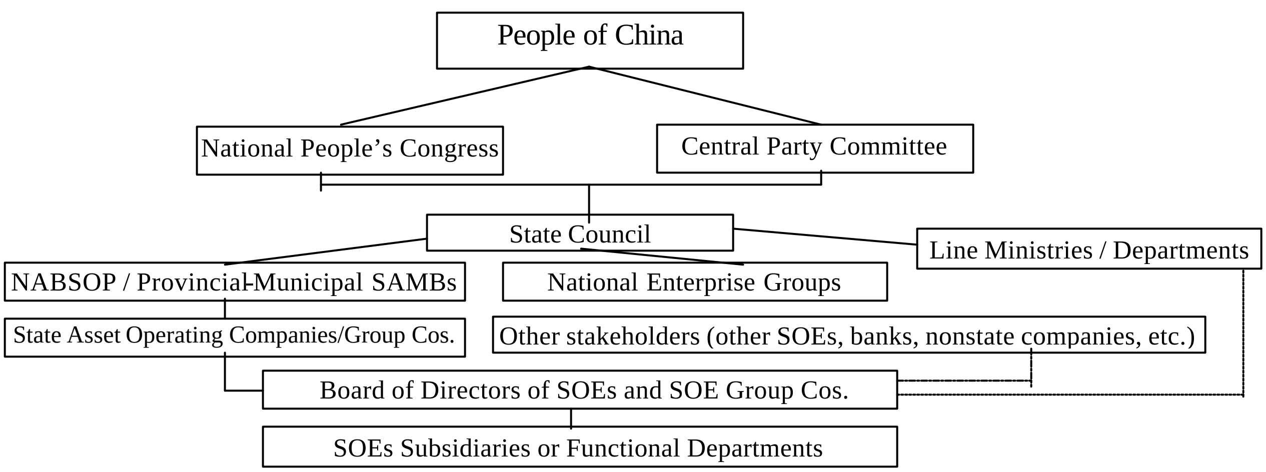
(a) ***In the past, line ministries/departments managed state assets in SOEs.***



(b) ***At present, enterprise groups (and other state asset management entities) are being introduced.***



(c) ***China's authorities plan to continue to phase out line ministries/departments; enterprise groups, other state asset management entities and other stakeholders will participate in SOE governance.***



China Will Still Need to Deal Head-on with Bringing SOEs to the Marketplace

- Record shows that past attempts at SOE reform have not met policy aspirations of the Chinese leadership

- Leadership willing to act pragmatically in the interests of economic development

- Great promise in WTO accession compelling further SOE reform: locking-in under international commitments will induce efficiency gains in SOEs

- Still, proactive steps are needed to decisively reorient enterprise incentives toward the market and reduce the state's *fundamental* involvement in SOEs
  - enforce distinct, commercial roles and incentives for managers and boards
  - allow for passive state minority shares managed by independent professional custodians…then fully privatize
  - simplify corporate organizational structures (away from large groups)
  - further "harden budget constraints" (no banking and tax subsidies)
  - reduce barriers to entry and foster greater inter-regional competition

Lessons: Overall Objective of Corporatization and Corporate Governance Reforms is to Make Enterprises Efficient, Profitable and Agile

- Most transition countries have moved along spectrum of enterprise reform

Commercialization => *Corporatization* => *Privatization* => *Restructuring* => *Efficiency*, *Profitability*, *Agility*

Corporate Governance

- Countries—such as Russia and China—have adopted different approaches and sequencing of reforms depending on:
  - Political and social conditions
  - Macroeconomic environment
  - "Initial conditions" of industry and market structure; rural vs. urban development
  - Government institutions and capabilities
- But they have fundamentally common features and lessons

Lessons: Modern Corporation Has Four Main Attributes

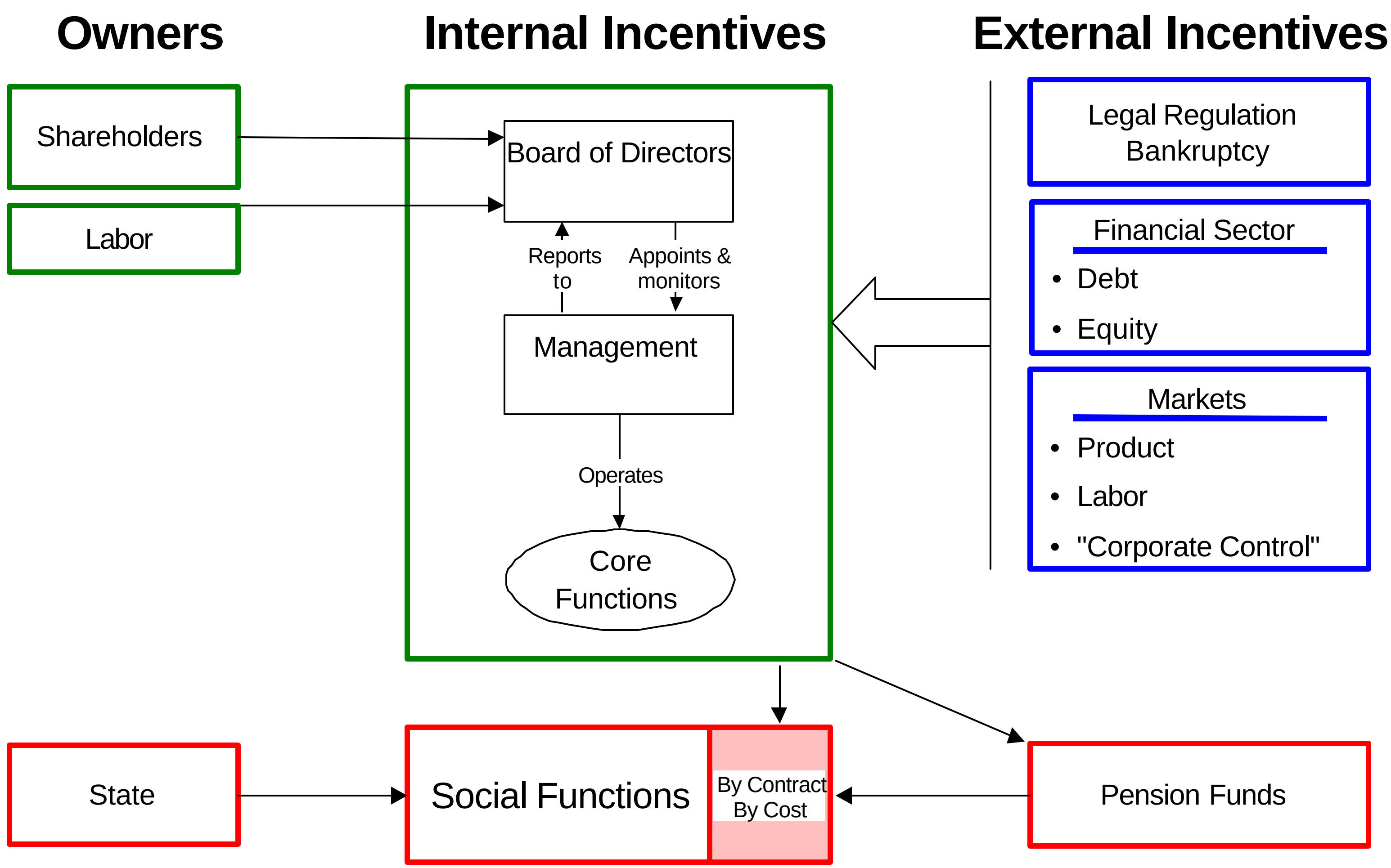
Separate identity. Corporation a legal entity distinct from its owners ("shareholders"), with clear definition and accounting for its assets and liabilities

Limited liability for owners. Owners' risk of financial loss limited to their contribution to the corporation's capital

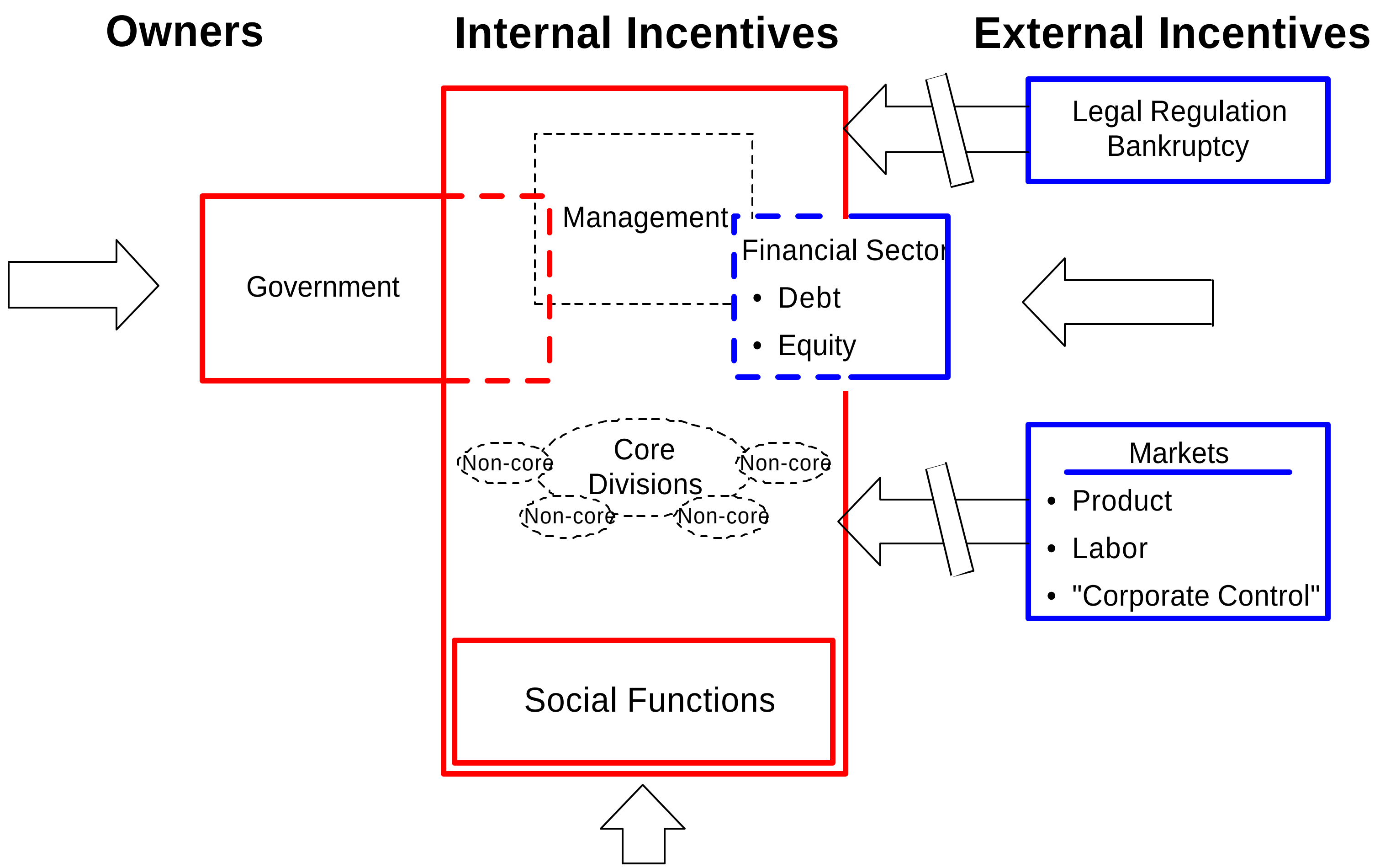
Centralized, autonomous management governed by board of directors. Firm's day-to-day affairs conducted by "managers", hired by the owners. Board of directors, elected by the owners, represents owners' interests, giving direction to management and carrying out oversight of managers' performance

Transferability of ownership shares. Shareholders' ownership interests transferable, and share transfer by an owner does not, in itself, change rights and obligations of the corporation with respect to its own assets and liabilities.

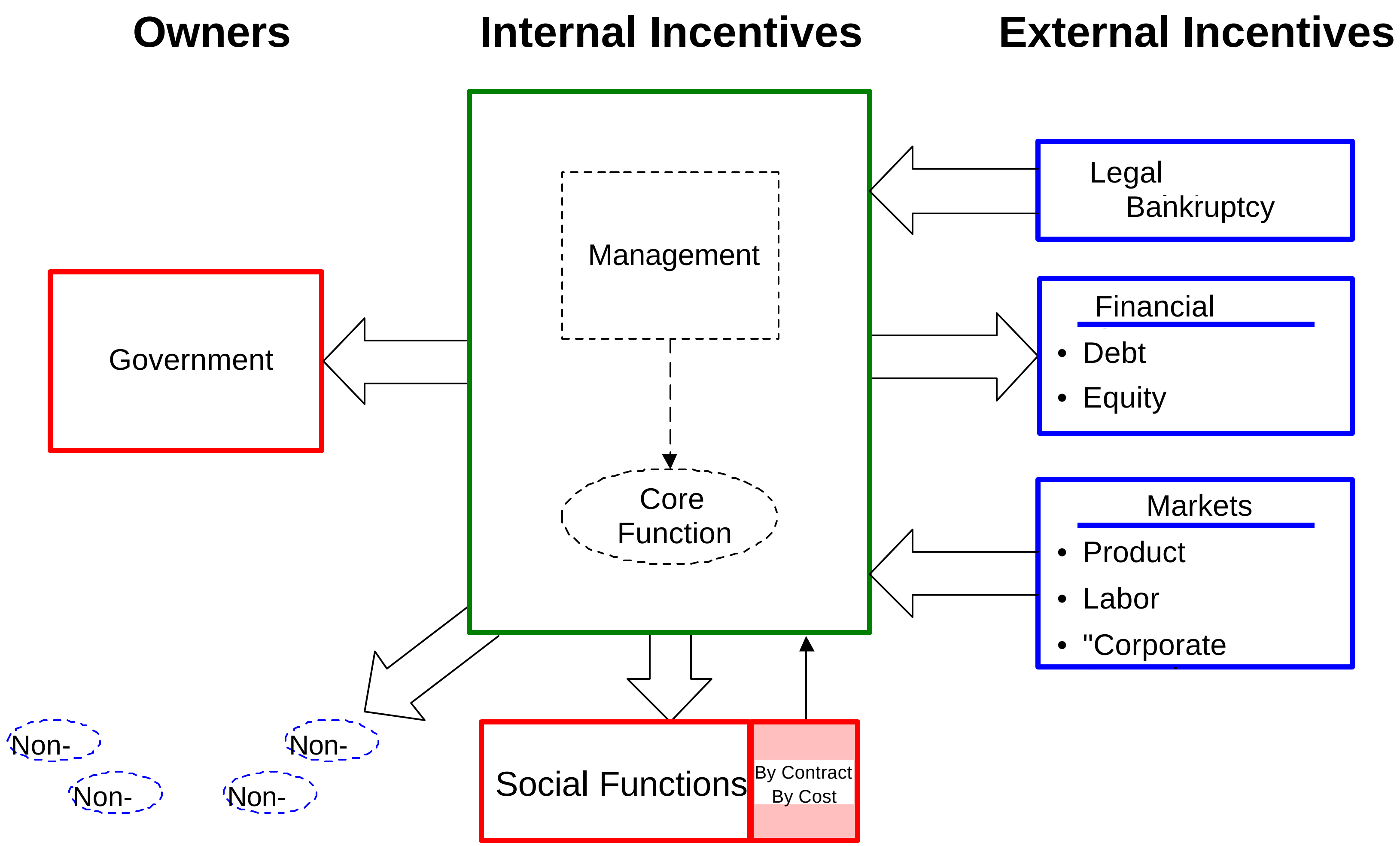
Lessons: Modern Corporation is Disciplined by Internal and External Incentives; and has Shared Social Responsibilities



Lessons: Typical State-Owned Enterprise has Blurred Boundaries and Functions; and Diminished Incentives to Perform Efficiently



Lessons: How to Reform SOEs: Change Internal and External Incentives



Lessons: How to Change Internal Incentives

- Clarify owner vs. manager roles; corporatize into shareholding companies
  - Delineate business functions from government/regulatory functions
  - Define and enforce property rights (asset ownership, use, and disposition)

- Divest share ownership to private hands
  - Can be done in phases with passive state minority shares first
  - Concentrated owners/strategic investors engender strongest performance

- Improve management structures and incentives
  - Elect independent, non-state representatives on boards of directors
  - Hire professional (non-political) managers
  - Use market/performance-based salaries

- Avoid creating large holding companies and financial-industrial groups
  - Simplify corporate structures

- Separate commercial from social functions
  - Establish social safety net for redundant workers
  - Divest housing, education, pension

Lessons: How to Change External Incentives

- Enforce "hard budget constraints"
  - Eliminate direct/indirect subsidies (input/output prices; bank credit)
  - Collect taxes
  - Eliminate enterprise-government and inter-enterprise arrears
  - Eliminate cross-subsidization

- Stimulate competition and enforce competition policy in product markets
  - Eliminate barriers to entry for new start-ups
  - Discipline incumbent anti-competitive firms
  - Replace discretionary policy with rules-based market regime

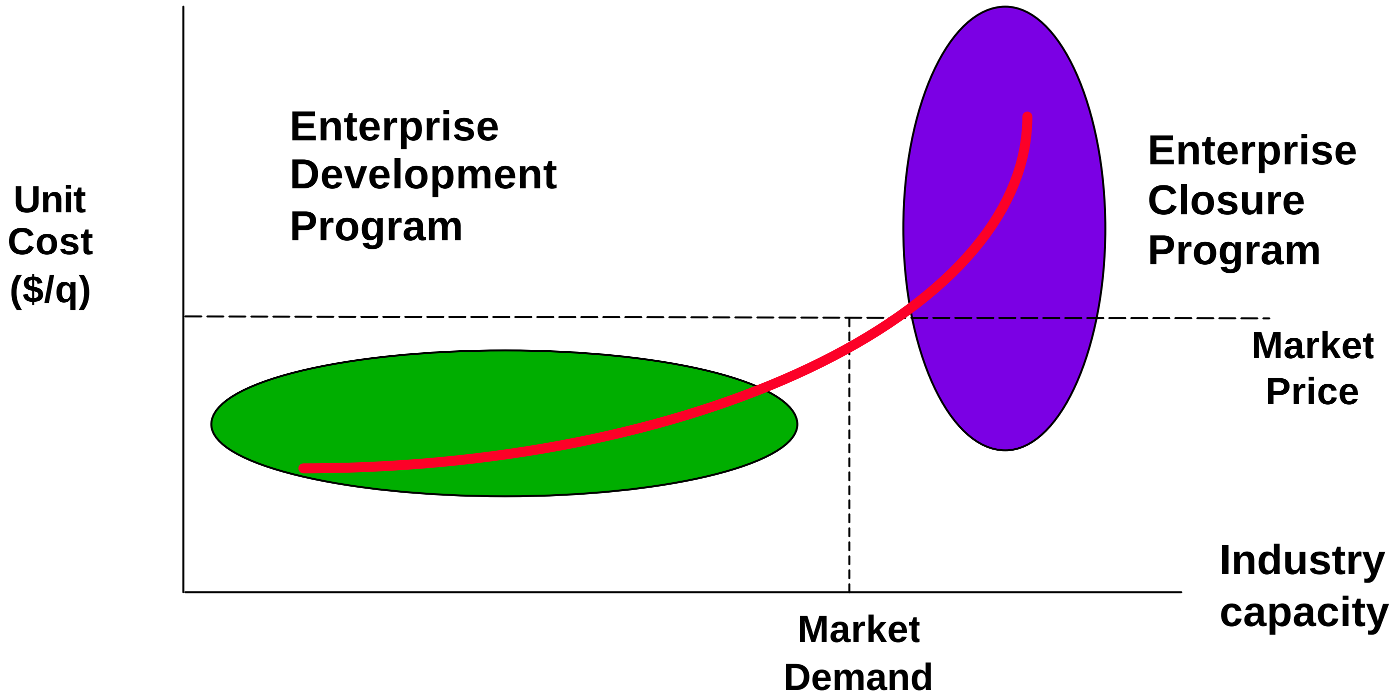
- Strengthen creditors' rights and incentives to reallocate enterprise assets
  - Facilitate bankruptcy procedures
  - Foster competition in banking and capital markets
  - Improve judiciary system
  - Require transparency in financial accounts through use of IAS and independent audits

Lessons: Delay and Lack of Follow-Through Can Worsen Problems

- SOE Losses and debt accumulate
- New firms and new jobs are crowded out
- Financial system weakens
- Firms become technologically backward
- Social funds go unfunded
- Growth slows down

Lessons: Divest Smallest Firms First; Carry Out Selected Divestiture/Restructuring/ Liquidation of Largest, Worst Performers

- Sell smallest firms first to gain experience, develop track record, establish credibility and draw investors to the market
- For the largest firms, pick worst performers to show that all businesses—even the most politically connected—must face the market
- Create space for new business development and employment growth



Lessons: Prepare to Deal with Social Problems

- Establish public support with *all* stakeholders for reform program
  - Build credibility for the strategy and time frame for actions
  - Outreach with workers, investors, managers, local governments, pensioners, educators.

- Dealing with social problems can be expensive, lengthy, and painful… … but steps taken in advance can reduce social costs
  - Stop public enterprise deficits
  - Accelerate job growth by eliminating barriers to entry for new firms
  - Promote mobility of workers
  - Unbundle housing, schools, health care, pensions etc. from SOEs: transfer to independent public or private entities
  - Finance adequate social safety net
  - Develop special policies for “one-company towns”