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Soviet Union - September/October 1990 mission notes transcribed 10 October 1990

USSR — Mission Interview Notes
J. Nellis
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THE WORLD BANK / INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: October 10, 1990

TO: Distribution

FROM: John Nellis, CECPS JN

EXTN: 37482

Subject: Interview/meeting/enterprise visit notes:Soviet Economic Study Mission

I attach a hard copy of notes taken in meetings in Moscow and Leningrad during the recent 4 agency mission to study the Soviet Economy. The main themes covered in the notes are ownership issues, enterprise performance and reform, and privatization. A report will follow, but some of you may find the details and nuances of the notes -- necessarily sacrificed in the larger report -- to be of interest. I attach as well: a guide/index to the notes, and a copy of a brief summation memo written just before leaving Moscow.

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J. Nellis -- Moscow and Leningrad

USSR - MISSION INTERVIEW NOTES

September 17, 1990, Moscow: Ministry of Justice; four officials. Principal presenter, Deputy Director, Mr. Golubov, assisted by Leonid Yefremov, Deputy Director International Relations Dept., a woman, Deputy Director Economics Dept., a man, Deputy Director Legal Dept for Foreign Economic Relations. Starts by saying they are willing to answer questions but they have no real knowledge on what will happen in the future; very fluid situation. Chief areas preoccupying the ministry: union/republic relations, a very complicated situation. Discussion at moment focuses on economic issues; planning process normally or formally used now in abeyance if not in disarray; plan for next year prepared but no one knows if or how it will be implemented. No general agreement between rep. and union govts.; a union treaty to define relations being drafted, but has not gone forward as anticipated. Some republics - Russia and the Ukraine - not cooperating, though he says they are "not clearly against" the treaty.

He says, revealing the extent of the disintegration of the union, that his ministry hopes to preserve and would like to see a national govt. with economic powers "a bit more consolidated than the European economic union." Sees substantial changes coming in the existing system of ministerial powers and responsibilities, with the major changes - and the major losers - coming in the branch ministries, which are likely to be greatly changed and maybe eliminated. (This would be in keeping with reform elsewhere; branch ministries -- along with planning commissions and trading agencies -- have been the biggest power losers.) Perhaps in the future there will be some economic advisory and regulatory agencies attached directly to the office of the President, he suggests. One concrete proposal is a Higher Economic, Council, controlled by the republics. (This is all speculation.)

Many fundamental questions of law to be decided. Their view is that "absolute priority" on a number of issues must be accorded in law to the union govt. if there is to be a successful transition to a market economy. (He views the recalcitrant republics as "spoiled children, stamping their feet.") The reps. see all power as in their purview, with the union govt. having only those activities expressly delegated to it from below, and that any union statement/decree outside the boundaries of its limited powers can simply be rejected by the constituent republics. He says the Ministry of Justice thinks this view is incorrect, and that economic realities will bring these strong republican views around to a more reasonable position. But it is true that the clock starts ticking on the 500 days plan in the Russian rep. on October 15.

Shatalin's commission, which evidently prepared at least 9 different draft laws on various elements of reform, contained no jurists; this upsets them greatly. As Manuel Hinds noted later, the program is being written by young and/or previously dissident economists, who probably expressly avoided the established legal and administrative experts. But this may pose an obstacle which can be used by anti-reformers, who could protest the reform plan's form, its lack of proper style, etc. Lots of inexperienced people throwing ideas about.

The Ministry is working on many items but simply does not know what the future competence of the Supreme Soviet will be. They say in effect: we can discuss the general ideas and the drafting of the will of the legislator but we do not yet know who the legislator will be, much less the details of the legislator's intentions. They refer us on details to the Abalkin Commission, "if it still exists." Nonetheless, in their view, the minimum legal requirements for any orderly transition to a market economy would entail legislation on:

1- law on single (all-union) monetary system; law on convertible currency;
2- law on process of all-union budget
3- law on union banking and bank activity
4- law on the issuing of financial paper
5- legislation on how the state will obtain its basic needs (this is more than how it generates revenues, and involves basic issues of property rights)
6- legislation on price formation specifying the period of transition, the prices that will be fixed and freed in this period, the process of precisely how to deregulate
7- general principles of civil law (now a republic matter and will remain so, but in their view there needs to be some general guiding all-union principles)
8- laws on anti-monopolization ("We are most monopolized country on earth." Proceeds to give a nice little speech on need for incentives that could have come from a public choice theorist, but then defends small sized collective farms or those producing a crop such as grain where the technology lends itself, in his view, to collective or at least cooperative production.) Council of Ministers passed anti-monop. decree on 8.16.90; an Anti-Monop. Committee will be formed and attached to Council of Ministers. Notes that Shatalin plan calls for such a committee to be attached directly to the President's office.
9- legislation on the basic rights of the consumer (admits shortage of expertise to draft legislation of this nature or on other subjects such as joint stock companies, limited liability issues, etc.)
10- laws on role of union government in infrastructure ownership and provision - transport, utilities, etc. Thinks rails will remain union matter while air and sea transport will be broken up and privatized on republican level. They want to ensure minimal all-union regulations on standards, safety, service
11- union level provisions on emergencies - financial responsibilities; e.g., for radioactive materials problems
12- law on labor market, to protect, apparently, rights of labor mobility across republican borders

On this matter he notes that it is no longer a problem for a worker to move from one area to another, at least administratively, and at least outside the major towns. The problem is housing; there is no housing market. We discuss the possible privatization of housing. Already possible in some ways and places in the past year, he suggests, and will become more widespread under proposed reforms which say in essence, those with <18m2 per person will get their existing housing free; those with >18m2 per person will pay some premium, presumably on a sliding scale according to space. Have many purchased over past year? Hard to say but thinks not. Why? If one buys then the up-keep and maintenance becomes a personal responsibility and obtaining materials and parts is a next to impossible and expensive job. The state may have been an inefficient landlord, but it was cheap and eventually the major repairs would get done (poorly). So this is a disincentive to purchase. On the other hand, the price is apparently very low -- set by local Soviets -- and someone with assets or access and of a speculative mind could probably make a killing by buying now and positioning himself for a capital gain of considerable proportions when and if a housing market emerges. (But next day our interpreter tells us that the Moscow Soviet has informed her she and her fellow tenants can buy the apartments they live in, but at a very high price that she estimates as equal to 10 years of her present salary; whereas her present rent, phone and all other utilities equals 5% of her salary. She sees no reason to buy the apartment; she already has the capacity to trade it for another apartment is she wishes, she is the 3rd generation in her family to live in it, and the payments have always been small. She is concerned that the rent will be raised dramatically under the new economic situation; if this happens then she may change her mind about the desirability of buying.) But the final question is: if you sell your home, and make a great profit, where do you go if there are very few other houses or flats on sale?

13- law on foreign economic regulations needed; customs, foreign investment, unified all-union regulations on foreign investors, unified system of accounting

Golubov's major point or hope is that the republics will come round and accept a stronger union role as economic reality sinks in.

<u>Committee on Light Industry</u> (formerly Union Ministry of Light Industry): Messrs. Adamaiatis (?), Deputy Chairman and Head of Foreign Relations, Romanov (textiles), Antonov (footwear and leather goods), Stepanov (foreign relations; speaks French, 4 years in Algeria on TA). Committee was formerly a ministry, part of the GOSPLAN. Changed to a Committee after 1989 reform to denote a change in operating philosophy from a direct allocator of resources based on command planning to a more indirect form of guidance and supervision, and one that would establish a "closer working relationship with the republics." Says that if the decision is made to move to a market economy further changes will be required, and if a full market economy emerges then there will be "no need for offices such as this."

Starts: hard to say what the future will bring. Their status and future in question; hard to imagine that they approve of what is happening, but there is no apparent resentment or active disapproval evident in the conversation. This committee supervises 30 branches of industry, with a total of 4,000 enterprises, having 720,000 employees (something wrong here, since this would give average size of 180 employees and he said some firms are very big, with as many as 10-15,000 employees in some footwear factories. I think translator meant to say 7.2 million?) Knitting, sewing, textiles, fabric production, porcelain, leather, footwear and furs the essential sectors. Also oversees certain aspects of export promotion and arrangements. Committee also negotiates with foreign firms for inputs or large amounts of consumption goods, "which is new for us."

Since the middle 1980s enterprise autonomy has been increased significantly. Enterprises may now, without any approval, carry on foreign trade, take credits from foreign trade, cooperate with banks and other enterprises; previously they could not do these things without official review and permission. More autonomy is coming. The responsibility of the committee is the realm of inter-enterprise affairs; they devise industrial or sector standards, produce guidelines on investments, carry out scientific R & D development and cooperation, help in supplies of raw materials and cutting edge technology. Before the reforms, all enterprises were "subordinated" to union ministries through republican ministries; now, enterprises are "subordinated" to republican ministries -- which in many but not all cases have also changed their name and operating style to "committees," for example, in Russia, while others, such as Byleorussia, retain ministries of light industry. The change in approach is summarized as: "before, we were in command; now, we render assistance. We do not interfere in operations of the enterprises."

Question: are you still producing according to a plan? They say no, and then explain. A plan for the sector is still produced in cooperation with GOSPLAN. Planning Commissions on republican level break plan down. This is just as it was in the past. First change: enterprise is now apprised of the targets and can, and often does, protest and insist on negotiation of new targets. Couldn't they always do this? No, now much more powerful, more strident in defense of enterprise position. Second major change: enterprise produces "state order" portion of production, according to the extent to which the production of the firm is regarded as strategic or essential. In foodstuffs and children's clothing and heavy industrial areas, high percentage of production falls under the heading of state order (and other group reports 60-80% of heavy industry production is under state order). In light industry, state order production varies from 0 - 80%, with 30% of firms having no state order and many firms having only 10 -30% of production in state order. The state guarantees input provision for the state order amount of production.

Sales: enterprise sells state order to the state at guaranteed, fixed price. Then goes out to quasi-market, in the form of republican industrial fairs, to sell remainder of production. Wholesalers and other enterprises can purchase, apparently using state order price as a floor, and they often bid above state order price to obtain products. (If this is correct it is unusual; most other actors interviewed said that even above state order production is still being sold at state order prices.) Enterprises obtain their inputs for above state order production in the same manner (or resort to barter deals, though we do not discuss this). Their point is that this is no longer a strict planning process, since the managers provide advice, have much more leeway and independence of action than in the past, and can even -- partially and sometimes -- adjust prices to reflect variations in input costs. Director, who was himself an enterprise manager in the old days, is at pains to express to us what a new and different world this is for him.

Did these changes come about as a result of 1987 enterprise law? Sort of; that law extended and codified, he says, changes already in effect and working through the system, and gave them legal status. Has all this had a positive effect? Strange story: he says, changes definitely resulted in increased production (but only cites one figure whereby one shoe company went from 710,000 pairs to 800,000 pairs after the changes). But shortages are greater than ever and indeed now extremely acute. How to explain? One possibility: changes have been accompanied by higher general salaries which have been used to purchase consumption goods; demand has grown faster than supply. Second, uncertainty regarding economic situation has led public to panic buy and hoard all consumption goods. Third, allowing some firms to export has led them to divert production to export markets. (Unstated fourth possibility: the figures showing increased production are wrong?) Big problem for the firms is the lack of raw materials.

Enterprises can now import without approval or licenses, he insists. License for exports still needed. Enterprises can normally retain 50% of all for ex earned, and can submit for higher %, up to 100%, in case of special need for imported inputs. They can sell excess for ex to other firms or banks, but at official ex rate, meaning that most firms hang on to for ex to purchase future inputs. Of their firms, about 10-15% export, particularly in textiles.

September 18: Ministry of Electronics Industry, Mr. Tnauri, Vice Minister, Mr. Sokolov, President of what appears to be an enterprise in the ministry's control, and a 3rd man whose name and function I miss. This ministry deals with: integrated circuits, microprocessors, VCRS, calculators, watches, transistors, semi-conductors, microwaves of several sorts, TVs, lots of other electrical gear. 1,000+ entities -- factories or plants ("zavod") and institutes employing 1.5 million people. Previous system one of ever expanding, ever increasing vertical integration; idea was to self-produce a guaranteed stream of inputs, given the need to fill a quota, and the unreliability of obtaining the planned inputs. Admits this led managers to underestimate production capacity, to hoarding, to building everything one's self, to huge cost inefficiencies. They saw themselves responsible for all aspects of the operation, from product design, input obtention, through to the sale and service of final finished goods.

Example: they got into computers, not because of plan or planners or any willingness or desire to produce computers for sales, but rather because they needed computers to automate their own production lines. Formerly had considerable military production in the microwave field, now in the process of conversion. Sharp decrease in military production in country translates into "very much" decreased state orders in many of their firms. The conversion from military products to consumer goods is not as easy as they envisaged. They have highly qualified workers, engineers and managers, but are finding it hard to produce in cost effective fashion (which was not an issue in military production).

Vice Minister's main story: previously we were isolated from the rest of the world and did not keep up with technological change. Our lack of specialization of tasks led to our trying to meet special needs internally, with high cost, small production runs. In the early 1980s, recognizing our problems, we attempted to obtain on license technology from capitalist country firms: RCA, Owens Illinois, Nippon Electric, etc. At that time we had financial resources to pay for this cooperation, but we were blocked from concluding deals, both by internal bureaucracy and resistance to trade potentially military technology from some foreign govts. Now the administrative/political barriers are much reduced but we have great difficulty in obtaining the financial resources to conclude needed arrangement -- but we are going ahead with cooperation as much as possible. We are in contact with Korea, Japan, IBM, Apple, Commodore, DEC and Intel; we want joint production in PCs, TVs, VCRs, microwave ovens, all sorts of electronic goods. We must increase production of high quality consumer goods.

Relations of enterprises with ministries greatly changed in last few years. 5 years ago "rigid centralization;" now, much more autonomy at enterprise level especially in production decisions and foreign trade for export. State order still exists; accounts for 75% of production in average electronics firm, but is going down "at high speed." Enterprises are creating their own foreign trade organizations; they are free to enter into all arrangements not requiring state financing. Their situation is that they are not really in the market but they "have lost some of our important tools from the previous command system." Key point: much more difficulty and uncertainty with regard to the provision of basic production inputs. We used to have a stable situation with regard to supply, to finances, to production targets; this is now gone. (In the case of this ministry this is said without apparent complaint or nostalgia, unlike the situation described in the next ministry visited, Metallurgy.)

Some enterprises and managers are searching for ways to turn this situation to their advantage. Ideally, they should shift out of production lines for which they perceive declining demand (he doesn't use the word) and move to high demand consumption goods, but the flexibility to accomplish these shifts is absent. They can't re-tool, they don't know how to get inputs for new product lines, and suddenly financing is very tight. Why all these problems? "Because of our isolation from the rest of the world." What do we need? A convertible rouble.

Only a few enterprises in his ministry are selling -- a small amount of production -- to hard currency markets. Circuits, TV tubes, TVs -- but he sees big possibilities for future because some of their components are of high ("pure") quality, particularly in microwaves. Enterprises can retain 36% of for ex earned (actually, 40 - 4% to ministry). This is going to be raised. Sees most important asset as large number of high quality engineers.

The ministry has a budget for research and for capital construction. It is funded (partly? mainly?) by part of profits earned by enterprises. It has maintained a centralized fund for special purposes. As of 1.91 there will be no more centralized reserves; all monies will be in the hands of enterprise managers and ministries will be funded or not on the basis of enterprises decisions. The notion seems to be that they must earn their monies by providing services and assistance that the firms will value. Vice Minister says firms need the financial assistance and advice provided by the ministry. They want total independence in theory, but they are starting to see the utility of the ministry's assistance, particularly in raising funds. "They will come back to us," he says. Still, the ministry now has 30% less staff than 5 years ago; still employs 800 people, but reduction of staff will continue. Complains that while Supreme Soviet has increased autonomy of SOEs, they still come to him and demand that action be taken when things go wrong.

Ministries have lost their power to command enterprises, and their control over resources that legitimated their command, but still are held accountable for enterprise actions.

Privatization: yes, but in the future. First, transform SOEs to joint stock cos. So far an intention, many steps remain -- decisions by govt., followed by enabling laws. Many contradictory statements presently being made on these matters and "I would like to know where I am" so he can get on with business. Price controls bothersome; state says all producers of an item should charge same price regardless of cost differences. <u>This should be the first thing changed</u>. Their non-state order production is sold at the same price as the SO production. Only price differences are those where state wishes to stimulate production; some variations then allowed. Small variation in product can lead to large difference in price; firms spend great deal of time varying marginally items to justify price increases. Black market strong for electronic equipment; double in general official price. After changes, production is increasing, but not as fast as before.

<u>Ministry of Metallurgy</u>: Mr. Radikevitch, Vice Minister; Mr. Mihilka, Financial Director, Mr. Fonick, Capital Investments, Mr. Zlokazov, External Economic Relations + others (spelling uncertain of names.) Huge ministry dealing with mining, ferrous & non-ferrous metals, scrap, ores, metals, steel, iron, copper, aluminum "74 elements of the periodic table." Support, maintenance and repair shops in hundreds, research and development institutes, foreign trade agencies, etc. plus enormous social services to workers. 3 million employees in thousands of firms. Ministry itself employs 1000 people.

These officials convey the attitude that the past situation was preferable because it was "stable" and predictable. The present situation is chaotic. The increased independence of enterprises in last few years has led to a "bit of everything," with some firms showing increases in production, some losses and some not registering change. In the present set-up the "braver the manager" the more he can take advantage of the new system." Still, Radikevitch insists that "long term problems require centralized planning;" independent managers -- in either public or private firms, he says -- will only take a short term view (a traditional defense of planning, belied by experience in pollution, for example). He repeatedly states that "limits" on individual enterprise behavior are desireable and necessary.

As ministerial influence has somewhat declined, what he calls "concerns" have sprung up to provide needed coordination services. These appear to be groupings of firms in his ministry, arranged on either a geographical or thematic basis (or both), that attempt to cooperate and solve some problems of supply. There are now about 20 of these, some very large -- for example, all scrap firms have banded together (200). Noted that firms are now able to opt out of ministerial control patterns and some -- nickel industry -- have done so, only to request re-entry (he says with some satisfaction). Mr. Radikevitch doesn't want "to go too far," he wants to avoid "extremes," he thinks the govt. should allow some change in enterprises but "monitor closely the situation," he wants to retain the good features of the old system, "privatization is not planned," he sees a need for a dual price system, he thinks one should not form enterprises into joint stock companies until the Supreme Soviet has clarified policy <u>and</u> all necessary laws have been issued; in short, he is a conservative, a gradualist and a fairly unrepentant intervenor.

He does agree that price liberalization would help correct the existing distortions and says in USSR "prices are more distorted than anywhere in the world." But what he says is desireable is freedom to set his output prices while his input prices remain fixed. He notes that all enterprises are allowed to earn foreign exchange and keep a part of it (50% normally; some variation noted with firms justifying heavy import need being allowed to retain 100%), but it is clear that few of his enterprises actually do this. When it happens the ministry deducts 10% of the for ex earned for its own needs. In barter arrangements, which are more common, the state gets nothing. Notes that the average state order is 95% of production; very high -- as it appears to be for all intermediate goods producers. If an export is made under state order, the enterprise gets none of the for ex earned.

When asked if bankruptcies are necessary or will be enforced he answers: if a bakery, which is an individual and clearly isolatable unit of production, persistently performs poorly, then it should be closed. But a Soviet enterprise is not so isolated; it is always, inevitably, deeply interconnected with a large number of production units and therefore its performance cannot be judged in isolation. I doubt this is true; even if it were the solution would be to isolate the unit as a cost and profit center so as to effect a definitive judgement; but this is alien to him; he thinks in terms of systems of units of production, and not in terms of costs and benefits. His overall attitude is revealed by his comment on the present debates between republican and union supporters: this is a "temporary euphoria" that will pass.

19.9.90: Ministry of Machine Tools and Tool Making; Minister Nikolai Panitchev and 14 colleagues including A. Markin, Financial Director; V. Marinin, Gen. Dir. of Stankoimport (trading agency); V. Galkin, Chief Engineer of Krasny Proletari factory; Deputy Minister Oleg Koroljow; and many others. 500 entities, of which 370 are separate legal persons (or full-fledged SOEs, we would say); 600,000 employees; 14 specialized directorates, with a production of 9 billion R annually, of which 45% comes from machine tool production. Also make consumer goods, motor blocks, ag. machinery, toys, etc. 5 years ago, ministry had 12 departments and 1450 employees; today a "2 tier structure" (?) and 500 employees. The ministry now directs, guides, advises, assists R&D, provides standards, helps on taxes, promotes foreign trade and training. A concerted effort to convince us that they have almost completely renounced planning and command mechanisms and have become "lobbyists" for the firms in their group, to the point where the minister talks of disbanding the ministry and reforming it as a joint stock company that will interact with other joint stock organizations. In contrast to Metallurgy, an apparent welcoming of change, a recognition that more is coming and that opportunities will surface, and a feverish effort to position themselves and their companies to take advantage of this change. Management and production functions are now in the hands of enterprises; the ministry's future job is to assist the enterprises to transit to the market, and to protect the interests of their enterprises in their relations with the state. Admits that the retention of partial planning -- though only 14% of production is (or soon will be) for state order, on average -- forces some intervention in firms, but sees this as ending.

Major changes began in 1988; they no longer do plans, enterprises do this on their own. But structure of ministry no longer makes sense in the new conditions. Thus, we have experimented with cooperatives, leasing operations, are working on JSCos (Stankoimport) will be the first. We studied the experience of other countries retaining a large state sector -- e.g. Austria -- and concluded that JSC status was the best arrangement. Says almost all firms in the branch agree that JSC status should be obtained ASAP, and -- as noted -- holds that even the ministry can use this form.

Problems: old and obsolete capital stock needs replacement, they must have increased production and increased accuracy of machine tool equipment to meet demands of customers. "We are behind, well behind, leading countries." But financial resources not available; they are investment starved. (All day pitch to the World Bank and indeed any possible source of finance to lend; cites "studies" showing that between $500 million and $1 billion would do the job nicely.) Complains that despite sector's prime significance, govt. is directing available credit to other, admittedly "important" sectors.

Consumer good production not sufficient; entered into licensing arrangement with Italian firm to produce 400,000 washing machines. Says they must introduce production system used in western countries. He wants to shift from large vertically integrated firms to small firms producing specialized products. States that excessive vertical integration has been at the root of the problems of Soviet industry, leading to small product runs, high costs and little technological innovation. The first step: constant contact with potential foreign partners. Lack of money the rest of the problem -- particularly with the massive losses seemingly coming from the demise of CMEA trade. Now worth 500 mill R a year to his ministry's firms (later someone says 350 million R, falling to 50 million R in 1991; they say this would cut their production by 4 billion R); can't pay with barter any longer, and will move to HC payments, in world prices, by 1.91. Sees this leading to a drop in export earnings of this ministry's firms to 1/7 of previous levels, at least in short run. On hard currency trade, firms retain 40%, 10% to ministry, 50% to state. Says some firms could export more but heavy domestic demand takes precedence. HC trade worth about 100 million R a year to them.

<u>Finance director</u>: enterprises now self-accounting and using cost accounting methods, and there is "equality of all forms of property" -- leases, coops, SOEs, JSCs; for example, there is equality of taxation for all forms of enterprises. Positive differences in firm level ops. since introduction of changes in 1988 is that average enterprise debt 20% of what it was, due to better use of available resources and cost cutting (and what might be increased cross-subsidization on sub-branch level through the creation and use of firm-related commercial and cooperative banks?) Enterprises are increasingly financing their own operations, he says, but then immediately talks of "credits" and "budget allocations," with the former used for "production purposes" and the latter for "national economic needs." Says or implies that in many cases state set prices did not allow firms to cover variable costs. (Then how could they be self-financing? May be a translation problem; E. Folkerts-Landau says the term is

sometimes used by translators when "self-accounting" is actually meant, and as shall be seen, this turns out to be the case here.) Since this was the case, to correct the situation and set the clock on zero, loans will have to be given to those enterprises that are presently in bad financial shape due to government imposed low prices. This will put all enterprises on an equal footing and allow them to start to compete against one another. (A good example of the social, as opposed to economic way of looking at the problem.) The basic problem of the past -- "the planning system failed to provide incentives for increased production." (This is followed by a review of major technical problems.)

Enterprises in branch import 350 million R worth of material a year, particularly those firms producing for export. Long answer to simple question of who coordinates component purchasing from other branches, firm or ministry. Basically, semi-independent ministerial agency deals with this, but now as an agent rather than a direct allocator. Some enterprises deal directly with other branches and suppliers, but this is still mainly a ministerial responsibility. These relations are increasingly unstable, with many suppliers not fulfilling obligations, as they can find other, more profitable outlets for their production. (At above state order prices? Not clear; nor is it clear what one does when a "contracted" order is not filled.)

Notes that only in 1990 did state order production fall to 14% level; before that SOs accounted for 47%. How was and is the rest sold? Remainder has gone to GOSNAB (at SO price), but in future they will sell "freely." How will the free system work? Unclear, but evident that prices will be tied to an SO floor. They agree that the price issue is crucial but argue that neither they nor anyone else is prepared for complete price liberalization. Too many rules of the game are unclear.

Non-state forms of production: JSCs - everyone talking, none yet in existence, Stankoimport will be the first. Some large entities being divided into smaller units to meet the legal requirements for small businesses (much more freedom of action). In several places "people" in enterprises have approached the ministry with offer to purchase firms or parts of firms. Private property issues not resolved in law, but clear that much speculative and positioning activity is taking place (and I suspect they are going to have <u>major</u> problems with spontaneous forms of privatization; enough to make the situation in other Eastern European countries look mild in comparison). 62 general agreements with foreign companies in existence for technology and 8 licensing agreements. Lots of training abroad - 100 officials this year alone. Now buying fewer licenses; looking for technology transfer of a more enduring nature. Several joint ventures (11?) in operation.

Biggest change since intro of new system is psychological. Managers are now counting money; they never did this before. <u>The good ones are seizing opportunities rather than following orders</u>. The attitude change and the need to generate profits are the most important aspects, they say. They say their enterprises better than others and that in the last three years, in a period of general production declines, they have managed to maintain 4-5% annual increases in physical production terms. Danilov of Economic Dept. says 75% of enterprises are in good shape after 88 changes, and these register production gains in the 7-8% range. Thinks that these firms will not have much trouble in adapting to new conditions. The remaining 25% pose problems -- introducing them to market will create "big losses." (Says ministerial rate of profitability -- P as % of costs, or markup --is 37%.) Notes also that <u>all</u> plants in the branch are monopolies or close to monopolies. With state prices,no problem, but with free prices these will require state regulation. (Or a break-up of the monopolies?)

Visit to <u>"Krasny Proletari"</u> (Red Proletarian) <u>Machine Tool Company</u>. V. Galkin, Chief Engineer and O. Koroljow, ministerial official who was head of this firm. 4 plants in country. First firm in ministry to escape from old foreign trade regulations and to put the new autonomy to use. Produces 6,000 units or finished products a year. Some use of CNC methods of production. Their output was 1,000 units a month 5 years ago; now 500 a month (of higher or more complex quality? higher unit value? decline in demand? halving of production not explained).

They have 4,000 employees. They use 400 different suppliers. Between 50-60% of cost content of components used purchased elsewhere; 40% made in their own plants. Much expected of new production using new machines. They are in a joint venture with a WGerman firm called EMAG, which supplied new materials for new machines. Took 18 months to work out the details of the JV and get in operation. Seems to be a true JV (many forms of simple agreements appear to be called JVs in the Soviet Union) where the WGermans invested, and the two created new company, jointly designed a product, trained staff, produced tools, jointly marketed product in Europe and USSR. 50-50 capital investment of two partners. All this moved slowly but now coming to fruition with items being produced and sold in the two countries. No government interference on price setting (in foreign markets?); no subsidies for production.

<u>Very</u> confusing story on how the price for the company's product is set on the Soviet market, and its relation to the export price. They say: normal Soviet tax on general profits runs from 45-55%, but profits earned in for ex are tax exempt. What they mean is that govt. simply takes a hefty % of for ex earnings, calculated in the following way: if an item sells for 100,000 DM the company first deducts all costs of production, including imported components, licenses, consultants, and all labor and local costs translated into DM at the official exchange rate, from the revenue. Say this comes to 50,000 DM. Govt. then takes 60% of the remaining HC profit, which amounts to a hefty tax. Remainder is the company's profit, which they can use to buy more HC inputs, buy shares in foreign companies, or buy goods for employees -- a common use for HC. And they say that they can and sometimes do sell excess HC to other enterprises at rate different from official. About 20% of enterprises in the ministry have an export potential, with experience in foreign trade and products with solid market or good potential.

Future relations with the ministry: there will be no ministry. It will evolve into something new and different, a lobbyist for its companies or perhaps something on the order of a holding company -- but the lack of clarity on the ownership makes it difficult to see what kind of a holding would emerge. What is clear is that the relationship must be restructured, from a hierarchial authority to a partnership. (The force of this statement is diluted by the fact that the questions are asked of management and it is the garrulous official of the ministry that constantly, and at great length, answers.)

Workers Council: 70 members, elected, meet at least once or twice a quarter, and they elect management. This relatively recent innovation (before: ministry appointed manager) will end on 1.91 when new enterprise boards come into being. According to the law, the boards will be composed half of workers reps. and half of reps. of owners; these boards will either appoint the manager or approve the appointment from the outside. Impression is that the workers councils are docile, relatively unimportant bodies, without much sense of residual ownership rights such as existed in Poland, Yugoslavia or Hungary.

Visit to Stankoimport: 60 years old. First imported machine tools; began to export after WWII. Turnover of $2 billion in 1989-90, 3/4 of which was imports. They have JSCos in 7 countries in Europe and Canada and Mexico. They have subsidiary companies in 42 countries and agency agreements in others. They have 430 staff, huge central showroom, wide range of contacts, much experience, access to and experience with financing. Plan soon to transform to JSCo; would welcome foreign partners. Goal: to deliver to partners and clients best products at best prices. At present ministry owns our property, and is our only shareholder. They see 3 types of shareholders in coming JSCo.: workers and staff, holding a minority share of around 15%, which they buy at preferential rates. These shares special, since they intend that workers share would remain at 15%, regardless of future capital injections. Other shareholders: other SOEs and the ministry. How many shares? 20 million R worth, at 1,000 R par value per share.

How can workers share fixed at 15% be reconciled with new enterprise law stipulating that half of board will be elected by workers? Well, they say, perhaps we will make ourselves into a limited liability company which, apparently, might escape the regulation of the enterprise law with regard to boards. It all seems speculative and ad hoc.

Nonetheless, the real issue is that they are looking hard to find a continuing role in the changing circumstances. They admit that "it is no longer popular to be a trading agency;" and these bodies have been eliminated in some other ministries (and in several other post-communist societies, one might add). They now have to compete with other service organizations, some of them other former state trade organizations, some of them coming from within enterprises that have, it seems, long resented using the agencies for activities they think they can do themselves, and some of them coming from coops and new JVs. So far the competition is not strong, and they are trying to get a jump on it. Some 8 firms in the ministry have already stopped using their services (no longer obligatory) and they know they will have to work to bring them back. These men say they have the networks, the contacts, the experience, the access to finance, the marketing skills, a package of services -- ads, transport, customs processing and clearance -- that will allow them to compete. Prices/fees: negotiated with customers, no state controls.

Our country's problem in exporting, they say, is not simply low product quality, but our producers don't know foreign languages, they aren't familiar with foreign travel or norms, and they can use our help. Says despite all problems ministry's exports to HC countries doubled in past year, and they are looking to maintain and expand this market. In sum: they see a different future and are trying to perceive where the opportunities will arise. They are set to decentralize, to diversify, to export, to involve themselves with foreigners, to innovate and lighten administratively. They do not know exactly what is coming but they are making an effort to place themselves in a position to survive, and maybe even thrive.

20.9.90: Moscow: Textile Factory, "Three Mountain Manufacturing Combine": Mme. Balaskovkaya, Director, plus financial and economic directors Mmes. Chernova and Balkin). Integrated factory on 9.5 hectares of prime central Moscow real estate across from Ukraine Hotel; producing 200 mill meters a year, 3 shifts a day, on majority imported equipment. Recently spent $4.5 million re-tooling for spinning; weaving done on Soviet machinery, but investigating prospects of buying imported equipment. Workforce 3500, 2600 female. Formerly a production unit with all inputs supplied, all targets and decisions imposed, all prices set, all production taken away and marketed. Here is the plan, you fulfill it. Even if a potential buyer saw a pattern, or ordered a pattern, the pattern had to be submitted to a central review committee which could and sometimes did reject the order on the grounds of "taste." Financially, banks were not our partners but our controllers, with "tons of paper" required to obtain credits, and much depending on personal relations. Now, vastly changed system and mostly all for the better. The enterprise has direct contact with the suppliers, it determines the volume and kind of production, the assortment and patterns to be marketed. Some attempts to direct us are still made, but we are in a position to resist directives we regard as ill-judged or useless.

How are inputs obtained? If the supplier is within the Russian republic then the enterprise itself handles contacts and arrangements; if the supplier is outside this republic, then they use an agency of the Russian republic government -- and they are worried about the breakdown of inter-republic trade that might result from the worsening political situation since some of their most important materials -- e.g., cotton -- come from outside Russia. In some regions, barter trade is used. She has one person working full time on supply obtention. They are now more free to design products to meet demand.

To date, all of output has been sold at the same price. Before they had 100 % SO, then the SO was cancelled officially but nothing changed in practice. Now, real change appears to be coming; the SO for next year will be 40-60% of production and the rest will be at the disposition of the firm. This, she says, is "very interesting." But there is great uncertainty about the future and considerable concern over stability of input supply. A branch of the Moscow Region Bank will be opened "on the territory of the enterprise," and this will, it is hoped, ease their obtaining of credits for working capital. "The Bank wants the firm to be profitable." (Exactly how this works is not clear, but Yugoslav experience -- where too close a relation between banks and enterprises led to catastrophic performance of both -- makes me nervous about these developments.)

They can now choose ownership arrangement and workers and management -- mainly management it is admitted -- are talking with the ministry about the possibility of leasing the enterprise. They've been thinking of this for 3 years. All "inspired by the ideas of perestroika." Our economy was sick and in need of care; we have to work on improvement of quality and attention to costs; "we have to run with our heads and not just our legs." Increasing production not their problem; producing higher quality goods at lower cost the issue. She seems knowledgeable and competent.

Investment financing: from where? Rouble investment costs are mainly self-financed from the enterprise "development fund." HC investments different; before, state planners determined acceptable or needed capital improvements and allocated for ex from union budget; passed on costs to us in rubles partly as credit, partly as loan. They paid and pay at official rate of exchange. At the moment they are paying a "long term credit" of 10 million R, that I gather was for imported machinery. Considerable confusion over what rate of interest they are paying, or will have to pay, for the loan they obtained to pay for imported machinery. Rates of 33-46% suggested (as opposed to 6% for rouble loans, though this may soon rise to 15%); perhaps the high rate is a way to offset the unreality of the official exchange rate? They also have a "credit for economic needs" of 11.5 million R. At the moment they export 3-5% of production, mostly to CMEA countries. The Director says they could export all of production. Their for ex retention rate will be 50%.

The firm is profitable; their "balance profit" was 28 million R last year. Up to now the tax on profits has been 84%, but they had some limited capacity to deduct certain revenues from profit. In 1991, tax rate will fall to 45%, of which half will go to union and half to republic.

The director reports to the ministry and the workers collective; the former is declining in importance and the latter is growing. But she says that it is difficult to overcome the workers "indifference;" they are not very interested in talking about increasing firm productivity, product quality or profitability; they are interested in increasing their personal incomes. Previous pay systems had bonuses built in for productivity and quality but they didn't work sufficiently. One bonus or "premium" was linked to enterprise plan fulfillment; if the plan was fulfilled total premium amount was divided by total number of workers to yield individual bonus. Those who contributed and those who did not rewarded equally. Impossible to fire anyone who shows up and is not overtly drunk, disorderly or defiant. Impossible even to deny this person the premium. New system allowed since April/May 90, being worked on to set individual targets and quotas and will result in rewards of up to a doubling of normal pay for extraordinary workers -- and "there are many." Has taken a very long time to prepare. Will apply to engineers and managers as well, though their "quota" is the factory's quantity and quality of production, not their own. New system will take into account difficulty and training needed of job, night or day work, hard or easy work, and seniority will count for less. Admittedly complicated system. Many workers in favor of a differentiated system based on productivity; some, naturally, resisting. Aims at reducing absenteeism and linking pay with productivity and quality control. Plant is open 6 days a week; normal workweek is 5 days; 8 hour shifts, slightly shorter at night,bonus paid for night shift. Many of the workers are "limichiks;" migrants who come to Moscow on a limited time pass to allow them to search for work, and they take most undesirable jobs such as in textiles (dirty, noisy, unsafe plant. The retirement age is 50; mgMt. says lots of sickness in the plant.)

September 20, 1990: Moscow: Price Waterhouse: Local office of PW, Alan Cooper, London, Michael Allen, London, James Glucksman, Moscow. Pessimistic assessment of future prospects. They are training 9 Soviets to Chartered Accountant status in UK, and hoping to set up local PW firm with Soviet staff. Advising EBRD on privatization. Their business - helping western businessmen to gain entry, access, logistics to operate. See the Soviet economy as coming adrift, the center gone. (Claims that accounting standards and taxation scales are uniform across sectors, including the banking sector.) Suggest that across the board investment cuts might harm some areas of potential comparative advantage; e.g., in military technology in aerospace or microwaves. Infrastructure has decayed terribly and there is no longer any "national glue" to put the system back together. Doesn't think anything other than present mess will persist for a time.

September 21, 1990: Moscow: Zil Truck Company: Mr. Borunov, Deputy General Manager, accompanied by his Director of Economics. This is called an "Industrial Amalgamation," consisting of 15 different zavod; this one is the HQ. Other plants scattered around the country up to 2000 km from Moscow; they all supply this final assembly plant. Produces: 200,000 6-10 ton trucks a year, mainly petrol engines, switching now to diesel engines as diesel/petrol price has now been revised to = 1/4. Wide range of other consumer products, from fridges, microwaves, kayaks, furniture, candlesticks: an amazing range of products. But trucks are the flagship of the operation.

Extreme vertical integration. Design, casting, blocks, sheet metal, parts of all sorts made by their units; only raw steel, electrical goods, rubber and glass made outside the "amalgamation." 100,000 employees in the group; 60,000 people in the Moscow plants alone.

Why did they diversify into consumption goods? Perceived a money-making opportunity? Not the reason. Zil was assigned the responsibility to produce consumer goods in short supply by state planners; the firm possessed industrial technology and capacity at a moment when a need was perceived. Why not hive the consumer goods section off and have it become a subsidiary or separate firm or even a profit center? That is not the way things were or are done; neither the planners nor we were thinking in terms of cost or profit centers, but rather was a matter of how could state resources be used to "serve the needs of the people." Now the view is changing. Zil is looking for information and licensing agreements for expanding its consumer goods operations, and especially refrigerator production, to 500,000 units a year.

Organization: 15 different plants. Are these enterprises in their own right? Could be, but they are not now really self-accounting -- they do not have their own balance sheet, but mgmt. does know roughly the balances of each unit. These are production centers, highly specialized in producing one or two inputs for final assembly, all of which takes place in the Moscow HQ. Central office obtains materials, allocates these to the plants, on more or less planned basis. (Doesn't sound like much has changed.) Orders for materials for plants are placed with other supplying ministries, say Ministry of Metallurgy; those ministries send the products directly to the factories and send the bills to the HQ. Most factories send some of their production to "industrial amalgamations" other than Zil; in a couple of cases as much as 50% of production goes outside Zil; on average, 16%. To Kamaz, for example. All production of factories is sold for the same price (till now), regardless of purchaser.

General Manager of Zil appointed by Union ministry. GM, in turn, appoints GMs and principal mngrs. of factories. Relations of Zil HQ and factories with ministry? Thorny question at moment. New, being developed, but remains unclear. For example, we used to pay all taxes to Union and it would distribute. From 91, Zil will pay roughly equal amounts of income tax to union and republic. This will be done on a factory by factory basis. If factories are not self-accounting, how can this be done? Not so hard, he insists, since the profit of each factory can be calculated. But even in the future they seem to think that the central office will pay the bill; it will simply be aggregated on a factory-by-factory basis. They are affected by the prevailing uncertainty; they don't know what laws regarding enterprises will be adopted by republics and feel they can't prepare for what they can't foresee (their passive attitude contrasts sharply with that of the MTools people).

Workers' Council (the collective): consists of 150 elected members, > 50% chosen from workers. Each plant also has WC, composed in similar manner. The chief functions of the WC, say the managers, is to discuss and advise on "social problems" -- benefits, sports, health, canteen, safety, facilities. Issues of technical policy and economic questions "are the prerogative of management." The WC can deliberate and make recommendations on these matters but they say firmly that final authority remains with management. Other members of council represent technicians, designers, white collar workers. The impression clearly conveyed is that the WC is not a serious endeavor; it has no power or claims similar to the WCs in Poland, Hungary or Yugoslavia. this has been a much more centralized, leader dominated system. Workers have no ownership claims. Note that the assembly line employs 1500 Vietnamese workers, on 6 year contracts. Borunov says average salary of workers 250 - 270 R a month; he has great trouble obtaining sufficient labor.

Relations with ministry: Today, the ministry states that the desired amount of production is X # of trucks; we argue as to why this is not reasonable and we negotiate and compromise. As in the past. Difference is now that "final decision remains with us." What is the difference between the plan and the state order? With the introduction of the SO system we have only a part of production which is mandated by the state: 5 years ago 100%; 2 years ago 60; today 40; supposedly less in the future. And we were supposed to have freedom to dispose of above SO production. But it has never really worked in the way it was supposed to. First, GOSPLAN reduces our SO, but GOSNAB still wants to distribute 100% of our production according to their priorities. Second, under the new system GOSNAB is supposed to furnish through their system at least enough inputs to produce the SO "but they don't even give us that amount" much less something above to produce beyond the SO. Even when armed with a formal order from GOSNAB suppliers sometimes say they know nothing and refuse to honor the supposed commitment. Third, GOSPLAN and GOSNAB "fight," and it would not surprise them if the SO system will fall apart or vanish and they will be left entirely on their own. Moreover, the notion of above SO production being sold in a quasi-market fashion, to a range of bidders, doesn't work; government still decides the price and Zil sells all output at GOSKOMSEN set prices. A note of cynicism and resignation regarding all this.

If this is case, from where and how do you obtain your inputs? Barter? Clearly a sensitive issue. Apparent that the traditional supply system is breaking down (as evidenced by GOSNAB's failures). Zil is thus forced to deal with other enterprises directly. Now, almost all enterprises are monopoly suppliers and they try to use this monopoly position to extract a higher price than that set by the state. But Zil is also a monopoly supplier, with a high demand good (trucks) to deal with. So he says that "a racket" goes on constantly as we try to trade our products for those we need "by hook or by crook." (This, supposedly, has always existed to some extent, but the matter seems to be far more acute than in the past.) But this maneuvering seems to go on the supply side alone; with regard to sales, Zil gets non-planned orders -- directives -- right from the Council of Ministers to furnish certain buyers and sectors and firm with trucks and the result is that "what is left for us is very small." In effect, the input side of planning has fallen apart while the output side remains, sort of, in effect. Worst of both worlds. They can now "contract" directly with suppliers, by-passing GOSNAB. What happens when the contract is not honored? Contracts specify precisely the obligations and the penalties and the process to be applied if commitments not honored. We take non-complying firm (and it has happened) to the State Arbitrage Commission, which imposes penalties; and they are satisfied with the work of this body. (This Commission is for conflicts between SOEs, and the lawyers insist that the court system is totally unprepared to enforce contracts between non-state units; indeed, the laws don't even exist.)

Competition: Could other firms in USSR produce similar sorts of trucks? Not without extensive re-tooling. Kamaz (another producer, now organized in JSC form) makes 3-5 ton trucks, but couldn't make 6-10 tonners without a prohibitively expensive reinvestment. (R. Amin concurs.) Says size specialization true of the 4 other truck producers in USSR as well. "No body can compete with us unless special factories are built." But entry is now theoretically open; markets are now contestable. Could you compete against imports? Yes. Imported trucks quality is higher but we have spare parts network in USSR, know-how, etc. They cannot answer question on what the price difference would be between imported Volvo truck (say) and Zil; they have no way of calculating, and say there would have to be a convertible rouble to make any sense of the issue. Zil exports 7 -8% of total production to about 35 countries, mainly to CMEA, China, Vietnam, Mongolia, Syria, Egypt, Iraq, some African countries, Afghanistan and "a very small amount" to Finland and Sweden. (From our inspection of finished product, unless the price were very low, the poor quality, very outdated Zil truck could not hope to compete in any way in a hard currency market.)

Management problems: transport of supplies a constant headache; information system improving -- fax, telex, phones. Had one factory 6 time zones away; was such a problem Zil disposed of it. How? That factory was transferred to another "industrial amalgamation" closer to it. And what did Zil get in return? Blank looks; Zil got nothing; this was not a part of our property that was "ours" to buy or sell; this was a ministry-owned, a state-owned factory, that the owner could move of or dispose of as the owner wished. In this case, the plant went from Zil's supervision to that of another firm -- Kamaz -- in the same ministry; this was a move of an item from one pocket of the ministry to another. And what about the products that firm produced? We obtain them from enterprises in this republic, closer to Moscow.

New laws and new ownership/organizational forms: New enterprise law coming on 1.91; so far does not affect us in any way (and they seem mainly to be waiting to see what happens before reacting, in contrast to the Ministry of Machine Tools which is making a collective anticipatory effort). One step they are taking is to look at small, self-contained production units that might be suitable for leasing arrangements to the workers' collective now employed in the unit -- a repair gang, paint shop, maintenance crew, etc. How will the lease rate be determined? Management -- here they seem perfectly willing and able to regard themselves as owners -- will determine the depreciated historical value of the assets being turned over and calculate the depreciation rate on those assets; the depreciation sum on the non-revalued assets will be the annual lease fee. In addition, the leasers will pay the firm a % -- 10 -15 -- of profits. Any capital improvement made by the firm will change the asset value, and thus the lease fee. It is hoped that the leasers will become in time owners, as all the assets become fully depreciated. What happens if lease-holder violates terms? Penalties should be negotiated in the contract; in case of need, the lease can be declared void. Details of how their output is sold back to the firm are quite unclear. (Seems that prospects for rip-offs and "spontaneous privatization" very high.)

Revealing that economics director says that total firm revenue is "a mystery." How do they pay for investments? Mainly self-financed from development fund. For HC inputs, credit needed, with higher rate of interest.

Meeting with A. Markin and M. Nabiev, Ministry of Machine Tools. Some interesting data re this ministry's enterprises: 401 in total, of which 370 SOEs, 28 lease arrangements, 2 coops and 1 JSC. They already have 55 "small enterprises" within their firms and 361 cooperatives "within the framework of SOEs." In addition, they have 120 R&D Institutes. On taxation, enterprises paid just over 50% of profits as income tax (not including a head tax to state on a per employee basis) in 1988 and 89; this is estimated to increase to over 68% in 1990; and as noted will fall back to a set 45% in 1991 and thereafter. Up to now, all profits are divided into one of three funds -- the wage fund, the social development fund, the fund for the development of production and science. One goes to pay salaries of workers and managers (it seems that in the USSR wages and salaries are not included on the cost side before profits, but come out of the total revenue minus non-labor costs figure that they call profit); two to non-commercial objectives of the firms, and three to capital investment and R&D. The ministry's division of profits by % is set by the Council of Ministers annually, but leeway is allowed for enterprises. In the 3 years for which figures are available for the Min. of MT:

Wage fund averaged	24.2%
Soc Dev Fund	19.7%
Prod R&D	56.1%

As of 1.91 the three funds will disappear and enterprises will decide what to do with their profits.

Regarding financial sources of enterprise operations:
% of average total enterprise income accounted for by direct injection from union budget:
1988 - 35.9%
1989 - 42.4%
1990 - 30.4% (estimated. If special, seemingly one time ministerial subsidy included, comes to 37.3%)
The direct injection (R. Amin objects to my terming this a "subsidy") is supposed to be eliminated entirely in 1991 and enterprises are to cover their costs and investments by applying for credit.

% of total enterprise income accounted for by credits
1988 - 7.4%
1989 - 3.4%
1990 - 11.2% (estimated)
From Ministry of Machine Tools Memorandum provided to World Bank mission on 21.9.90: 4.3 % of metal cutting equipment in USSR is Computer and Numeric Control (CNC) machines, compared to 10.5 in US, 7.0 in FRG and 13.0 in Japan; comparable figures on "machining centers:" 0.4, 2.9, 1.2, 3.0. Point: MT industry in USSR "is inferior in many ways..." Development of production potential lagging; in last 15 yrs. growth rate declining from 4.2% (annual average r of g?) to 3.6%. Branch not supplying internal market with MT needs. Ministry appears to supply (unclear from text; may be does not supply) the following %s in the following categories:

finishing grinding tools	-	65%
jig-boring	-	25
NC machines, machining cents.	-	31
elec-phys-chem equipment	-	48
sheet working equipment	-	24
metal cutting tools		34

Lack of hard currency to purchase needed modern inputs. Need to cooperate with foreign companies. Yearly demand in finishing MTs 40K, internal supply 20K. And plants producing those tools in great need of reinvestment and modernization. Domestic suppliers incapable of producing needed components with the required speed. Problem: massive size of component suppliers. Solution: "create a net of small enterprises, including joint ventures aimed at the production of components for machine tools." Strategy already proposed to govt., which hasn't the HC resources to move.

MT industries instructed by planners to produce consumer goods to meet the massive domestic demand. "However, these are not specially oriented capacities, and so their efficiency is rather low." The MT ministry would like to obtain licenses from Western firms for MT technology and pay back with barter "by supplying to the West different components of the goods (example - the project on washing machines with Italian companies.)" HC shortages the problem. Memo's point: HC financing needed, could be put to immediate and productive use with a group that know's what its doing.

24.9.90: Leningrad: Visits to 3 enterprises of the Ministry of MT: CNC, a CNC producing factory under construction and nearing completion; an old reducing gear plant ("Reductor") which was threatened with closure by state inspectors because of the poor quality of its output; and the "V. Sverdlov MT Amalgamation," making MTs.

CNC: General Director Stryapin, Technical Director Ribanov, third official without a card. An extraordinary story. We are taken to the industrial estate 15 km outside the city where a huge plant -- 55,000m2 -- is under construction for the manufacturing of computers and numeric controls for MTs. The General Director is an enormous man, whose size is matched by his drive, energy and liveliness. History: MT drives and inputs previously made by firms of the Min of Electronics; their quality is poor; their quantity insufficient. Min of MT had to import to stay on the technology curve; cost of $70 million HC a year and rising. This company formed to produce domestically to meet increasing needs, and given ministerial mandate to produce highest quality products. Particularly important in this field because imports blocked by West in some potentially military-use fields. Another part of problem: Min. Electronics produced one set of components and parts; another ministry another set; endless delays and bureaucratic difficulties in obtaining even the low quality elements that were available. This firm will produce complete systems. There is another competing supplier, LEMS Co. of the Min. Electronics, but they don't regard this firm as a serious threat since it has proven incapable of making basic and needed changes in its operations, and it "has no incentive to change."

Their approach: with a Finnish-built plant, divided into ten different production profit centers and four supporting service profit centers, employing 2500 people, they plan to produce 5,000 complete systems a year -- exponentially more than the 750 a year output first envisaged. Recognized that this operation cannot simply be managed in the traditional way and they have opted for the profit center approach, similar to the multi-divisional western private firm. Each profit center will be self-accounting, will maintain a separate account with the bank integrated into the firm, will be encouraged to produce over the amount needed for the parent firm and sell it independently, and in general to operate "on a very long leash" -- unlike any other Soviet SOE. The idea is the brainchild and pet project of Minister Panitchev, and enjoys his personal support.

The financial and administrative complexities of the story indicate in miniature the promise and problems of Perestroika. Construction on the plant began in 1988, with financing supposedly to come totally from the Ministry in the old, planned method. As planning started to wane the financing arrangements changed to 33% direct financing from government; 67% on a 5 year credit from the VNB (State Trading Bank) at 7% interest, the total sum guaranteed by the Ministry. As 1989 went on and more talk of the demise of ministries as traditionally organized -- and presumably the demise of traditional ministerial financial guarantees to loans to their enterprises -- surfaced, the VNB stopped discussion on the loans. The Ministry and Stryapin went to potential foreign partners in WGermany, Finland, Italy and elsewhere and found ways to have the foreign partners give the necessary guarantees to the VNB. How? Looks like a combination of a co-production and buy back arrangement; the major Finnish partners build a turn-key operation and then get paid in finished products they will sell in the West. Not a JV in any normal sense of the term. Highly likely that the Finns have arranged some suppliers credits from their own ex-im organization. CNC has a license from WGerman firm to produce some components and part of production will be "bought back." A very tangled story of agreements with foreign suppliers and partners, including one deal with Finland where the Soviets bought from a Finnish firm machines that will be used in the yet to be finished plant, leased plant space and other facilities from the Finns in Finland, sent Soviet workers to Finland to produce items on these machines, and are now selling the products in the West. The money goes mainly to the Finnish firm; the payment for the Soviets is training for the skilled workers. The equipment and the workers will return to the USSR in 1.91. (Training is taking place in several other European countries as well.)

The plant is to come on line in 6.91, a short start up time for this sort of operation. Construction has been halted 18 times due to Bank stopping of credits. Stryapin has always found a way to restart the credit flow; he prides himself on managing in the "bazaar" that the Soviet system has now become; he characterizes it as wide-open, and looks like he enjoys it -- "We don't follow Soviet customs." But he is breaking rules right and left -- the building he is in is owned by the contractor and he uses it without payment as his HQ; he wheels and deals with the foreign partners and makes financial arrangements that he frankly says are technically illegal "but we don't have the right not to do it." Admits that if there is a crackdown "I could go to Siberia, one way." But the results are impressive.

The production profit centers:
1- printed circuit boards (PCBs)
2- cabinet production
3- modules for PCBs
4- keyboards
5- drive assemblies
6- CNC systems
7- wiring and transformers
8- press shop and finishing tools
9- plastics for packing
10- transportation

plus service profit centers in maintenance, printing, servicing, etc. All expected to sell "above quota" production on the market and to make money. (Still, it is apparent that this is a highly integrated firm, with inside operations -- transport, printing -- normally contracted out in the West.)

Anticipated that 40% of products will come from outside plant; 60% of components from within. Of external inputs, from where? We would like to import everything, but that is not possible, and in any case will depend on who is the owner of this enterprise. We will have to balance HC availability, product availability, the needs and demands of our partners/suppliers and government policy. Several options: as quality and availability of Soviet made components increases, we could use them and probably decrease the price of the final product; but our foreign partners wouldn't care for this since they are also suppliers of key inputs. He then produces a graph in which he suggests he would like to increase the price as quantities increase and thus keep all his constituencies happy, but it looks like magical economic thinking.

Notes that to manage the plant they have acquired a sophisticated MIS from Motorola. Stryapin says that he will continue to use Stankoimport to market his products abroad and assist in arranging deals because they have the contacts, the experience and know-how to handle his external operations. On ownership: they would "love to know who owns this enterprise;" as everyone else, they regard the resolution of this question as priority one. The workers and management have heard of plans to sell them the enterprise -- but why should they buy that which they feel they already partly own? They like much better the rumor/suggestion that firms will be given to the "collective" - the workers/technicians/managers in the firms.

All this is most interesting, and encouraging, but bear in mind: this is a turn-key operation with most of the inputs and labor coming from outside the country; the project is far from completion and could still come to a halt if the flow of funds or credit is halted and Stryapin's haggling can't conclude a deal, and the capacity of the Soviets to take a finished plant and make it function is not yet proven. In addition to which are all the legal/organizational problems of functioning in the transition period.

"Reductor" gear plant: ancient plant in downtown Leningrad. V.Nikiforov, Director, V. Lizbanov, Economy and Production Director, M. Vorobev. 525 employees producing 150,000 gear assemblies a year. Also producing line of consumer goods in children's toys. Turnover: 13 million R a year. The interesting aspect of Reductor is that they operate on a 12 year lease, signed in 1988, from the Min of MT. This firm was one of a group of enterprises that were in deficit and more importantly they were actually closed down because state inspectors said the quality of their product was too low. While some of 10 of 13 plants in somewhat similar conditions were closed (they say) Reductor was one of three turned over to a lease in an attempt to solve quality and financial problems.

They have monopoly position for the type of gears they produce; the internal demand for which is 500K a year. How is the rest of the demand filled? The suggestion is that it is not. They say that many military plants converting to civilian production have great and new demand for their products and that accounts for the shortages. But we are at the limits of production in our cramped space and with our old equipment. As usual, they are in need of investment capital and restructuring and are seeking foreign partners, loans, etc. They think it would be hard for competitors to emerge, but the technology is not difficult -- if their assessment of demand is accurate, this might be a good point for a new entrant.

They receive the castings, bearings and gear blanks -- 50% purchased inputs; 50% manufactured on site. On supplies: not a state order but inputs are received by "agreement" with the Min., which in turn receives all of output at a set price. The lease: signed when financial position was very poor, so payment is 150,000 R a year (as opposed to the 500,000 R that the formula of historical book value x depreciation rate would produce) for 2 years, then 500K.

Tax exempt for 2 years as well. We, the leasees, purchased new equipment (which is henceforth "ours") and sold some old. Workforce number remained about same, but managerial staff reduced by 25%. Salaries of workers and managers doubled, on average: average wage rate now 438 a month. Salary increases "allowed workers to follow technology" (which may mean incited them to show up and make a go at working), and quality of production greatly increased. Quantity: very slight increase, marginal.

Had there not been a lease the plant would have closed. Idea was mainly that of former director (just migrated to Israel last week) who sold Ministry on plan, and Mr. Silayev, now PM of Russian Republic. The Director signs the lease for the whole collective. The collective chooses the Director; competition for the post is strong (which might make it likely that maintaining high pay for the workers will be a number one priority of management). The collective's representatives meet once a quarter, but an exec committee of 15 meets monthly to -- significantly -- <u>"settle the question of how to allocate profits."</u> Who speaks for capital in this system? What steps are taken to see that the firm is not decapitalized or run into debt in order to maintain high rewards to workers and managers? How are funds set aside for needed investments? For them, its simple. You take the total revenue of the firm, minus costs of inputs (but not labor). That is the Soviet definition of "profit," on which they will henceforth pay 45%; half to the Union, half to the Republic. Then they pay the Ministry 500,000 R lease fee. (Unlike other leases we've seen, there is no additional payment as percentage of profits.) Then there will be something to the city Soviet, but they don't yet know what it will be. The workers <u>must</u>, they feel, continue to receive the incentive wages they now receive; else they will slip back to the previous poor performance. What is left over will be reserves for investment? <u>And</u> "social development."

Trying to put numbers on this one obtains: last year Reductor made 4.5 million R. after paying the minimal lease fee of 150,000. They were excused from income taxes, but they did pay an unspecified sum of taxes on the wage bill. Presumably the 4.5 mill is the after tax profit. They paid 2.5 million R in wages (this <u>must</u> be wages and bonuses); spent 1.5 mill on new equipment and held a reserve of 500,000 R. Let's say next year, year 3, is the first year of normal operation and their revenue is an even 5 million. Tax of 45% = 2,250,000 R, leaving 2,750,000 R. The lease fee of 500,000 R leaves 2,250,000. Thus, even before paying local taxes they have insufficient funds to cover the wage bill (at previous levels) much less set aside any reserves for investment, etc. To solve the problem they could increase production, but mgmt. said that was unlikely. They could raise prices under the new freedoms coming in 91, as they are an oligopolistic supplier; but their input prices are likely to rise, and their is no telling what demand they will face. They could cut wages and salaries, but workers would resist, mgmt might be voted out, and it was supposedly the incentive wages that led to quality improvements anyway.. Or they could go back and ask the state to extend the tax and lease fee holiday. (The last is, administratively, the easiest course of action, and, economically, the worst.)

If ministries disappear, to whom will the lease be paid? To the agency that replaces the ministry -- and they are sure there will be one, be it a committee, an association, a concern, a holding, a joint stock company. It doesn't make any difference; some body will replace the ministry though they can't guess what. They note: lack of clarity on ownership is a major and persistent problem; increasingly difficult to obtain even Soviet inputs for rubles; and at the end of the lease the assets will go to the "owner," but the owner might be the collective -- who might either buy or be given the firm.

"V. Sverdlov MT Factory," Mr. V. Pokassyuk, General Director. A leading Leningrad firm, formerly directed by Minister Panitchev. Oldest MT firm in USSR. Began with simple machines; 4 principal divisions today: boring machines and flexible systems; jig boring machines; coping and milling machines; and special machines. 350-400 machines a year (seems very low). Turnover: 58-100 million R a year, depending on product mix. 25% of production exported, of which 50% goes to HC countries, and the other half to CMEA. Obvious problem coming in CMEA; looking for new markets; attended trade fair in US and thinks he has some American interest in his products. Sells milling machines in Brazil and Argentina, other products in Egypt, India and Iran. Commercial contacts in 60 countries of the world; 4000 of his machines are operating worldwide outside the USSR. 30,000 tons a year casting, of all sizes. The usual vertical integration with their own construction company, designers, other services. A typical SOE structure.

Produces a range of consumer goods. Presently generates 5 mill R worth of consumer products a year; up 50% per year for the last several years and scheduled to continue to rise by this amount in the future. Produces basically 3000 small saw-lathe woodworking shops for handymen. These products are located in one shop which has been hived off into a cooperative which buys all inputs from the enterprise and sells most of output back to it, and they are free to sell their above quota production anywhere (at state prices). He is happy with the arrangement, and so apparently are the workers in the coop as they get higher wages than others in the plant. The company also has a co-production arrangement with WGerman firm in Dusseldorf in which the Soviet firm has 6% of shares. Not clear why coop form used in the consumption goods unit. Could be because this was a separate production cycle and that it started later, when some flexibility was allowed. If result is satisfactory why not divide whole plant into production units and apply same formula? That is exactly his intention, he says. Inputs are sold by enterprise to coop at same price state supplies inputs to enterprise; no markup.

On prices: we want more freedom to set output prices, especially for consumer items. Our capacity utilization between 87-90%; was 70% as recently as 1987 (shows knowledge of concepts of machine and labor optimum time, but at same time there is a concept of filling the plan in here as well). 2 shifts; in some units 3. 3500 workers of which 1000 deal with MT production. 100 MTs a yr. using CNC. Could produce more but 40 % of orders are for simpler machines. 25% of the price of products is attributable to wages; 35% to inputs purchased or obtained outside the amalgamation. This 35% = 6 million R worth of goods, of which 2 million is for inputs purchased in HC countries. Hydraulics, pneumatics, inputs for export items. In some products "nothing is obtained" from outside; in others, very high external content.

Difficulties coming in CMEA trade unless govt. makes HC available or makes rouble convertible. Privatization? We have a big army of workers and a complex mgmt., not sure privatization could handle the problems (tendency to think of privatization as essentially personal in orientation and small in scope). He sees the future as follows: divide the plant into individual production units. Management presently "makes too much money and is not flexible enough;" there is no accountability at the level of production centers, no interest in the work, incentives are poor and insufficient, wages and bonuses don't relate to performance. Last year mgmt. organized a new system of performance stimulation and evaluation based on higher pay for quality and quantity of work; passed it through the collective, and we think it would have boosted morale and production. But it never took effect, because the union authorities said it violated principles of the national salary scale.

Control of state banks over the firm: very great, bureaucratic and damaging. He has to submit three sets of documents to obtain credits, the slightest error in one of the three complicated sets results in delays, repeat submissions, lost time. System overwhelms his efforts to impose accountability on the production floor. Can't continue with a system designed to see that nobody steals a kopeck, but defeats chances to effect huge gains and savings. How do cooperatives escape bank bureaucracy? Banks don't have the legal right to interfere.

Who owns this enterprise today? Good question. 3 yrs. ago he tried to make the collective -- workers/technicians/mngrs. -- assert themselves as the owners. He failed. Why? Not clear, but seemingly a combination of lack of enthusiasm on part of workers and resistance from higher authorities. "We are not the owners of the plant." He says: It is state property; then adds: But who is the state? <u>How can the state be regarded as an owner when it consistently takes steps that work against the interests of the plant?</u> Now a "conservative" view is to sell the plant to the workers while we also hear less conservative views to give the plant to the collective. The closest thing to an owner is me, the manager. "I am the owner, speaking frankly. But I can also be directed from above." And "I have put nothing (in terms of capital) in the plant." Shows good understanding of the problem and its complexities.

If plant given or sold to collective, would performance improve? Mgmt. would like to organize so as link more closely effort and rewards. "To awake the interest of the workers they should have to pay for the assets they use." <u>Sell</u> shares in the firms to workers (maybe 20%, he says). We have a long and negative experience with property that costs nothing, and if it is not valued in the future everything will remain the same. The attitude toward free property is very bad. <u>Maintenance is poor, the worker doesn't care, and mgmt. doesn't have the means to impose discipline.</u> Long speech on the virtues of and need for private ownership, essentially to represent capital properly. Says in effect that attitudes can be changed if things are earned and if those taking over formerly state assets have their personal capital at risk.

Excess labor in plant? Yes, but a complicated story of how "big-ness" was formerly a virtue, how plan fulfillment overrode cost considerations, including labor cost, how labor became excessively specialized, and how low average wages all led to little thinking on labor needs (again, excellent understanding of the problem). This is a matter of sensitivity, but he says he has reduced plant employees by 1000 in the last few yrs., that another 1000 are scheduled to go in the next 4 yrs., and many more could be eliminated if coops and small enterprise units become the norm. Plant of 5100 workers at present could get along with 1/2 the number, he says; "and it would still be too much."

He has some domestic competitors in the woodworking tool line -- 10 other plants -- but "our product is best." Could export these machines but domestic demand takes precedence. Would like to increase run to 15,000; export a bit, and still wouldn't touch market demand. The emphasis from govt. is find ways to export the main product lines, and increase runs of consumer goods for home market. Says there is a confiscatory tax on wages in excess of planned limits. A most informative discussion.

25.9.90: Leningrad: Officials of the Foreign Economic Committee of the Leningrad City Council (LCC): Messrs. Chervijcov, Staroverov, Morozov and a fourth official whose name I missed. Members of a democratically elected Leningrad Council that came into office in the spring of this year. Notes that there are many differing economic views in the Council, which is made up of several hundred representatives. Their one and over-riding goal: "independence" from Moscow, meaning definitely the Union government and even perhaps the republican government as well. They want to run their own affairs without the involvement or interference of Moscow. They want the LCC to negotiate joint ventures, to create a Free Economic Zone in the area, to find ways of keeping in the area the vast sums of foreign exchange and resources they think are generated by Leningrad's economy and tourism, they want to run their own show and not have anyone else involved. They have numerous grievances against the overly centralized banking system, the approvals required for JVs, barter arrangements, and indeed just about everything -- a very long list. Do they want to transfer the power to direct the economy from Moscow to Leningrad, or do they want things done differently, according to the free market? A little bit of both, it seems; though they generally say the right things about the need to liberalize. "We want to take part in the market reforms in Russia and maybe in the USSR too." They want an expansion of the banking system in the region; they want both to allow new entrants and sell off SOEs in the industrial field; they are pushing to re-open the stock exchange (closed since 1914?).

What powers should Moscow retain? Less of a response than a repetition of the complaints. Moscow took all the profits from local SOES, did not allow any contacts of any sort between city and foreigners, all JVs paid 30% tax, all of which went to Moscow in spite of decree that 5% should go to LCC, Intourist pays only 10% of profits to LCC, this is criminally insufficient, etc. We were first in demanding reforms; we want help from Moscow, not hindrance. What is the legal base for your demand for what amounts to near total independence? Russia has already declared its independence, and we have good relations with the Yeltsin govt., and we feel that we have legal authority for our action. (They are young, feverish, impatient, assured: this must be a bit what the Bolsheviks were like.)

Why should a western investor want to enter in these unsettled political circumstances? As many others, they seem to think that a mass of moneyed investors sits just over the borders, eagerly awaiting the slightest opening of the door. They generally support but have some problems with the Shatalin Plan, since it apparently calls for the founding of free zones all over the country and Leningraders feel or fear that these others will insist on using the plans so carefully elaborated by LCC. Unfair, they claim; this would throw away our hard earned competitive advantage. They say the correct things about stimulating competition, monopoly pricing, anti-monopolization.

Do they want to control or simply tax SOEs in the region? Not clear; they think SMEs should be privatized ASAP; they are correctly worried about JSCos being formed without any financial disclosures, and they are awaiting some legal rulings and decisions on property rights, opening up of private sector. Can one enter the market and undersell an SOE? Yes; this is happening. What if new entrant outproduces and undersells SOE to the point of the SOE's collapse? Too bad, they say, but there will be no bail-outs. This is already happening, they insist, as coops undercut SOEs some have collapsed. What happens to the affected workers? Depends on the nature of the affected enterprise. Workers are normally reabsorbed someplace, but technicians in some closed R&D institutes they know of have simply been laid off.

On coops.: lots of truth in the negative attitude toward coops; they take materials from SOEs free or at less than full cost and then sell a product back to the SOE or the public at a high cost, and enrich individuals. This is unfair, a "rotten aspect of our centralized system." While coops are more flexible, more innovative, they are at the limits of the law. They think, on prices, that government will have to support prices of some items; can't forget the elderly, retirees, etc. We discuss targeted income supplements as a replacement to subsidies; they seem unconvinced given their limited faith in govt.'s ability to identify the deserving or provide them with an income supplement. Supported prices may be a blunt and distorting weapon, but it is one they know how to use.

Energomash Bank, Chairman of the Board, Leonid Talmach (who is also President of the Leningrad Association of Commercial Banks). This bank formed in 1988; the first to register in Russia. Registered with GOSBANK twice; once in conformity with a stipulated procedure that GOSBANK then changed; then again in the revised manner. In this and other matters the story is one of constant, hostile and excessive bureaucracy against which he has had to struggle. In the future the State Bank of Russia will be the registering and supervising agent, with more or less the same set of regulations, but he expects it to be more tolerant and supportive than GOSBANK has been.

Strategy: to be a universal, full-service bank offering long and short term credit, taking deposits of all sorts, working lease deals. His is a JSCo, with 70% of his shareholders involved in one form or another of energy matters. His shareholders are mainly SOEs, though a state bank holds the largest single block of shares (worth 6 million R), and an "association" of SOEs has what he calls "secondary" resources which may mean a form of non-voting shares? Why do they invest in this bank? Because its profitable; he paid a dividend last year of 10% and expects to do the same this year. Regulations required him to split his 20% return on capital between dividend and reserve fund for expansion. Most all of his stockholders borrow from the bank, in some cases far above their holding in equity. Legal limits to this? Law states no more than 35 million R to any one customer; and he has an exceptional position since the normal regulation is that shareholders can borrow only to the amount of equity held.

He has an exception to this rule because of his stability, but he is expecting new and lower limitations on loans to any one borrower. He has at present 98 borrowers, only 16 of whom are shareholders; some shareholders do not borrow. He has a total paid in capital of 23 million R (and I read somewhere that the gearing ratio for commercial banks is set at 20; for coop banks 12).

Dividends are treated as ordinary income, with the tax rate varying from 20 to 55%, according to the type of entity that earns it. Can't explain the variation; "it's govt. policy." In the future, JVs will be taxed at 30% and all enterprises at 45%, except for banks which will pay 55%. (Why these differences?)

What do borrowers apply funds to? Expansion and social investments. What are the latter? No clear response. Why borrow from you rather than the state banks? He says: 1- a shortage of official funds, an enterprise cannot always get a loan or the amount of a loan it wants from the regular banks, and therefore they come to us. 2-we offer a better, faster, more efficient service, we have "a different mentality." We do <u>not</u> offer a higher rate of interest on deposits (did I get this right? later the implication is that he does indeed so offer); we compete on quality of service. We could have 1000 customers if our facilities -- office space, telecom, infrastructure -- were not such a problem. Just getting a place to do business is the biggest difficulty, but he repeatedly states that the situation is much better than one or two years ago, when bureaucratic harassment was constant.

Says there are 300+ commercial banks in the USSR now; 12 in Leningrad, 11 in his association. Interest rates on loans and deposits averaging 8-10%; average interest on loans is 7%. How is this? These seemingly bizarre figures are explained: in order to match the services of the state banks (and to offset competitors' claims that the commercial banks can't do what they do) he gives some loans for social purposes at 1.+% a yr. Not many; just enough to meet his public relations needs. At the other end of the scale, some of his largest loans to enterprises are at 15%, and these are numerous. There have been steady increases in deposit and lending rates through this yr. But there is "absolutely no problem;" he will make 20% return this yr. too. Also has something which is neither capital nor deposits; sums parked in the bank by enterprises for short terms. We pay interest to coops who do this but not enterprises; though this will change. (Looks like a lack of a money market.) We return the money to enterprises with no service charge. Why do they park here? Not clear; could be some penalty applied to idle working capital?

Embryonic inter-bank market developing. One member of association serves brokerage function, finding out which banks have money to move and which are in need; charges a commission.

How are loans appraised? He states the basic principle: they want as close as they can get to a guarantee that their money will be returned, unlike the state banks that are first and foremost serving govt. policy objectives. "Only one thing is of interest to us; we want our money back. What it is used for does not interest us." He looks for collateral; for property or assets of the borrower. If there is no property or assets there is no loan. Problem: since there is no law on ownership -- since there is a pervasive vagueness about property rights -- the property of an SOE borrower is not true collateral since it cannot be seized. This is a prime question to be settled in law.

His staff look into applicant's operations, estimating their overall financial position in terms of their market situation, their profitability, their management, the nature of the specific project to be financed, and verify that they have the approvals and guarantees necessary to do their job. "We try to protect ourselves and minimize risk. You must persuade us on the quality of your proposal vis a vis its competitors." On bad debts: we can get something back. If a client is a shareholder in the bank we can negotiate to divert the dividends to repay the loan. If securities are held by the borrower theses can be taken. They have no capacity to impose bankruptcy on an enterprise however. He would like to lend only to JSCos since in the event of non-payment stocks could be seized. Laws have to be changed to produce true collateral.

He employs 38 people and has 1.5 billion R "annual monetary circulation" (a sort of turnover?). (NOTE: In a later meeting Vladimir Stryapin claims that Talmach had 80 employees last yr., "30 this," and is a declining force as enterprises find him too small and don't see why they can't do for themselves the service's Talmach gives them. Unclear.) Says he needs "an insurance fund" to guarantee loans so as to encourage and support foreign investors. He says the idea has been accepted by the LCC and they will be involved in the fund. This is in the framework of the FEZ. (Seems to think that an insurance company of this form could, with state money, more or less eliminate all risks from commercial operations; an unrealistic and dangerous idea.) Stock exchange developing; Swiss firm is to computerize, Swedish and US advice/training underway, working on a sort of commodity exchange for opening in 91. LCC has approved the privatization of housing and retail trade. A competition for the purchase of 70% of retail stores is to be completed on 1.10.90, and the winners announced, with the LCC taking the proceeds. For the remainder, the idea is to begin to sell SMEs and eventually issue shares in the larger SOEs, which will be sold -- not given away. But since the population lacks money those advocating give away schemes are popular. Needs to be settled.

Physical shares do not yet exist; not printed. Some enterprises have them but not commercial banks. Pointless to issue shares in absence of stock exchange, he says. Union Ministry Finance putting out rules & regs. re stock issuing. Some commercial banks are organized as GMBH in Germany, others as AGesellschaft. Nobody has yet issued fixed income securities. The Savings Bank hopes to issue something like CDs soon. "I really believe the market will take off," he says, and states that the country cannot go back to what it was. When challenged, he admits that the popular perception of the market, the private sector, the changes -- is generally negative. People who started coops tended to "grey elements, thieves and hooligans." But honest people followed, both in coops and commercial banks. The more people get to deal with them (and the more there are) the more they will accept, he says. The need is for many coops to create competition and lower prices, rather than try to go backwards. Comm banks looked on in same light. It is providing better and faster service and charging different rates and this has provoked resistance from regular banks. Says regular banks, when approached by clients and told to switch deposits to his or another commercial bank, simply refuse to do so. He has to find ways -- putting in contracts that a certain % of the funds of a project will be held in his bank, etc. -- to force the reg. banks to comply with the wishes of their customers. "If they want customers, let them pay the same interest rate."

Biggest need: infrastructure and information sharing mechanisms. We don't know who has money; we need intermediaries, brokers, access to liquid funds. Can't advertise his services; though this will soon change. Feels he has already overcome great obstacles and difficulties. His Board: Meets once a year; real exec. body is the Consultative body of 6 major shareholders that meets once a quarter at least and addresses the question of how to manage the bank. It approves accounts and auditing. At AGM, profit distribution and general policy discussed. Min. Fin. regs. require reserve build up to 25% of original paid in capital before distributions can occur. Very interesting and informative.

27.9.90: Leningrad: President of the <u>Leningrad Industrial and Commercial Bank, Mr. V. G. Semenov</u>: Banking is <u>the</u> key problem in economic reform, he says, and the govt. has been late in seeing this. Now trying to shift regular banks to commercial banks. Difficulties particularly acute for large banks. Why so? Implies that central control and large number and varying type of clientele makes heavy demands on scarce administrative resources; perhaps he is saying that he is at a disadvantage vis a vis new comm. banks? His bank the first to work on a "self-repaying" (independent financial system) basis, 2 yrs. ago. Increased his autonomy and gave him "a necessary dose of freedom." The banks "buys money for our clients" and takes deposits; lends and makes profits on the turnover and spread. Also makes money on a <u>factoring system</u>. Very important: in the recent past many enterprises in big trouble due to high accounts receivable; indiscipline spread and inter-enterp. arrears mounting, but goods were still being delivered. (A common story in SOE sectors.) Govt. asked banks to intervene and clear up. Banks took on role of payments control. Ent. A sends goods to ent. B. Bank pays ent. A directly for the products and bills directly ent. B. Why will ent. B pay bank when it didn't pay ent. A? Because the bank will have checked to ensure that B has the funds (and we know from other sources that the bank won't allow A to send goods unless it so knows), and because if B objects it will directly dunn B --and if it is not B's bank it will use a corresponding bank network to push B to comply. Banks have more power than enterprises; their discipline is "more strict." The banks deal with the banks and "the enterprise is out of the game." The banks have in effect become the financial departments of many enterprises. This explains why enterprises have been complaining about bank powers.

Many sources of funds for this bank. Other banks, large enterprises, insurance cos., coops. 70% resources raised on our own; 30% from outside - meaning the central GOSBANK? Total cap.: 150 mill R, 50 mill R reserves, but has 3.5 billion working. Admits that the right of clients to demand deposits is limited; some limits on liquidity of demand. But "for sure" enterprise can go to another bank and take their resources with him. He could cover all withdrawals. How? "Some things are commercial secrets." If and when bank law passes won't change operations dramatically. (But earlier he said lack of clear laws was a major obstacle to reform.) They will become a comm. bank, get new sources of funds and expand lending. Doesn't like existing comm. banks and says they can't and don't provide the range of services he is obliged to provide. They are "speculative." But he has shares in 5 comm. banks in Leningrad. Why? We (in the reg. banking community? the state?) created these banks to destroy the monopoly of banking services; it was a political decision; we don't get big dividends; the monopoly decided to end its own monopoly. (This is a first.) Says, insists, there are 17 comm. banks in Leningrad area, with new ones forming all the time.

Main risk: lending to coops. We have lent 200-300 mill R to coops -- 15% of loans -- and about 10-15% of these non-performing. Far higher than in other sectors. Law permits coops to form without initial capital; they are quickly established and they just as quickly go out of business. Courts not taking any corrective action he says.

Leningrad International Management Institute: Sergei Mordovin, Deputy Director, A. Shapovalov, Director of Programmes. A joint stock company, JV operation with Italians (a university, Fiat, ENI, and others), the Dutch NMB, the Soviet govt., an Institute, the University of Leningrad. Purpose: to train Soviet business people for foreign and domestic operations; and to help western business people do business in and with the Soviet Union. 3 courses: 1 basic 6 weeks course; 2 sets of specialized shorter term courses. Holds seminars on special topics: convertibility of rouble, JV accounting, etc. Would like -- along with many of the 120 management schools in the USSR -- to start an MBA but it is "not yet possible." Research, contract and contacts with foreigners, consultant work, and direct operations: they are translating Lotus into Russian and they will sell and service. Preparing case studies on business operations in the Soviet Union. They aim at top mngt. only; not middle mngt., at least not yet.

Basic course: 40 participants on average, real mngrs. from enterprises, coops, lease operations, SMEs, LCC, ministries. Emphasis on foreign trade activity; desire to show students how things work in western business systems. In the special programs they have about 600 participants (a yr?); mainly middle managers from Leningrad industries. Course content: 6 hrs. a day, mainly lectures to now, some simulations, business games. Repeats the main theme: how business is conducted in the west and the applicability of the principles to the Soviet scene. Themes include: legal basis and laws; the regulatory framework of western systems; marketing concepts; advertising; corporate finance; accounting; and credit and banking. 1 week devoted to organizational behavior. Cost: 2000 rubles total fees R&B. Well below market as other schools charge from 5-20K R. But this covers all costs and then some. Why below market? Because this JV is a non-profit org. And few can afford even 2K R in any event.

Full time faculty 10; hope to expand to 20. Part time 30 or more. Easy to obtain lecturers even from Moscow; "a special culture here." Enterprises send mngrs and pay from social fund which is many cases is flush and cannot be spent on production expansion purposes. 1st course 2.89. Trainees "interested in practical things;" not interested in theory. They think participants ask applied and practical questions but want pat answers, or blueprint responses, to their queries. They see as the major problems the lack of clarity on property rights and the absence of a sense of self-reliance on the part of mngrs, even CEOs. Mngrs. not prepared to take decisions, they fear independence, they tend to wait for someone to tell them what to do. Must change mentality or nothing will happen. How? It can be done; look at us. But generally people here do not understand that selfishness helps society. This requires a long term educational program, including the education of officials such as those on the LCC.

FEZ? Scorn; what is it? Nobody knows. Will not come about according to timetable, they say. How to de-monop. lg. ents. a major question; the 1st step on road to privatization. First, transform to JSCos, then sell shares to other ents., then see whether one can progress to shares to individuals. Overall, fear and uncertainty great; govt. fears what would happen if min. supply to ents. totally reversed and eliminated, fear chaos. (And someone said, Sergei the interpreter, that Gorbachev has declared the need for the old min. supply system to continue for 18 more months?) Speed of reform the issue.

Are you teaching mkting skills to mngrs.? -- suppliers, wholesaling, etc. Information is supposed to be available to mngrs from the "All Union Mkt Research Institute" of the For Trade Min. But "changes are too quick for them to handle." Comm banks: insecure, don't trust, could go out of business tomorrow with a quick change of policy. Barter rampant; transactions costs high. Brokers have emerged, but people regard them as unethical -- and the hint is that they do as well. In general, service provision of this nature is fair, but when dirty tricks are used, or there is some shady behavior with the customer, then it should not be allowed. They say the right things -- people should be able to earn money as middlemen -- but there is a hint that even these pro-capitalist trainers have their doubts as well. A fear or disapproval of those who are smart, active and take advantage of contacts to facilitate deals. Coop prices are 3-5 times higher and this is not unethical, it is normal, it is the market they agree.

<u>LIMI</u>: 6 mngrs participants in course give views on what is happening in the country and in their firms.

1- mngr of a JV on computers, VCRs, software, with WGerman firm
2- mngr in an AEROFLOT affiliate, working to lease aircraft and support from the airline and start a competing regional airline, on same routes, in Siberia
3- Rep of Info and Consulting Center for construction of nuclear plants
4- President of "practically private" coop, employing 50 persons, making TVs and doing telecommunications work. Obtains inputs by hook and by crook; credit from Pomstroy bank, customers because they are starved for his products and his quality and after sales service is better. Price of product is roughly the same as state, slightly higher, but service prices considerably higher. Problem: negative attitude of people toward coops.
5- Another coop mngr; 30 people in multi-aspect firm -- body bldg equip., souvenir production, car repair, construction, convert petrol cars to petrol/natural gas combinations, etc. Problem: obtaining materials and facilities. Shortage not of shops but of willingness to lease them. How are inputs obtained? "Our little secret." Agrees that population has neg. attitude toward coops but thinks that as people deal with them more and more they will come to accept them. Coops will "change their names to SMEs and operate the same way." He fears the reintroduction of central controls.
6- Mng. Director of Juvenile Delinquency Prevention Agency. Really, a security/guard agency with social work aspect. Commercial, but has the goal of devoting part of the profits earned from the guard service to a

juvenile delinquent rehabilitation program. Advertises, caught 600 offenders last year, including 10 "serious criminals." Personnel not armed; rehab component of work a serious aspect of the company. Part of the LCC.

These mngrs see the basic problems as: lack of political and legal stability; difficulty of obtaining inputs; corruption; need to adopt Shatalin plan; excess monopolization; "absence of workable laws;" telecom and infrastructure problems and difficulties for non-SOE ops to obtain financing.

28.9.90: Financial authorities of the LCC: LCC starting an active program of SME expansion. Registration with LCC of businesses easier than in past; no fee charged. Can a new entrant operate in same field as SOE? Yes. Can it undercut prices of SOE? Yes, except in a few selected and unspecified fields. In the future, prices will be a matter for arrangement between the producer and the consumer; no interference from govt. If the SOE complains or starts to go bankrupt because it can no longer sell its production? Impossible for them to envisage; their problem is acute, pervasive scarcity of everything; constant unfulfilled demand. Thus, any production of any good of any quality at any price is immediately snapped up. The question is effectively dodged.

Coops: 80-88 % of those formed in LCC area still working; 20% or less disappeared or formed into something else. Their attitude is that coops possess advantages in law and in practice that allow them to exploit niches in the market and evade regulations that hinder SOEs; our view based on experience elsewhere is that coops are at a disadvantage because of lack of access to inputs and credits. (And indeed, the next day, in talking to the Association of Leaseholders, we hear of a case of a coop that transformed itself to an SOE for precisely these reasons.) Coops come and go quickly. Last yr. all prices up, interest rates and salaries up as well, salaries up higher than production increases; this led to increases in scarcity and hidden inflation. Will you need a price control agency in the future? Yes; some controls will be necessary for a time to show the people that their interests are being protected. Essential if popular support is to be retained for reform. 8-10 key areas to be regulated for a time, and monopoly pricing will have to be regulated. Leningraders are having a hard time adjusting to the fact that there are now many prices for the same commodity when in the past there was but one single enduring price.

2nd meeting with V. Stryapin, this time in his role as President of the Leningrad Industrial Estate Association. Major change in three days time: He received a visit from Minister Panitchev, during which he (I surmise) was told that the ministry can advance Styrapin's operation no more money. This, combined with continued delays in payment by the VNB of his Finnish contractors, has him in a panicky situation. He needs 2 million R -- a paltry sum we agree -- to finish the Soviet supplied section of his operation, and he needs VNB to pay the now quite late contracted HC payment to the Finns (who have their own bank payment in Helsinki to worry about). Revealing story: where can he get the 2 million R? The ministry no longer commands resources and while the Minister is doing his personal best to assist/find funding, he has not come up with the cash. The regular banks? They are short of funds and are lending only to those firms now producing, since these firms have products to use on the barter market; i.e., assets to trade or market. Firms in progress but not on line such as Stryapin's take a back seat or indeed no seat at all with the banks, regular or commercial;

they have seen too many "sure thing" guaranteed projects stall or collapse in the last few years. (This helps explain the large number of unfinished projects.) Go to the employees and "sell" shares? This suggestion gets a laugh. The LCC? They have many ideas and many demands on non-existent funds; they are not yet a taxing, resource allocating body. The coop banks? Too small. He sees his only hope as attracting a foreign partner and receiving an injection of capital, or an external guarantee for local credit, to allow him to continue..

He offers a wild plan which totals the enterprise's projected debt and equity (67 and 33%, respectively), and then proposes to assign a sort of "ownership" of the equity to the ministry, the non-yet existent foreign partner, and other enterprises and banks, and the amount represented by the debt to the collective. This makes no sense as we discuss it (for example, I note that even if this approach could somehow be made workable, as the debt is paid off, and if the capitalization remains the same, the collective -- with 67% -- would eventually become the majority owners of the firm. This is greeted with astonishment). We suggest they consider that the equity represent the total capital of the firm; that the ownership be parcelled out to the collective, the ministry, the foreign investors, the banks, etc., and that this entity then take on the debt in the normal western commercial manner. <u>They do not have the first idea of how these things are arranged in capitalist countries</u>; all of this comes as a revelation.

Most importantly, no financing methods, tricky or not, can be tried unless and until the firm is a JSCo, and the legal basis for ownership is up and functioning. (The next day Professor V. Musin, a legal expert, insists that the law on ownership passed in June allows in theory foreigners to buy and sell property other than land.) It doesn't seem likely that a westerner would invest in the present unsettled circumstances, at least not in any large way. He sadly agrees, and asks: when the legal/property issues <u>are</u> settled, how should I look for and attract an appropriate foreign partner? We offer the usual advice: prepare a slick and professional prospectus on the firm, its assets and potential; use existing contacts to be in touch with foreign firms known for their capacity in this line of work; hire professional consulting experience to market your approach and assist in the transaction, etc. His problem is that finishing the construction and searching for foreign involvement (the goal for everybody we meet, small and large) is overwhelming. His last two hopes: 1- somehow his entity owns shares in a firm in Finland; he may try to liquidate all or part of these and use the HC cash to pay his Finnish and Soviet suppliers; 2- he has a completed print shop on the premises, WGerman equipment, supposed to be one of his profit centers; he may sell or lease this out and retain only an option on part of its output. He is in deep trouble, but he is still fighting, and he has assets to bargain with.

In his role as Pres. of Industrial Estate Association he is advancing the interests of the group -- and some others from outside the area -- in their financial dealings with LCC; in trying to put together a bank to evade the normal "crazy banking system;" to combine marketing efforts and reduce costs (common presentation of products recently in Finland). 89 different firms; mostly SOEs, some coops, SMEs, leases, 2 limited companies (meaning ltd. capital, not limited liability.)

<u>Textile Firm No. 42</u>, in the former Putilov works, on the outskirts of Leningrad. Deputy Director, Technical Director, Design Director. Comprised of 4 "little factories," employing a total of 2000 workers, producing weaving of all sorts: rugs, scarves, hats, mittens, elastics of every sort, shawls, specialized medical weaving in artificial arteries, tubes and ducts, valves etc. Trying to export a part of their product but nothing much as yet. They use Swedish designs, Italian wool, mostly their own designs and products. They use 500 home workers -- invalids in many cases -- for part of their production. Some machines from abroad, average age 4-6 yrs., some machines 10+. 600 different items produced.

Prices: set by state, ex-factory price the consumer price. Ministry formerly provided all inputs; Russian Min of Lt. Ind. now replaced by a "concern," or association of 500 textile related operations in the Russian republic, divided into three geographic sub-associations. They band their purchasing power and inputs information and availability; so far this new system works as well as the old, maybe better -- but there is some uncertainty about the future (less so than in any other ent. we visited). Who owns the enterprise? Some doubts for a question never before really considered, but they are pretty sure it is the Russian republic. The LCC? No.

Production: 40 mill R value a year. Inputs come as colored yarn. Costs? They cannot say. Not sure of themselves on financial/economic questions; they are production people, concerned with style, quality and quantity of product, and how the product matches up -- in appeal and quality, not in cost terms -- with other products they or we have seen. (And the products seen seem remarkably good.) But you will have to go soon to "market" prices, yes? Agreed. How will you set prices in the new situation? They offer an offhand and vague comment that the more of an item they produce, the higher the price will have to be. They cannot estimate what % of total costs is labor and what % inputs; rough guess of 50/50.

They have practically no state order; they work on "requests" from well established clients. They are quite at home in this system and happy with it. They have contracts with big shops and wholesalers and think that if they tried to move away from these established procedures the State Arbitrage Commission would force them to go back to set practice. They know that in 2 years (first time we've heard this timetable) they will have to set all the orders and outputs for themselves.

They make some childrens' products -- scarves, mittens -- that they sell at very low price. Could you stop making this product if it proves in the new circumstances to be a money loser and you can't raise the price? Consternation. 1- The idea that some items make money and some don't is alien to them; for them the plant as a whole either makes money or does not, depending on the overall set of output prices decreed by the state. 2- These are regarded as important socially necessary products for the good of children and it is right and just that the prices should be kept low. (We get a couple of glances; we have just confirmed what they were told about heartless capitalists.)

New freedoms? They consult heavily with clients on designs. They work with R&D institutes on the medical weaving technology, for which they have a lot of hope. They are building a new 14000M2 new building alongside the old, half of the space will be devoted to medical products (the old plant is in a former church in which, believe it or not, Father Gapon was the pastor in 1905). Are they in debt? None whatsoever. How then are they funding the new bldg? All Union GOSPLAN is picking up all the capital construction costs and will give us the plant. Just started to think of inventory control with computers; have acquired a few. Difficult with 800 different buyers. Firm is profitable (and why shouldn't it be when the state picks up all the investments?). Privatization? Maybe some leasing arrangements in future; impression is that they have a stable situation and are not keen on change. Claims a 90% capacity utilization with 2 shifts.

They have a trade union and a Workers Council. 3 yrs. old. Council discusses firm's plans, how to divide profit, where to invest. Council is the authority but "management must sell ideas and the Council must approve." How will the new law change things? More freedom for the firm; more autonomy to the constituent plants; most important, more latitude on paying workers according to output and closer monitoring of performance; before, different people got the same wage.

Leningrad: 29.9.90: <u>Association of Leaseholders</u>, Mr. Kashtan and 2 associates. 140 members of the association of non-SOEs, or people or groups breaking away from SOEs. The members represent 80,000 workers in the Leningrad area. Some are lease, some coops, some enterprises, some SMEs. This association exists to assist aspirant leaseholders through the maze of administrative and financial hurdles that must be overcome before one can legally operate a non-SOE activity. They were created by a one-time grant from several lg. area SOEs (why? Levy heard a conspiracy story that all these efforts are nomenklatura generated and funded in an effort to shift their power from plan to economic).

How does it work? An SOE finds that its internal transport division is not doing the required job. Suggestion is made to hive off the transport division into a lease operation; fee is arranged, duties of the lease operation to the SOE are determined; assets are placed in charge of the leasing group; they provide the SOE with the required services, but -- because they pay workers and managers more and arrange work more efficiently -- they have plenty of time left over to undertake additional tasks, in and outside the SOE. They generate profits. May use profits to buy leased equipment from SOE; easier way is to use profits to buy totally new equipment in their own name and substitute for leased. In this way the lease operation gradually shifts from a lease to a private enterprise; assisting in the creation of fully private enterprises is the avowed medium term goal of the association. Constant reminders to us that this process, especially early stages, interminably complex with many steps and harassment along the way.

If people approach them with a query on how to form a lease they assist. No fee is charged. They examine the bona fides of the applicant(s). If acceptable they assist procedurally and in some cases financially (limited). Payment comes from operation when the lease is up and running. 20% of profits come to the association. They too see increased contacts with west as the nirvana, the panacea, opening markets, transferring technology and solving all problems. With regard to the coop which transformed itself into an SOE, note that it retained the crucial right to pay wages and salaries outside the normal salary scales. Their description of the convoluted system is revealing; for example, the commercial banks in the region (Talmach's group), fearing a crackdown -- possibly led by jealous regular banks who will use the popular argument that the comm banks are gouging exploiters -- appear to be proposing to fund a scheme to give 350,000,000 R to the citizens of LCC area. This would be done after a general increase in prices to meet prices prevailing in neighboring Estonia. Seems that much smuggling is going on as Leningraders buy products at official prices --esp. meat -- and take it to sell in Estonia at far higher prices. (This story takes ages to explain.)

We agree that it is good that prices be raised to reflect scarcity values. We agree that it is reasonable to protect the low and fixed income groups from the effects of what will be substantial increases. The rest of the scheme is daft. 1- Why should the comm banks fund a transfer payment; this is the role of government. 2- Even if the banks do this as a PR gesture (and their shareholders allow it, which seems unlikely) how will a one time payment of insignificant size offset the permanent increase? Moreover, there is a half-baked notion of issuing a "credit card" equivalent to the population -- the whole notion is mad.

Still, these people are at the cutting edge of the transition to market forces. They are trying to hive off production centers and make them more productive and financially profitable. The economics of what is going on are dubious in the extreme; the politics probably worse. But these are the only people who are offering a means to put the now generally idle or underutilized assets in SOEs to more productive use. The method: incentives and self-interest. These are the good guys.

29.9.90: Meeting with Professor Valery Musin of the Leningrad School of Law. Apart from his positive and liberal interpretation of the existing law on ownership (see above) he offers the news that both the Russian and Union Supreme Soviets are presently considering laws on bankruptcy and insolvency; mortgaging of property, and financial protection of foreign investors. Notes that the maximum rate of tax on coops is now 65% and agrees that this is confiscatory, but argues that the average tax rate is actually 30% because local soviets have ability to shift tax rates downwards depending on their assessment of the social worthiness of the firm. We argue strenuously against such a power being placed in the hands of administrators; but this is another sample of the anti-coop, anti-capitalist sentiment prevailing in the country. The country may have renounced socialism, but it is far from embracing capitalism.

Moscow

GOSPLAN: October 1, 1990: All Union, Mr. Bizrukov, Head of the Economic Planning Commission, Mr. Rizhov, Deputy Chief of the Financial Committee, and Mr. Stepanov, macro-planning and modelling. What is the future role of GOSPLAN? "We would like to know too." Outlines past command system and insists that Soviet planning had its accomplishments in terms of "prognosis, balance methods, allocation of productive forces, and huge state projects." Now shifting to a market economy. For Bizrukov the market is an "instrument to raise and upgrade the effective work of our organization;" it is a tool to increase the efficiency of productive labor, it will assist/improve mngt. of the economy, improve enterprise performance and integrate the Soviet Union into the world economy.

New principles on which future action based:

1- tolerance of different types of production -- SOEs, leases, coops, SMEs, JSCos -- and their being treated equally in law and in practice;

2- independence of industrial enterprises; much more autonomy for enterprise managers; law enshrining this comes into effect on 1.91; henceforth they will contract with @ other, no planning from above; they plan and we assist and evaluate;

3- economic sovereignty of union republics; division of political and economic powers and responsibilities not yet fully settled; number of laws passed but not enacted in practice; an all-Union treaty to govern relations being worked out; issue of asset ownership and priority of union or republic laws being debated, but remains essentially unresolved.

GOSPLAN view: the USSR should retain, must retain, control of: energy, transport (air, sea, rail), communications and mass media, space activities, management of the defense complex, and a few "others." Other areas under discussion between central and republican governments are money, banking, credit and foreign debt. Admits the obvious; that some basic principles of economic management and the division of labor are unresolved. GOSPLAN says that there will need to be unified custom regulations, mechanisms to support socially disadvantaged population elements during transition process; this last issue key. Large families, students, pensioners on fixed incomes -- they must be protected, through compensation, indexation, etc. Says that income has risen lately far faster than productivity; the wage policy needs reviewing and ways should be found to link rewards more clearly with productivity.

Changing role of GOSPLAN:

1- "deepening of function of economic analysis." Quite a different process and uses different methods from past command system. As uncertainty increases needs more effort.

2- "economic prognosis" now needs more attention and emphasis; forecasting.

3- Assisting major state projects and problem areas; e.g., pollution, conversion from military to civilian enterprises.

4- Management of the economic affairs in the strategic or reserved list of sectors noted above; state ownership and planning of more than an indicative nature seemingly justified here.

5- Building direct and indirect regulatory instruments.

<u>Direct</u>: State order being cut back but not eliminated, esp. in transport, communications, huge state financed projects and scientific research. GOSPLAN will continue directly to supervise efforts to resolve major state problems.

<u>Indirect</u>: set, in conjunction with other public actors and agencies, new rules of the game for all Union markets, including price policy, taxation, financing and credit, external trade regulations. Assist in drafting laws and we will review actions and if needed correct the economic regulations.

6- Foreign debt matters also our concern.

The shift in planning approach has already begun, he says, but will accelerate in 1991. GOSPLAN will shift from being an allocator of resources to being a forecaster, policy-suggestor, evaluator. <u>But</u>: we are creating a plan -- read set of commands -- for enterprises remaining under state control. It will be more flexible, lower SO, more independence for enterprises, but a plan nonetheless, with a quota of production, the guarantee of inputs for this amount of production, the guaranteed purchase at a stipulated price of the production. Necessary because "the army needs guaranteed supplies, for example." Says some republics acting in concert with them on food supplies, but we haven't seen much evidence of this.

Provision of the social safety net requires state support "even though these functions are under republican governments." We support certain vital industries -- in medical supplies for example, in basic necessity products such as soap -- but this is for a transitional period. <u>When scarcity is eliminated, rules will be relaxed</u>, he says. (The opposite is the case, of course; when the rules are relaxed there will be a chance for scarcity to be eliminated.) State will order between 10-30% of production in the special product lines and areas mentioned above. It is about, on average, 35-40% in 1990. Will it eventually diminish to zero? No, he says; it seems there will always be some direct intervention role for GOSPLAN (a not surprising view, considering the source). Big difference is that before all attention was paid to the material (quantity) aspect of production; now much more emphasis on cost and quality considerations, plus externalities such as pollution (he uses the term unplanned social impact, not externalities). Says correctly that the smooth functioning of the market system in the west requires considerable government involvement in economic affairs. Concludes incorrectly that western experience justifies continued functioning of GOSPLAN, -NAB, -KOMTSEN, etc. Does admit that the personnel of the old system don't have the experience or skills to run the new approach. Adds that "legislation is needed quickly before the economy gets out of control completely."

<u>Price policy</u>: 2 approaches proposed; rapid transition to free mkt prices (Shatalin); more cautious state approach that proposes to deregulate a key set of "wholesale prices" and by a 60% increase (on average) bring them closer to border prices (official says Soviet prices are on average 2 to 3 times lower than world market prices). Further or faster increase would run the unacceptable risk of throwing into insolvency a huge number of enterprises presently functioning on the administered prices, and would provoke social problems by creating unemployment, posing hardships for disadvantaged elements, etc. Admits that some ents. would be "guarded," meaning subsidized. When equilibrium is established (breezy assumption that it would be) "contract prices" -- presumably

prices negotiated between buyer and seller, but there is a certain vagueness on this key point -- would replace administered wholesale prices. Timetable? Vague. Govt. would establish reference or floor prices and the contracts could be higher or lower. A draft presidential order on this approach is presently being worked out.

Step two: change retail prices for consumer goods and foodstuffs. Must be matched by social security steps for population segments at risk. System of indexation (of pensions? wages?) to be changed. They want to change the price of capital that SOEs were charged, from 0.5% for 10-20 year loans to a range from 3-11% depending on maturity. (Would this be real positive?) Under old system "everyone" became as deeply indebted as possible. They wish to raise the personal savings rates to 2-8%; adopt European-style accelerated depreciation rates to stimulate plant modernization; lots of other minor pts.

Stepanov on macroeconomic management: uncertainty is now accepted and new ways of valuing output are being adopted in order to eliminate distortions. "We are following methods developed in your countries." Financial regulatory mechanisms more and more important; direct allocation less and less, he says. But when we ask if GOSPLAN will simply become a provider of guidance and advice to other ministries the answer is no; they still wish and hope to retain a reduced but nonetheless interventionist role. Though they admit that some of the firms to which they provide orders could be in the private sector. Will GOSPLAN's changing role be set up in law? Looks like it won't, for unclear reasons. At points, the interventionist nature of Bizrukov comes out: i.e., In some cases "there cannot be and should not be any discussions on this point." Notes that President G. has emergency powers to apply reform program to 31.3.92.

States that the press has said that in the govt. plan prices would be fixed and stay fixed indefinitely; this is a misrepresentation of the govt.'s position. Says that while state did continually bail-out poorly performing ents. in the past, in the future this must be revised, though "for social reasons" some ents. would have to be kept afloat by subsidies ("guarded"). In these cases, where possible, and particularly where closure of the firm is a real threat, they will seek "some other owner." (Sell the losers and keep the winners seems to be the policy.) "We realize competition will spur efficiency." It would make firms innovative; make them seek least cost operations (someone has been reading Samuelson in GOSPLAN?)

On privatization: our plan is to transform firms to JSC status, then eventually sell some share to workforce in these companies, and in the further future considerable a further form of sale. But state will still control many large SOEs, organized as JSCos, which could perhaps sell shares to one another (the Algerian model? unclear). Some SOE mngrs. using present uncertainty and unsettled situation to do anything they wish; others are paralyzed and doing nothing at all. When will rules of the game be settled? Cannot say. (While they are talking of the achievements of Soviet planning I am watching through the window a huge line forming across the street as citizens queue to obtain some scarce product this marvelous system has failed to create or distribute.)

Bizrukov complains that Shatalin plan is getting more press coverage and publicity on TV than the govt. plan which, he says, many westerners have been impressed by. Obviously exasperated by the media's role in shaping opinion. Moreover, he says many republics "feel the need for a strong center." The center, he says, "doesn't interfere in their (the reps.) contracts or treaties," and that the role of the central govt. is to help. This benign view of the Union government is not what we encountered in Kiev and Leningrad.

Moscow City Council: 7 officials and consultants affiliated with the Commission on Economic Policy and Entrepreneurship: Dr. Glooshetz, A. Lazarevski, S. Shatalov, S. Chernyak, L. Futumi and others. As in LCC these people are Council members of liberal, pro-market, pro-democracy views, and "experts" and consultants hired by them or working with them out of conviction. This particular Commission (one of many) is interested in privatization, ownership issues, banking and accounting, inter alia. The atmosphere is even more chaotic and feverish than in the LCC; this appears to be a group of talkative (everyone in USSR talks a blue streak; either it is a national trait or they are finding the possibility of talking openly intoxicating) well-meaning people looking for ways to go forward. They have many self-styled "crazy ideas;" but they are inexperienced in govt., inexperienced in the ways and means of the market, and are genuinely looking for practical solutions to overwhelming problems. As they put it: "We desparately real knowledge of real functioning market systems."

The problem in Moscow as they perceive it: 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. The MCC has little power to influence the situation since only 20% of the total number of enterprises in the area are "subordinated" to the local govt. -- and these tend not to be the largest enterprises in either economic value or employment, though some firms in the MCC's control are huge. The rest are republican and mainly Union controlled. On pollution issues, the MCC can impose a maximum fine of 50 R. The MCC hasn't been able to close polluters, as has been done in Kiev (at great cost and in a haphazard way, it seems). The MCC is facing an immediate and huge problem as there is a financing gap in next year's budget of 12 billion R; i.e., 50% of total projected expenditure (due to ending of some transfers from the central govt?) Their needs: to raise money, to enact their program of moving to market structures in the region, and to impose the radical solution of private ownership and privatization, as soon as and as extensively as possible. The major obstacle to privatization is "public opinion," which is not exactly against the concept, but demands that "social justice" accompany any privatization process. ("Social justice" apparently means that the "accumulated national income be equitably distributed among citizens" so that all start off in the new market situation on an equal footing. It also means that steps be taken to minimize unemployment effects, protect population segments at risk, etc.)

Lazarevski says the lack of functioning market mechanisms forces us to retain the old systems, with all their inefficiencies. "If we dismantle these instantly it would only be worse." He gives the example that a change of ownership would not by itself raise a bakery's output. He says also that prices are "meaningless" and a market couldn't correct that overnight. (We would argue a bit with the latter notion.) Says the problems are eventually correctable, but the adjustment period requires regulation and intervention to prevent severe dislocation. The result: "real steps toward the market have been very few."

Where can the MCC, with its limited resources and limited powers to effect changes in economic structures, begin? They think that the first efforts should take place in the real estate market. It is the most important asset for the MCC. At the moment neither the law nor public opinion accepts the notion that land can be owned by anyone, but they hope to use the notion of long term -- 25 year -- leases to get around this. Their ideas (nothing has crystallized into a "plan") are many: they want to get western real estate people in to advise them on how to start a lease market, on how to value assets (a leading priority), on how to organize and implement the scheme. They have talked to several western firms who -- naturally -- want to buy property, including land, for HC, and get a legal title or deed to the property, and are not much interested in anything less. The MCC people want to develop the rouble market; what ideas can you provide us for this? Who is knowledgeable on this, how do we get in touch with them, how can they be paid? Is it possible to think of a situation where foreigners will purchase in HC and Soviets (read Muscovites) in rubles?

Shatalin plan says 10% of lease or sale fees for privatized enterprises would go to CCs; 90% would be returned to GOSBANK and de-monetized, to get at the monetary overhang. We ask many questions, only a few of which they have the slightest answer for. When an enterprise is sold or leased, who now values the assets? It seems that a special state (Union) commission does or will review the transaction to ensure fairness of valuation -- which apparently will be based on a depreciated net book value concept. What will the state commission review, the original transaction or subsequent, later secondary transactions, or both? One person says secondary sales should be banned until legal situation clarified; some in favor of sub-leasing, some opposed. The more market oriented the person, the more they favor wide open transactions.

SOEs here complaining that best skilled people are leaving for the private sector, and this will doubtless accelerate. Now SOEs are trying to create incentives to retain key people (another reason for the spate of coops and leases). The MCC, as everyone else, is looking to set up banks under its own control, since the central govt. blocks the HC earnings that legally should be accruing to the MCC for HC transactions conducted by enterprises in the region. (One participant deplores the fact that the new Commercial banks "only lend money to low risk operations where the returns are highest.") Next year the MCC will start to generate revenues from the tax on SOEs. The 45% profits tax will be divided 22% - union, 23% republican, but this latter sum will be further divided between the republic and the local govts. % not yet known. Some in republics complaining that the 45% rate is too high; may be lowered; if so, republican and local govts. will get a lower amount. While worried about the loss of revenue, they think 45% "may be too high for emerging businesses." They have no real estate tax, no sales tax, no property tax, no local income tax.

In order to raise goods for barter trade, mainly for foodstuffs, they want to force ents. under their jurisdiction to set aside 12% of production for barter use by MCC. They asked the central govt. to instruct the many Moscow ents. under its control to do the same and make the goods available to MCC, but after 2 months of consideration they have received no decision. (Such is the daffiness this system imposes.)

10.2.90: Continuation of discussion with MCC: Glooshetz, Vishnikoff, Chernyak, Lazarevski, and deputy Marina Ouljanina. "We clearly understand that the only way out of the present critical situation is privatization." The 20% of ents. in region "subordinated" to MCC operate in a range of fields from agro-processing to consumption goods, transport (not the Metro), bakeries, etc. Not exclusively but mainly smaller firms. 1.5-1.8 million workers in MCC ents. (of 4.5 million enterprise workforce in the Moscow region).

Gives as a case study of evolving situation the case of BUTEK. An SOE in the construction materials business originally, Butek was one of the first or the very first Soviet ent. allowed to go on lease-hold operation, years ago. In 18 months they replaced all the leased assets with self-owned assets and were considered a great productive success. Several firms sprang up around Butek to supply them and did well because of Butek's relative freedom of operation. In an acknowledged experiment, the govt. is allowing Butek to incorporate into itself other firms whose collectives propose themselves for this transformation. How many have now done so? Unclear. Why do they do this? Because of the greater autonomy and freedom from layers of administrative control provided Butek and its associates; because of freedom Butek has to pay higher wages and salaries; because of local nationalism that saw Butek as a regional rather than a central operation. Govt. decree of 1.90 formalized Butek's independence. (See notes on Butek interview, below.)

The usual confusion on valuation and payments. Seems that Butek received from the government the control of these firms with a clean balance sheet; i.e., central govt. ate all existing debt, and Butek paid nothing for the transferred assets. Collectives of enterprises may or may not have paid -- or contracted to pay in the future and took on debt -- the net book value of the transformed firms to governments (all levels) in some proportion. Assets valued by special commission of central govt. Details murky; law vague in the extreme; a participant says "this is not the only crazy document adopted by the central government." Who owns Butek? Its collective. Still subject to SOs? Yes.

Their thinking on privatization (Glooshetz the spokesperson):

1- ent. assets valued by special commission methods
2- first offer is to existing employees who may buy, using their own savings
3- if funds needed, and they will be needed given the poverty of workers (who has this famous monetary overhang?), then banks will be involved and they will receive shares for their funding of the workers' buyout
4- if workers don't buy within 6 months (Shatalin plan says 1 month) ent. will be auctioned to Soviet legal entities, specifically including private individuals, or enterprises
5- priority in the first auction given to Moscow residents, regardless of where they come from in the USSR
6- if firm not taken in this round it is offered to any citizen of the USSR regardless of area of residence
7- if this fails, the firm will be offered to foreigners

This plan goes from a narrow market to broader. We note the obvious: The broader the market the higher the price. This plan appears to sacrifice revenue, maybe speed of completing deal, a broad search for competent managers; for what? "You have to consider the mood of the public and observe the concept of social justice." Over the last 70 years the Soviet public has had 6/7 of all they produced removed from them and expropriated by the State. All feel they have contributed, that they have a stake in the state assets, and they want part of it back. Foreign partner involvement? Yes, in collaboration with Soviet partners, as minority participants, some sort of acceptance but limited. Chernyak, who wears a Cato Institute pin, says he has no time for the social justice argument but still thinks that foreign purchase must be limited since Soviet citizens don't know or understand market functioning. They must be educated and taught how to deal with the market before turning over ownership to outsiders.

What will happen to the other 80% of ents. now subordinated to central govt? If Shatalin plan is adopted -- and Deputy Ouljanina says Moscow Praesidium yesterday adopted (not approved) Shatalin plan -- the ents. will be subordinated to the Russian Republic. Indirect actions on these from the MCC could entail real estate tax, rents for use of land, ecological standards, anti-monopoly actions. What anti-monop actions? They will be divided into smaller units; for those not amenable to this a limit on the rate of profitability will be set. Criteria on how to divide? Some units producing lines far removed from their original goal; these to be separated. Realization that vertical splitting a possibility as well. On setting profit rates, does not that mean the monopolies will simply increase costs? Union govt. has adopted a policy that if the ent. controls >65-75% of mkt it will be subject to strict price control and regulation; if between 30 and 50% some milder regulations, and they will be prohibited from rejecting orders from regular customers. Their response evidences an attitude that direct instruments can and must still be used to effect desireable economic outcomes; impersonal competition as a more effective force is outside their knowledge and comprehension.

Dr. Glooshetz, who has consistently avowed his acceptance of the free market, thus astounds us by saying they are thinking of devising a system of "municipal orders" for the firms under their control, for which the MCC will guarantee inputs, and buy all output at a stipulated price set by the MosSoviet; and even the above quota production will have prices influenced by the MCC -- they will have "coefficients of profitability, because we understand their costs." If price set results in "excessive profitability," then they will raise taxes. We (Soltwedel, Hare & Nellis) explode in opposition, which surprises them. Active debate; interspersed with our attempts to illustrate how profits act as a signal to entrants, etc. They acknowledge their lack of experience and exposure to western economics (Mr. Lazarevski asks: "What is a natural monopoly?"), and ask for TA help to advise and lead them. We agree that some of the firms being dealt with are monopolies outside the MCC's control, but for many ents. in their jurisdiction -- bakeries, food processing plants -- competition is quite possible.

The meeting concludes with statements reminding us that they are radicals on the Soviet scene, and that the objectives they have set -- free markets and democratic government -- are totally new. If the old guard returns to power they will be ousted and exiled ("executed," says one). Their lack of knowledge of the marginalist mechanisms we work with and espouse should not blind us to the fact that they are struggling with a desparate set of problems, with no resources, and with little or no guidance and theory. It is natural that they turn to mechanisms they are familiar with -- intervention, control, social justice -- to handle the issues of the day. They are uninformed, not unintelligent, and they need and deserve help.

10.3.90 Wrap up meeting with Minister Panitchev of the Ministry of Machine Tools and 5 of his colleagues. Interested in our observations on his enterprises; quite naturally enjoys hearing that we found his ministry and enterprises more dynamic, innovative and positive than others. He is not too pleased with our recommendations that he cast loose the enterprises "to sink or swim" on their own; for all his talk of loosening the reins of control on his enterprises he still envisions an active, interventionist role for the ministry. Hard for him to dismantle his own empire. His argument the familiar one: an immediate and massive de-regulation of controls and prices would be a "nightmare" because it would result in enormous production declines. Moreover, in a poll of the enterprises in his ministry only one voted to sever all links with the ministry or its successor organization; the companies know they need a central coordinating force; they have too many "horizontal ties," they need the center's help on foreign trade issues, R&D, SOs, etc. Still, he welcomes and encourages the firms in his ministry transforming themselves (or being transformed) to JSCos, and indeed he is ready to receive supplying companies, from other branches, into the sort of "holding" he is proposing. With the assistance of a leading political figure he is proposing an association of all leading MT companies in the USSR, but the Prime Minister opposes because he fears it would constitute a monopoly (and it sounds like the PM is right).

Nonetheless, he agrees that "we have to have competition if we are going to have a market." So he is encouraging the spin off of SMEs, coops, hiving off of product lines (such as consumer goods units). But he feels that his managers are not generally ready for full independence; they need training and assistance. Only his specialized ministry can give; the central authorities will not and cannot.

Prices are pulled out a hat, off the wall, no reason to them, he says. Many raw material producers are given output prices that render them unprofitable. Export prices show how part of the process works: MT costs 5kR on domestic mkt. This domestic price is then transformed into $ at official rate, then multiplied by an "export coefficient" to yield external sales price. This turns out to 1.3 or 2 times the domestic price, in official R. The economics director says the pricing is not all that unreasonable given the parameters of the system; says the problem is that we talk of going to the market but we still want to control the market (he's right). He says one solution is to free prices, but then backs off from his own recommendation, saying it would be a "nightmare" if that happened. They fall back on the notion that prices must be liberalized gradually, and expanded and accelerated as the legal situation on private property and JSCos is clarified. On property rights, they think there should be full private property but the issue is far outside their control; a matter for high political authorities.

Conclusion: they want HC, help, contacts, TA, guidance, assistance. The fundamental dilemma is that ideally they should not exist in any form. If a coordinating holding is needed in the MT area it should be done by the private sector; as the track record of public sector holdings has been less than splendid. There is doubtless a long term need for a guiding/analyzing Ministry of Industry at both the Union and republican levels in the USSR, but these will be grand coordinating units with terms of reference far beyond the Min. of MT. One can construct a second-best argument for an interim MT public sector holding -- though interim solutions tend to become permanent very quickly -- to carry out many of the roles Panitchev outlines, but it would have to be far less interventionist that the approach he is evidently thinking of. The point: even the more forward looking and dynamic people are accustomed to direct and command; the notion of letting events unfold according to impersonal market processes is alien in the extreme. Panitchev took advantage of our being here to try to make an impression, to learn something, to obtain contacts and resources, and many of the firms we saw, and the information we obtained, comes from him. He merits praise and future contact.

<u>The Union of Cooperatives</u>, Mr. Tikhonov, Director (also a member of the Supreme Soviet of the Russian Federation). States flatly at outset that coops in the USSR <u>are</u> the private sector; it is the only way the private sector can exist and function. The dominant form of coop is for the initial capital to be contributed by private persons. Production coops -- in all fields -- compose 37% of the total number; 63% service. 215,000 coops in total in USSR employing 5.2 million workers. Of these, 65% are members, 35% hired workers. Total sales in 1989: 40.3 billion R, 5% of GNP. 1st 6 months 90, 32 billion R; projecting 70-75 billion R for whole of 1990, 8-10% GNP. Coops employ 2% of workforce, and produce this output. 3 phases of evolution.

1- Started only in 1988, 2 short years ago (remember we are "still infants"). Govt. policy towards coops was neutral; they were allowed to form but they received no assistance. They enjoyed favorable tax conditions, however, and by the end of 88, 140,000 has formed, employing 1.5 million people.

2- End 88, beginning 89, the first "attacks" on coops, coming from monopolist SOEs (and their ministries) and the party apparatus. The arena of activities permitted to coops was restricted. Attack intensified in mid-89. Input prices charged to coops raised; they paid from 2-12 times SOE input prices. "Terrible" customs duties levied on coop imports that still exist -- cites a 250R duty on a suit costing $60 US as example. SOEs pay far less. As a result, coops generally quit importing inputs. Profits taxes were increased by a factor of 3 or 4 over previous levels; in general coops pay 3 times the SOE rate. Cites a rate of 65% (though another, official source interviewed previously said "average" coop paid 30%, and local govts. could and did often alter rates; we don't get a chance to discuss). At the start of the year coops increased; as "onslaught" went on, and the party made official anti-coop statements, situation worsened. 18,000 coops disappeared in last 6 months of 1989.

3- Starting in 2nd 1/4 of 90 "liberalization" begins, and tax rates on coops lowered to match SOE rates. President spoke out saying private property and ownership was not simply tolerated by socialism, but was actually encouraged by it. Still no easy access to inputs, and that is their major problem; differential prices on materials/supplies. Example: Kamas truck costs SOE 7000R; coop is charged 72000 R. The relaxation -- to the extent it exists -- came about as officials recognized the benefits of competition to SOEs, and increasingly saw the poor production and performance of the SOEs. Many SOEs depending on coops for crucial inputs. At the moment, therefore, situation is somewhat better.

In the presently improved circumstances (improvement mainly due to the Russian republic he says; no faith in the central govt.) his association is moving to promote the direct establishment of private firms, individual farms, "collective" small enterprises -- meaning worker/manager buyouts, a la Butek. Says they are opening membership in their organization to include truly private firms, and all sorts of non-SOE forms. Plenty wish to join, he says.

Example of differences in performance: coop "Builder" in Karelia Republic; a road construction firm. Employs 600 people, had 20 million R gross output in 1989. Construction SOE in same region, working on same sorts of projects, employed 1300 people, had gross output of 11 million R. How to explain? Coop workers work longer, harder, better. 6 days a week, 11 hours a day in summer. SOE 5 days a week, 8 hours a day. Coop average salary 1300 R a month; SOE 260. (Coop works only 8 months a year; SOE employee has only 18 days off.) Coop completes projects on average 1/3 the time of the SOE. Coops have skilled, qualified workers who line up to join; SOE loosing its best people to coop. Now there is competition to work at "Builder." Coops work on SO just as SOE; prices are partly the same -- though for above quota production coop charges higher prices. Says that on average in USSR coop wages and salaries 2X SOE levels. Less bureaucracy, no ministries to insist on rake-off for barter trade. Says coops on average have production costs 35% of total revenues; SOEs 66%. (This may be indication that some inputs are obtained at less than cost or zero price?)

In the larger scene, we must liquidate system of monopoly SOEs and open the market. True that coops charge higher prices, but fewer & fewer state produced goods are available, and the prices for these scarce goods are moving upwards rapidly, 2.3% a month he says (where does he get such precise figures?), while coop prices are stable. Why are there few coops in ag. products retailing? Coops have no access to land; rural population conservative; collective & state farms are monopolists -- all this acts against coops in this sector (products sold in free markets are individual farmer transactions, not coops?). We need a land reform that distributes land to individuals if they so want. Has hopes that Yeltsin govt. ("Yeltsin is very positive about private enterprise in all spheres.") will pass such a law soon.

This year we obtained more freedom to create coops and private enterprises and wider access to foreign markets. We are creating an "external economic amalgamation for export/import." Can make direct deals with foreigners without govt. approval. Have the right to create "mixed banks" here and abroad. Credit: none in west; all obtention of western inputs (little anyway) done on barter deals; coops look not for HC but for goods. Lots of HC earned in west stays there; coops have $380 million in western banks; will grow as liberalization deepens. Domestic credit "not difficult" given the widening network of coop comm. banks. Hard for coops to get credit from regular banks (recall Leningrad regular bank that had a 10-15% "bad debt" rating on loans to coops) but we can easily obtain from coop banks -- at higher rates of interest: 12%. The real problem, enduring problem, major problem is obtaining inputs and materials from generally monopoly suppliers. "No anti-monopoly law exists," no single law yet adopted. "We need a system of anti-monopoly legislation." If approached by outsider his association will assist investor/partner to find suitable local coop. Doing this right now for Dutch/American group looking for Soviet coop partner in the dairy business. How do you identify local prospects? In contact with the Association of Russian Farmers and Coops. (Consistently talks in term of Russia; not USSR.)

Negative attitudes towards coops: understandable, has 2 sources: 1- people used for 70 yrs. to state subsidized prices, often at less than cost, for a range of essential goods. Small range of products but at highly subsidized prices. Consumers don't see reasons for price increases; they see only the problems of higher costs, and conclude that coops are robbing them. 2- anti-coop propaganda from SOEs and ministries and particularly party apparatus "which is very good at propaganda." This has more or less ended by the end of 89 and, he says, the negative attitudes are beginning to disappear. Cites a recent opinion poll that the majority of people favor the workings of coops. (A bit glib on this point. Questionable?) Says also that the substantial accumulated capital of the communist party machine is now being invested in all sorts of private enterprises and ventures, including banks.

All in all a breath of fresh air; here is a force concretely and practically pushing to enter and expand a market. There is a lot of "wild west" activity taking place no doubt -- e.g., <u>where</u> are the coops getting the inputs; is seems obvious that most of their material comes from the state (some at low or no prices); does not the dramatic decline in official supply rates indicate that the missing resources are going into the coop sector, etc? But: they are putting the assets to productive use; they are paying incentive wages; they are getting people to work and putting goods and services into the economy. They -- with leasing, SMEs, collective enterprises -- are the only game in town. (Note: A. Ewing later points out that if 5.2 million workers constitutes 2% of Soviet workforce, then the total workforces is 260 million people, which means everybody but 20 million Soviets are officially at work. This is clearly incorrect. Since Mr. Tikhonov is so wrong on this figure, are others questionable?)

10.4.90: <u>BUTEK "Peoples' Enterprise"</u>: Mr. V. Voronin, Vice President and Pavel Nefidov, member of the BOD. Butek is a "collectively owned enterprise" that is something of a blend of a holding company (but they hold no shares in any of their members); a venture capital fund; an advisory/consulting service; and an agency to promote an idea. It is an association of 350 enterprises, associations, organizations and economic units which have "bought themselves out" of state ownership, control or affiliation. The association includes 25 bought out former SOEs; these 25 alone employ 12,000 people. Their members are in a very wide range of activities, from machine building to "gypsy choirs." They have a machinery division, construction, transportation, tourism, publishing, others.

Relation of Butek to its member enterprises? Relationship has 2 aspects; organizational and economic. 1st task: we help firms or entities to get through the complicated buy out procedure; we provide them with organizational and marketing advice and restructuring. 2nd - we often make a financial input in capital to the firm, but this is not equity, we don't have shares in these independent firms. We take a % of the profits derived from the investments made by the additional capital. If we furnished money for 90% of a machine, we take a proportionate % of the profits generated by the machine's operation. Where no capital is injected we sign a protocol requiring the enterprise to pay us 1% of profits (on average), for our services as promoters/advisers.

From where does Butek get its capital to invest? From profits. Doesn't appear to borrow. Initial capital came from capital injections of founding members. What do enterprises get from Butek? Autonomy; considerable freedom from central and bureaucratic control. (Later told by non-firm person that Butek firms pay only 30% of profits as tax, as opposed to 45% rate paid by everyone else; this is supposedly a special exemption negotiated by the politically well connected head of the organization.) Don't firms joining Butek lose their guaranteed access to inputs and credits? Sometimes yes, sometimes no; Butek is itself a powerful purchaser and finder of materials and they help organize inter-enterprise transactions. Legally, @ firm in Butek is a collectively owned enterprise, just as Butek itself is.

Financing: complicated; some enterprises receive capital from Butek; others pay capital into Butek. No debts or credits anywhere; always a matter of taking a percentage of profits earned. Butek does not yield dividends on the basis of pooled results. It does not recycle profits from winners to losers. "We are not responsible for the firms; we do not run them."

Says there are "scores" of coops in Butek. Why? Because Butek provides them with a "roof" that shields them from the prevailing negative attitude of the public (exactly how not described). In general, members of Butek gain advice, organizing assistance, help in overcoming the hurdles of formation as a collective entity, assistance in marketing and financing -- including access to the banks in Butek. (They are not obliged to use Butek banks.) No failures to date, but still early days. Principal long term objective of the organization? "Used to be a commercial secret," but is no longer; we would like to evolve gradually into a consortium/multi-divisional private conglomerate on the western model. Private business the goal.

How does an SOE go about the buy out process?

1- Someone, usually an inside manager or managers, becomes interested in the idea and sells it to the collective as being in their self interest;
2- interest/decision is conveyed to the controlling ministry (assume their acquiescence if not full approval is required);
3- a Special Commission, composed of members of the collective and reps. of the All Union Ministry of Fiance, is formed to value the assets; they use depreciated book value;
4- the collective pays the entire sum, all at once, to the controlling ministry; and
5- they are henceforth a collectively owned enterprise (all this is according to Council of Ministers' decree no. 77; they insist a proper legal framework exists).

Financing: some of the firms bought out have been fairly large; cites a Moscow firm with 2000 workers, a Kalingrad paper mill valued at 20 million R. Where do the enterprises get the money? Interesting that in most cases the collective pays the ministry out of accumulated reserves in the enterprise development fund. Butek has never been involved in the buy out of a deeply indebted company, though they admit that some of their members are now thinking of acquiring deeply indebted firms. They have so far never had to worry about liabilities of the member firms. They think the valuation method is OF for now; at least they can't think of any acceptable or workable alternative. Admit that some in the Ministry of Finance object to the method, claiming that the assets are being undervalued by this method; that the store is being given away. Some of the enterprises have even managed somehow to obtain something akin to ownership of land; how not specified. They acknowledge a need for lawyers to assist them.

Performance of firms after joining Butek? First performance assessment available in two weeks; they suspect data will show improved production, lower costs, fewer workers and managers, increased salaries (by 10% on average); but these are guesses, not established facts.

Computer Factory in Zelenograd, Ministry of Electronics Industry, Mr. Dyakov, GD, Naydin, Deputy GD and Tech. Dir. Relatively young "amalgamation" of computer enterprises in a satellite city, 40 km northwest of Moscow. Plant value estimated 200 mill R; "further growth practically impossible." Have not been "benefiting from internal division of labor;" the result is a highly vertically integrated firm in an area where, worldwide, small firms lead and dominate. Notes that funds have been pumped into this sector by the state, concerned to bring sector up from seriously lagging position. So: firm established in 1964 as integral part of ministry; from 1974 an enterprise in its own right; comprises 40 different companies, of which 8 in Zelenograd (producing half of production) while the other 32 (with the remaining half) are scattered all over the USSR. They produce 500 mill integrated circuits a year of one sort or another. 100,000 total employees; 4 billion R turnover.

This year: structure of enterprise radically altered; they signed agreement to become a "concern" or association of companies. From being the GDir of the entire undertaking he -- Dyakov -- henceforth is the Chairman of the Board of the association, and CEO of the R&D coordinating unit. The constituent firms are now much more independent operations, though they have all signed "protocols" that recognize the central, leading role of the unit he heads as CEO. From being an administrative hierarchy they have switched to an economic hierarchy. What is the real difference for him? Before I ordered; now I must suggest. Still allocates a centralized investment fund. The association will divide profits on the basis of amounts invested. If a company wishes to leave the association it can do so, but it would have to find a new "partner," another association, to assist it to survive in an environment where an independent single company cannot operated. He thinks it unlikely many or any will leave.

75% of all inputs produced by units within the association, from silicon wafers to crystal growth and on to every aspect of the finished product. They have to have such vertical integration to assure availability of key inputs.

(As R. Soltwedel says, here "just in time" inventory is just a dream.) The firm accounts for 80% of industrial production in Zelenograd. Legal status: the association will soon become a JSCo, and perhaps in the future so will the constituent firms, but this depends on gradual weaning from the state budget and SO system. They will seek foreign participation and capital; they need HC for imported inputs (the computer plant we later visit has close to 100% of imported machinery.) He says they are rather content to be in the Ministry of Electronics which has treated them well; their only extensive external links are with industries producing metals, chemicals and textiles.

Each associated company has clearly defined assignment. "If the component is not produced within the complex I have to go out and get it; the ministry doesn't help anymore." Money doesn't obtain goods; one has to barter. He believes these incessant barter deals mean he "is already living in the market economy." Deplores "uncontrolled invasion" of competing SEAsian items into Soviet market. He notes the firm has always had a SO of 100% (and as a priority sector he hasn't had to worry about supplies, credit or access to for. ex.). He doesn't know what next year's SO will be and is worried -- he has never gone into October before without knowing the SO; he is "starting to think about what to do" if there is no SO. He is worried about production falling and supply difficulties if the republics move to autarky.

Unhappy in the extreme about coming changes in the tax/resource flow system. Before: from his general revenue, he deducted total costs (including labor; my earlier thinking that this was separated out may be incorrect or a misunderstanding) which on average equalled 70% of income. He then paid 75% of the remainder as tax. <u>But he got back 2/3 of the tax, from his ministry, as a payment to support R&D</u>. This payment amounted to about 2/3 of total R&D expenditure; the remainder he obtained from his after tax profits. Now, his tax rate declines to 45%, but there will be no return payment for R&D.

49% of product ICs. He has 6 "competitors;" other Soviet computer firms, not taking into account JVs and coops. In some product lines he "has scores of competitors." Is there price, advertising or quality competition? No price competition, no advertising, on quality he is "confident" his products are superior (but our Soviet friends insist that the product is high priced, of limited capacity, with difficult software, and worst of all, breaks down often. It would be interesting to contrast black market prices for his products vs. other Soviet models). He says that for every R of wages we sell 3 R of products, a high ratio for the USSR (international norms of any sort available?) Price competition is not relevant since there is an acute shortage of chips, PCs. Quote of the interview: when asked what justification there is for a strong central coordinating unit he says the associated companies must be "forced to expand production of their more successful models."

He will soon switch to "contract prices." Just what are these? He says he simply doesn't know how these will function. He has always had a price list for all products simply handed to him. He seems to think that contract prices may apply only to new product items. Any HC exports? Gives a vague answer; perhaps question misunderstood, in plant visited later we hear of several items being exported to HC areas -- and are shown them. Dyakov talks of many deals with foreigners being investigated, planned, on the verge of signing ("in

November"). Has no licenses for import. Claims a comparative advantage in computer assisted design (CAD).

Expresses need for $30 million HC for new factory. Factory we visit has some $16 million foreign equipment which he expects to pay back in 4 years. How will new organization aid performance? Talks of -- and we later see something of -- flexible production teams; in essence, a fixed amount of wage bill is set aside for x amount of production -- with quality controlled. Worker teams can choose the number of workers necessary to produce the output and the time to do it. Thus, it is mainly in their hands; the more people involved and the longer the time taken, the less the individual pay; and they have charts on the wall showing the payments and trade offs. Clear incentives for the workers to work hard and economize on labor. Works well he says; units using system way over production; some people work on break times (everywhere we go the pace looks leisurely, I must add). Competition keen to get into the special units; pay is much high, more than double average. Foremen recommend workers to join. All this freedom a function of the new status; could not have easily been installed previously. Cost containment measures added; 1% of all cost reductions added to the general wage bill.

Coops and leases in the concern? "I don't tell anyone but we have quite a lot." (Fitumi translates his aside -- "practically every employee is in this or that coop.")

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