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THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION/MULTILATERAL INVESTMENT GUARANTEE AGENCY

OFFICE MEMORANDUM

DATE: October 10, 1990

TO: Messrs. Fred Levy (EAS), Alan Gelb (CECSE), John Holsen (PADSS) Stanley Fischer, Paul Hare

FROM: John Nellis, CECPS JN

EXTN: 37482

SUBJECT: Study of the Soviet Economy: Draft Summary of Component

Here is a draft of the brief BTOR/summary statement on individual components, revised from the version I gave you in Moscow on 10/5. The changes are: the addition of the last sentence in para. 1; re-wording of sentence 2 in para. 2; significant re-wording of sentence 1 in para. 3; the addition of a last clause at the end of para. 3; the addition of a new sub-section c, on the need for a hard budget constraint, in para. 6; an additional sentence on the composition of Boards of Directors in section e of para. 6; some minor changes in para. 8 concerning the work team system; the addition of the last two sentences in para. 11; slight re-wording in the first part of para. 12, and the addition of the two last sentences in the same para.

In addition, I add a separate section on the mechanics of privatization; this in response to Stan Fischer's reflection that the issue was insufficiently covered.

Ownership rights in Soviet state enterprises.

1. **The overwhelming bulk of productive capacity in the USSR is still officially owned by the state** (though the very word, ownership, has a connotation difficult to apply to Soviet circumstances). There are between 46,000 and 55,000 state owned enterprises (SOEs) in the industrial sector alone; these account for the bulk of Soviet non-agricultural economic activity. There has sprung up since 1988 a large number of non-state economic entities -- service and production cooperatives, leasing arrangements, "collective" enterprises, "small" enterprises, and "limited" enterprises, for example. These have tended to be small in size in terms of employment and production, but large in number: for instance, as of 10/90 there are an estimated 215,000 cooperatives operating. Moreover, the economic importance of these non-SOEs is growing: one source asserted that cooperative production alone accounted for 5% of GNP in 1989, and will account for 8-10% in 1990.

2. **The ownership issue is currently in a state of acute flux and uncertainty.** The 1990 law on ownership, and that on enterprises, can be interpreted to mean fundamental changes in the concept -- short of allowing full private ownership of all forms of property -- but the crucial, detailed enabling/implementing texts are lacking. This leads to considerable speculation about what the laws intend and allow, but no practical policy has yet been elaborated. **This issue requires urgent attention by Soviet authorities.**

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3. The mission met no one who could state definitively to whom the enterprises will belong as of the beginning of 1991. The passed but not yet enacted laws suggest a diminution of the ownership role of "the state," and an increase in the property control functions of enterprise managers, acting with and through the enterprise councils. Avenues for the transformation of enterprises into joint stock companies, collectively-owned companies (manager/worker buy outs), leases etc. have been opened; and many opportunities have already been seized. **These latter mechanisms are steps on the way to true private ownership**; but the lack of legal details means they are happening in an ad hoc, sometimes chaotic manner.

4. The unsettled circumstances allow the bold and the entrepreneurial to seize opportunities and obtain strong controlling powers --verging on ownership rights -- over previously public assets. While this appears to be leading to dramatic production gains, much of this activity is of dubious legality. **Nonetheless, the report should argue that the economic benefits of these actions far exceed the socio-political costs.**

<u>Performance Improvement in State Enterprises</u>

5. Officials and ministries feel they have recently increased autonomy at the level of the firm. **They are incorrect; the process has not truly begun.** Until enterprise General Directors have the right to hire and fire, to tie rewards (and sanctions) to performance, to choose inputs and adjust product line and output prices according to cost structure and market demand, etc., they will remain production engineers and not enterprise managers.

6. What is to be done? (with apologies to Lenin): **The optimal solution is to privatize the enterprises, as rapidly and as massively as possible.** For those enterprises that will nonetheless temporarily or indefinitely remain in state hands, the following steps should be taken:

a- All SOEs should immediately be transformed into joint stock companies with their shares held by State Property Agencies brought into being at the appropriate levels of government. This Agency represents the owner.

b- The owner should issue a clear policy statement stipulating that SOEs will be run as profit-maximizing commercial operations.

c- In conjunction with the introduction of price liberalization, a hard budget constraint must be imposed on all enterprises.

d- The notion of "non-commercial objectives" should be introduced. The assignment of such objectives to firms should be minimized; but when the owner assigns such objectives to SOEs their cost should be calculated and the firm compensated for their fulfillment. The performance of managers and workers should be evaluated on the basis of transparent commercial factors within their control.

e- The owner -- or its agents; the need to deal with thousands of enterprises would overwhelm even republic level agencies -- should guide and assess enterprise performance through membership on the enterprise Board of Directors (or some modified body to conform to the details of the Law on Enterprises). This Board should be composed of technical experts in the field of the enterprise's activity; of legal and banking experts; and in appropriate cases, of persons representing the firm's clientele. The Board should have full power to appoint, evaluate and dismiss enterprise management. The owner has the same rights over the Board. The Board deals with the enterprise; the owner deals with the Board. The owner has no direct dealings with enterprise management.

f- The Board should establish and monitor a formal system of annual statements of corporate intent, containing objectives, clear targets against which performance shall be judged, a dividend policy, non-commercial activities and their compensation, and details of the reward or sanction if the objectives are (are not) achieved.

7. Is any of this feasible? Even if technically so, can it work in a system of state orders? The assessment is that with time (3 to 5 years), commitment, considerable technical assistance and a capacity to modify the plan to suit evolving local circumstances, this general schema could be productively applied to Soviet enterprises.

8. Right now, performance improvements and efficiency gains can be produced by: accelerating the on-going division of enterprises into production units and allowing the workers and foremen in these units to spin themselves off as coops, "collectively-owned" entities and lease-holders; expand the use of "flexible production teams" encountered in a few enterprises (x amount of wages are set aside for y quantity -- and z quality -- of production; worker teams decide how many people they need to produce the stipulated quantity and how much time they want to expend); and in general by allowing and encouraging methods that link higher pay to harder, better work.

(On <u>Labor participation</u> see Manuel Hinds' note.)

<u>Owner/Enterprise Relations and Management Issues</u>

9. Owner/enterprise relations are covered sufficiently for the moment by the schema proposed in para. 6. On management: the present crop of Soviet SOE managers require considerable assistance and retraining. **The optimal solution would be to use new, differently trained, inexperienced -- and thus unspoiled -- entrants.** Failing that, the existing stock must be upgraded.

10. The minuscule sample of General Directors interviewed tended to be bright, dynamic and forward looking -- but this should be somewhat discounted since one can assume that the ministries chose carefully the firms to be visited. In the few cases where we chose the firm, the GDs were less impressive. Still, **the key areas requiring improvement will be at less than GD level.** There is a near complete lack of notions of business; i.e., of marketing and advertising. The situation is not much better for cost containment, quality control and design (with some exceptions on the latter). Accounting, financial management and management information systems as utilized in the West are rudimentary.

11. Management training centers and schools are popping up all over the USSR; reportedly, they already number 120. They range from hastily conceived bodies that offer low-cost weekend crash courses in someone's apartment, to 60,000 ruble MBA programs, complete with internships in Western firms. They have tended to concentrate on top management, exposing them to the principles of Western business operation. **This needs to be supplemented with courses aimed at middle management, on production issues; i.e., the kind of training offered to middle**

management "in-house" in Western firms.

12. The needs are immense and overwhelming; the scope for diagnostic studies, technical assistance, and training obvious. **The Soviet Union should take advantage of the considerable experience accumulated to date by other post-communist countries and the technical assistance agencies formed to assist the transition process.** Even if the experienced granting agencies -- the World Bank and IMF, British Know How Fund, the OECD, etc. -- cannot immediately make assistance available to the USSR, the various levels of Soviet government can send at once teams to London, Paris, Hungary and particularly Poland to inquire into the problems encountered in the transition process, resources available and the ways devised to deal with turning civil servants who were receivers of orders into managers who seize opportunities. Particularly useful from the enterprise perspective is the highly regarded Polish program of training "company doctors." These teams make a rapid triage of enterprises, and divide them into the comparatively healthy, the hopeless -- candidates for liquidation -- and those in which restructuring would prepare them for sale or healthy performance.

Mechanics of Privatization

1. In Yugoslavia, Poland and Hungary, enterprise-controlling workers' councils have established claims or rights that severely complicate the privatization process. The difficulties of resolving these claims, combined with widespread fears that uncontrolled or "spontaneous privatization" was resulting in injust and illegal transactions, have slowed and complicated divestiture efforts in those countries. In the USSR, workers councils have not had as much legal power, nor have they exercised what powers they possess for a lengthy period (since 1987 only). **Conclusion: there is not yet among Soviet workers a strongly developed sense that the enterprise in which they work is "theirs."** However, a number of radical voices are now advocating giving free of charge the enterprises to their existing "collectives" -- the totality of workers, technicians and managers in a firm; and this position is finding a receptive audience among workers.

2. A competing claim, expressed more by managers and ministries, is that the Soviet experience with "free" property has been disastrous, and that any and all transfers of ownership must involve payments. In addition, as in the other countries named, there is considerable public concern over the illegalities and inequities of the on-going changes in enterprise form (the coops, leases, etc.). All of this discussion is preliminary and unsettled; **it has not yet reached the stage of deliberation found in the three countries named above, or Czechoslovakia.** Thus, there is little or no thinking about the specific mechanics of privatization in general, and in particular, on whether or how the population at large should be involved in the ownership change process. There is to date no talk of "voucher schemes," "ownership coupons," or widely-held holding companies. One reason for this is that discussions of the extremely unsettled union/republic situation have taken precedence over consideration of more technical details.

3. It is likely that the issue of privatization techniques/mechanics will soon come to the fore, at the local soviet and republican, if not the all-Union level. It is equally likely that complaints will start to surface from the large number of people whose work positions will not automatically confer ownership rights

under a system of direct transfers to the collectives (whether free or paid). These include professionals, administrators, intellectuals; i.e., articulate and powerful groups. **Work should start at once on examining the experience in ownership change carried out or envisaged in neighboring post-communist countries, and applying the lessons so far learned to the Soviet scene.** Here as elsewhere, concrete advances depend on the prior resolution of the legal framework; i.e., the clarification of private property rights, the resolution of what level of government owns the enterprises, the transformation of SOEs into joint stock companies.

4. Institutionally, the apparent logic of combining in a single agency diagnosis/restructuring/portfolio management <u>and</u> privatization responsibilities has seldom worked out in practice. Each task is sufficiently difficult to justify a single purpose body, though they must often consult and work in concert. **The creation of an appropriate set of institutions, and the division of labor between them, requires urgent attention from Soviet authorities.**

cc: Messrs./Mmes: J. Linn (CECDR), Hinds (EMTTF), Shirley, Lee (CECPS)