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## THE FORMER SOVIET REPUBLICS CONFRONT PRIVATIZATION: A RUSSIAN ANALYSIS

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### INTRODUCTION

One of the most urgent tasks for the republics of the former Soviet Union is to dismantle their inefficient, state-dominated economies and to turn over to private ownership virtually all state-owned agriculture, businesses, housing, industry, and land. This transition from a communist command economy to a market economy—commonly known as privatization—must be undertaken with unprecedented speed, because the Soviet economy is collapsing, and only a growing, robust private sector can save it.

Privatizing the state sector will result in increases in efficiency, higher quality products, increased wages and decreased costs to government. Of course, privatization is not a panacea for all that ails the republic economies. To be effective, privatization must be accompanied by other reforms such as price and trade liberalization, tight control of the money supply to avoid inflation, deregulation, tax reform, and budget cuts.

**Formidable Obstacles.** Recent experience with privatization in Eastern Europe demonstrates that the republic policy makers face formidable obstacles. Foremost among these is the sheer size of the undertaking. By some counts there are approximately 46,000 large state enterprises and 750,000 state-owned shops on the territory of the former Soviet Union. In addition to finding methods for turning these entities over

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This is the first of a series on privatization in the former Soviet republics. The purpose of this study is to provide an overview of some of the problems the republics face in trying to privatize their economies. Subsequent parts will offer recommendations detailing the options available to republic policy makers to overcome the obstacles to privatization.

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to private ownership, the 50 percent of the housing stock still in government hands and the bulk of agricultural land also need to be privatized. Privatization on such a mass scale has never been attempted.

Technical and economic obstacles to privatization in the republics include the lack of savings, an absence of capital markets and banking institutions, and a currency that cannot be converted into Western "hard" currencies needed for international transactions. Agricultural privatization is a particularly difficult task. Furthermore, the irrationality of Soviet prices, which have been set arbitrarily by the state rather than market forces, makes it nearly impossible to correctly value the state enterprises to be privatized. As if these problems were not enough, political and social obstacles to privatization are sure to arise, including opposition from local officials and the *nomenklatura*—the Soviet Union's entrenched bureaucracy—new problems of envy, the need to privatize in an equitable way, and control over part of the underground economy by the Soviet Union's own "mafia" of organized crime.

**Sound and Savvy Policies.** While the obstacles to privatization in the former Soviet republics are formidable, they are by no means insurmountable. Most of these problems have been encountered in privatization efforts in other parts of the world, and have been overcome by economically sound and politically savvy policies. The lack of capital markets and domestic savings and the problem of how to value enterprises can be overcome by giving away state assets, rather than selling them. The opposition of workers, factory managers, and local officials can be turned around by giving them a stake in promoting the development of a market economy. Some of the giant "agroindustry" state farms can be privatized by turning them into joint-stock companies and giving workers shares in the enterprise.

Finally, the republics should be expected to rely on internal financing and private foreign investment for privatization, not Western government handouts. Foreign firms are already very active in the republics. In the near future, there should be much greater foreign interest in purchasing stakes in the more profitable enterprises. Republics should encourage greater foreign participation in the privatization process because it brings in needed capital and managerial expertise.

Without doubt, the peoples of the former Soviet Union will encounter political and technical difficulties in the process of privatization. However, they have no alternative but to embark immediately on this task. The longer they wait, the more difficult it will prove.

## POLITICS AND PRIVATIZATION

The new political situation after August 19's failed coup has resolved the issue of what to do with what is known as "all-union property." Virtually any enterprises or other assets owned by the Soviet central government, or "center," it is widely acknowledged, now will belong to the republics. It also is clear that privatization will be almost entirely the responsibility of the republican governments rather than what remains of the center. While some republics unwisely may choose to go slowly, republican control of privatization on balance should accelerate the process, as has been demonstrated with privatization efforts around the world.

The main danger is that some republics may try to exclude outsiders from bidding on enterprises within their territory. Such a restriction of capital flows would be self-defeating because it would decrease the amount of capital available for purchasing and subsequently modernizing the enterprises, thereby slowing the process. These and other restrictions on capital flows and free trade—such as restricting exports—explicitly should be rejected by the republic governments. Any program of privatization also will require tailored approaches. Policy makers, for instance, face much different political and technical obstacles in privatizing housing than they do in privatizing large industry.

**Problem of Restitution.** Eastern Europe's recent experience with privatization demonstrates that the issue of restitution—returning land and buildings nationalized by communist governments to their former owners—can slow privatization significantly. This is because competing claims on properties can result in prolonged legal battles and uncertainty regarding title to properties. It also discourages foreign investors, who may fear that their investment will be lost in the event of a claim by a previous owner. Restitution currently is a real issue only in the Baltics, which already are committed to returning land taken from private owners by the Soviet government after World War II.

In the rest of the former Soviet Union, restitution primarily affects those who emigrated around the time of the 1917 revolution and ensuing civil war. This is because only those living outside the Soviet Union managed to hold onto the legal papers to their estates; within the Soviet Union, possession of such documents could have meant a death sentence during the Stalin era. Up to now, this issue was seldom discussed publicly in Russia or most of the republics. But if restitution to emigrants becomes an issue it could be an extremely controversial one, especially since the land of many former "countryside" estates is now part of heavily industrialized cities.

## HOUSING

Housing is one of the most politically sensitive sectors of the economy and needs to be privatized rapidly. Only one half of the housing in the Soviet Union currently is privately owned. These are primarily houses in small towns and villages, as well as some condominiums in large cities. The average Russian citizen has 160 square feet of living space, or about the size of a kitchen in an American home. Most housing is heavily subsidized by the state and therefore very inexpensive, equalling only 5 percent to 10 percent of an average individual's salary. Yet this system had tremendous costs to the average citizen. There is a dire shortage of housing in the Soviet Union. Some families wait ten to fifteen years for housing. And some never get their own apartments and are crammed in with relatives or housemates, particularly in the cities.

The process of assigning apartments is a bureaucratic nightmare; there are innumerable waiting lists for all categories of people, including veterans, families, singles, and others. Assigning housing is one of the most important, and lucrative, activities of local authorities. Corruption is rampant. As a matter of course, bribes to local officials are required to obtain apartments. Once apartments are obtained, residents come to consider the apartments their own, even though technically owned by the state, since it is

virtually impossible to lose an apartment even if the rent is not paid. This will make privatization of housing a contentious political issue, since those who want to keep their homes will have to start paying for them, and because local opposition will arise if individuals from outside the community begin to move into local housing, displacing current residents.

Between 1986 and 1988, there was considerable growth in housing construction. However, since 1989 the rate of construction has dropped by one-fourth. The absence of private land and restrictions on entrepreneurial activity are preventing any improvement in the situation.

**Recent Reforms.** A law passed in early August by the Russian parliament gives all Russians the right to own their own homes. Existing living quarters will be transferred to current residents if they want to become owners. The first approximately 200 square feet of space per family member will be transferred free of charge. If the total area of the apartment exceeds this, then the resident will have to pay the state for the extra space. Price will be determined by quality and location of the apartments. Those who choose not to assume ownership of their apartments can continue to pay rent instead, but the rent will go up significantly based on market factors. A similar program of housing privatization is being undertaken in Lithuania.

One problem with the Russian law is that it is not clear who will own the buildings the newly-privatized apartments are in, and who will be responsible for maintenance of common areas, connections with public utilities, landscaping, and other tasks. Plans are for the state to retain responsibility for maintenance, but there is no reason to believe that the state will do any better than the poor job it is doing today.

Ultimately, the critical need is to encourage the new construction of private housing. This can be done by slashing complex and burdensome government regulations governing construction—regulations that were set up for the precise purpose of discouraging private construction. This will facilitate free entry into the housing market. The result could be a housing boom that would be a driving force behind economic expansion by increasing the demand for lumber and other construction materials, wiring, plumbing, and other goods needed for homebuilding.

## **TRADE, SHOPS, AND RESTAURANTS**

The experience in Eastern Europe demonstrates that privatizing retail trade and food services can be relatively easy. In Poland for instance, over 60,000 such establishments were privatized in a little over one year. Armenia, the Baltics, Georgia, and possibly Ukraine also will be able to rapidly privatize shops and restaurants. However, small-scale privatization may go more slowly in the other republics, including Russia.

There are several reasons for this. For one thing, there still exist strong prejudices against private trade, ingrained by years of exposure to “official” ideology. Many people misguidedly consider trade a form of “profiteering” that benefits small groups at the expense of honest members of society. Such anti-market attitudes, while probably not that widespread, could be an impediment to reform in some localities.

For another thing, in many parts of the former Soviet Union the so-called "underground economy" largely controls the regional supply of goods. All attempts by the government to uproot this suppressed form of market economy have failed. To be sure, the underground economy has its advantages. With the breakdown of the state distribution system, the underground economy has become the only reliable source of supplies for retail shops. On the negative side, a segment of the underground economy is controlled by organized crime, which is engaged in extortion, racketeering, protection, and drug pushing. In many areas, the local crime organization is in collusion with the *nomenklatura*, which is bribed to protect criminal monopolies. A significant percentage of cooperatives are controlled in this way, resulting in much higher prices for goods that are of the same dismal quality as those which would be found in state stores, if they had anything on the shelves. It will be extremely difficult for the government to separate the beneficial and the criminal elements of the underground economy. The greatest danger is that the *nomenklatura* will use the need to break up the criminals as an excuse to crack down on legitimate business activity.

Another obstacle to privatizing shops and restaurants throughout the former Soviet Union is that retailers often must still rely on the inefficient state distribution system for supplies. New private businesses could fail due to the inefficiency of the state distribution and wholesale system. To avoid this, policy makers should privatize the wholesale, distribution, and retail levels of the economy simultaneously, rather than simply selling off the shops and leaving the rest of the economic chain controlled by the state. Ironically, there are examples of entrepreneurship in the wholesale sector developing already from the Komsomol — the young Communist league. Previously, Komsomol members represented different enterprises in their districts, and therefore had a good working knowledge of available resources. Recently many have put this knowledge to work in the private wholesale trade, using their personal connections with the *nomenklatura* to ensure that supplies reach retail traders.

## AGRICULTURAL LAND

Due to the tremendous inefficiency of collectivized agriculture, fertile regions that once were agricultural exporters, such as the Baltics and Ukraine, now must often cope with food shortages of their own. Privatizing agricultural land will rapidly increase the productivity of farms in all the republics and ensure that reliable supplies of staples reach hungry citizens. In some republics, agricultural privatization is proving relatively easy. Example: Armenia already has privatized 70 percent to 80 percent of its agricultural land. This was possible because the agricultural plots in Armenia were not very large, and therefore could easily be turned over to the peasants who worked the land. In some other republics, particularly Russia, quick agricultural privatization faces significant obstacles.

One problem is the scale of Russia's "agroindustry." The huge size of Russia's state farms, known as *kolkhozes*, is not in itself the problem. In China, beginning in 1978, huge state farms similar to Russia's were privatized quickly by simply dividing up the land and distributing it to peasants. But on many large Russian collective farms there is the added factor, not present in China, of widespread reliance on sophisticated large-scale machinery. Such machinery cannot easily be divided up among the workers of

collective farms. Furthermore, many of the large farms will be more efficient economically if they are not broken apart before being turned over to private owners.

U.S. agriculture, for instance, is far more efficient and productive than that of Western Europe because American farms are much larger, and therefore can take advantage of economies of scale. One solution for the large and relatively productive *kolkhozes* is to turn them into joint-stock companies, and to give freely tradeable shares in the new company to the workers.

Another major obstacle to agricultural privatization is the strong political and economic power of the managers of the agroindustrial enterprises and of local government authorities in rural areas. Their very strong political lobby convinced the Russian parliament to write off about 70 billion rubles of debt owed to the state from the *kolkhozes*. In many cases these debts were owed by healthy agroindustrial enterprises.

**Significant Clout.** These managers and local officials also have significant economic clout. Collective farm managers control the distribution of such supplies as fuel and fertilizer and the allocation of resources. The new, private owners of land will be dependent in the short run on the willingness of these same managers and local officials to sell them supplies. The managers could use this economic power to sabotage the new private farms.

Local authorities and managers of state farms have a great interest in preventing the successful privatization of agriculture because they will lose the powers and privilege they now enjoy. Most of these communist bureaucrats do not have the skills needed for farming on their own and are unlikely to be hired elsewhere in the near term. The only realistic way to blunt the opposition of these powerful opponents of market reform is to turn their opposition around by giving them a financial interest in the success of agricultural privatization. This can be done by giving them land and shares in the privatized *kolkhozes*.

A final obstacle to rapid agricultural privatization is that many of the agricultural regions in Russia are deteriorating and are very sparsely populated. Demographically, they have aging populations since most of the brightest young people from the countryside—those who will be needed to make the new private farms productive—were recruited to work for the bureaucracies in major cities like Moscow. Young people working in city factories and bureaucracies, many of which need to be shut down anyway, should be encouraged to go back to the land. One way of doing this would be to employ a homestead approach similar to that used in America's old West. Citizens from urban regions would be given the opportunity to stake a claim on formerly state-owned land in return for a promise to cultivate it.

## LARGE STATE ENTERPRISES

Around 46,000 large enterprises, employing many millions of workers now are coming under the control of republic governments. The majority of these enterprises are inefficient, and produce goods and materials of vastly inferior quality and design to those in the West. To improve efficiency, production, and quality, and to bring these factories up to Western levels, they must be turned over to the private sector. Putting

## Fixed Assets in the USSR at the End of 1988 by Industry

Area	Billions of Rubles	Percentage Distribution			
		Russia	Ukraine	Baltic Republics	Caucasus Republics
<b>Industry</b>	901.9	64.7%	15.7%	2.63%	3.42%
<b>Construction</b>	96.6	65.8	11.3	2.43	4.68
<b>Agriculture, Forestry</b>	395.6	50.6	17.5	4.61	4.11
<b>Transportation</b>	359.6	63.5	14.1	3.21	3.93
<b>Communication</b>	28.8	61.9	13.3	4.06	4.16
<b>Storing, Procurement</b>	31.2	59.7	12.6	2.77	2.94
<b>Trade and Catering</b>	60.7	64.9	14.2	2.74	3.45
<b>Information</b>	2.6	50.9	12.7	7.99	6.25
<b>Production Total</b>	1887.0	---	---	---	---
<b>Housing</b>	524.8	—	—	—	—
<b>Public Utilities</b>	125.2	---	---	---	---
<b>Education</b>	102.0	60.4	16.0	3.43	3.19
<b>Science</b>	49.6	76.6	10.9	1.84	2.15
<b>Culture and Arts</b>	20.3	47.5	22.1	4.63	4.65
<b>Public Health</b>	60.7	64.5	15.1	3.15	5.51
<b>Other Branches</b>	42.3	—	—	—	—
<b>Non-Production Total</b>	924.9	---	---	---	---
<b>Gross Total</b>	2801.9	—	—	—	—

**Note:** Baltic Republics = Estonia, Latvia, Lithuania; Caucasus Republics = Armenia, Azerbaijan, Georgia  
Data compiled by Leonid Grigoriev.

these enterprises in private hands in a relatively short period of time will not be an easy task. In Britain, it took nearly ten years to privatize about two dozen large state-owned enterprises.

There are numerous impediments to privatizing state enterprises in the republics. These include a lack of capital markets, the near impossibility of correctly valuing the enterprises, high inflation—which makes investment inherently more risky—and a shortage of household savings to use to purchase shares in enterprises.

Most of the savings in the former Soviet Union are concentrated in the hands of a small percentage of the population. Those who could be classified as “rich”—usually private businessmen or black marketeers—possess more than half of all personal savings. For the bulk of citizens, household savings are not great enough for major investments. Even among the relatively well-off segment of the general population, those with annual incomes in the 300-400 ruble range per capita, average savings are sufficient only to buy one or two major items, such as a car. The majority of the population possesses only enough savings to buy ordinary consumer durables, meet run-of-the-mill unforeseen expenses, and supplement state pension funds for retirement. Such in-

dividuals, with their limited resources, cannot be expected to play a major role in the purchase of state assets.

Another potential problem in selling state enterprises to outside investors would be opposition from the managers of the enterprises. Many managers consider themselves the de facto owners of the enterprises that employ them, and would strongly resist the loss of control. The failure of the August coup reduced the power and size of the existing *nomenklatura*, but many still will attempt to assert control over enterprises and profit from their privatization.

An often-proposed solution to overcoming all the obstacles to rapid privatization of state enterprises in the republics is to issue vouchers free of charge to every citizen. The vouchers in turn could be used to purchase shares in state enterprises. The Russian parliament approved an initial voucher system on July 3, 1991. These vouchers have been termed "privatization accounts," and can be used by Russian citizens to acquire shares in state and municipal enterprises from local or republic authorities. The voucher system has much to recommend it, yet distributing the vouchers to hundreds of millions of citizens entails enormous administrative problems. Moreover, with little available accurate published information about individual enterprises, the average Russian citizen—in fact, even many financial analysts—will have no idea which enterprises might be good investments, or what their real value should be. The process will more closely resemble a lottery than a market-oriented approach to investment based on potential profitability. Lastly, such an approach would mean that in the short run, ownership of enterprises will be broad and diffuse. Without the presence of strong core owners, the enterprises may continue to operate as inefficiently as they did in the state sector.

A better alternative than having citizens invest directly in state enterprises with vouchers would be to assign large state enterprises to "investment funds." The investment funds would first turn the state enterprises into limited liability, joint-stock companies. The investment funds would be charged with selling or distributing stock in the new joint-stock companies and appointing Boards of Directors to head the companies. The investment funds would be required to sell off their portfolio of state enterprises within a given time period, perhaps ten years.

## CONCLUSION

The failed coup has opened the door for dramatic political and economic change in the republics of the former Soviet Union. One of the most urgent reforms for the new governments is privatization. Housing, land, agriculture, industry, stores, restaurants, and services all need to be transferred rapidly to the private sector.

While the need for massive privatization is generally acknowledged by most of the new leaders in the republics, privatization faces daunting obstacles that may discourage many leaders from launching an ambitious program. For instance, the lack of a capital market, which allows savings to be transferred efficiently to investment, constrains privatization. Other obstacles are the absence of market institutions, high inflation, a worthless and non-convertible currency, opposition from the *nomenklatura*, and the sheer size of the task in the state-run economy.

**Surmountable Problems.** To develop appropriate policies, policy makers need to have a clear understanding of the numerous political and economic obstacles to privatization. They must recognize that though the obstacles are formidable, they are not insurmountable. Instead of selling state assets and running into major problems with valuation, for instance, state assets can be given away. Problems with agricultural privatization can be overcome in a number of ways, including turning large agroindustrial complexes into joint stock companies and giving away shares in the new enterprise to the workers.

The experience around the world with privatization—from Britain to Chile to Kenya—demonstrates that heavy political opposition and serious technical difficulties to privatization can be surmounted through creative strategies. The republics of the former Soviet Union can draw important lessons from the success and failures of the worldwide privatization movement and the recent experience in Eastern Europe. Although the course will be a difficult one, privatization in the republics ultimately will be the critical first step to building prosperous economies in the republics of the former Soviet Union.

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