

**Various Problems concerning Corporations**

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## 1. What are obstacles to business?

I would like to discuss various problems concerning Russian corporations by dividing them into external environment and external environment. To this end, first, I would like to investigate business problems posed by the external environment surrounding corporations, by referring to the outcome of a survey of more than 3,600 business managers in 69 countries published by the World Bank in 1997. In the survey, the managers were asked to judge on a six-point scale how problematic various obstacles are for doing business in their country. The six points range from “the least serious obstacle” to “the most serious obstacle” Table 1 is a list of scores of each item in the left column. The survey obtained responses from a total of 3,685 managers in 69 countries, including 254 managers in 11 advanced countries, 139 managers in the South/Southeast Asia countries (Fiji, India, Malaysia), 771 managers in 11 Central/East European countries (Czech Republic, Hungary, Poland, etc.), and 650 managers in 10 CIS nations (Russia, Ukraine, Armenia, Azerbaijan, Belarus, Georgia, Uzbekistan, etc.). The table shows that for business managers in the world, high taxes are the most serious obstacles to doing business. But, the seriousness of other items as obstacles to doing business varies depending on the region and the level of economic growth. In terms of world average, “corruption” comes next to “tax regulations and/or high taxes” as the most serious obstacles. But in Central/East European countries and CIS, “corruption” ranks third. In Central/East European countries, “financing” is viewed as more serious obstacle and in CIS, “policy instability” is viewed as more serious obstacle than “corruption.”

**Table 1 Region-by-region rank of obstacles for doing business**  
**(1 = most serious obstacle, 15 = least serious obstacle)**

	Total	Advanced countries	South/Southeast Asia countries	Central/East European countries	CIS nations
Regulations for starting business/new operations	12	5	5	12	11
Price controls	14	14	14	15	12
Foreign trade regulations	10	10	10	9	7
Financing	3	4	8	2	6
Labor regulations	9	2	4	10	13
Foreign currency regulations	13	13	9	13	10
Tax regulations and/or high taxes	1	1	1	1	1
Infrastructure	4	7	2	5	9
Policy instability	8	11	12	7	2
Safety or environmental regulations	11	3	13	11	15
Inflation	6	12	3	4	8
General uncertainty regarding costs of regulations	7	6	7	8	5
Crime and theft	5	9	11	6	4
Corruption	2	8	6	3	3
Terrorism	15	15	15	14	14

(Source) Institutional Obstacles to Doing business, p. 60.

As shown in the table, even within the problems of the external environment surrounding corporations, the extent of seriousness of the obstacles felt by business managers varies greatly. Of the problems of external environment, I would like to discuss corruption that ranked second worldwide and third in CIS and Central/East European countries, price controls and their related problem of monopoly, taxation problem, and trade regulation problem one by one. In addition, I would like to discuss privatization problem, a problem peculiar to transition countries.

As problems concerning internal environment, I would like to study productivity problem. Table 2 shows industry-by-industry changes in Russia's labor productivity (ratio of output to labor force) as against 100 for 1991. The table shows that labor productivity was on a downward trend for a long time, though it recovered slightly in 1999 thanks to the recovery of import-substituting industries and brisk exports of oil, both brought about by the devaluation of the ruble after the financial crisis in 1998.

**Table 2 Russia's industry-by-industry labor productivity (1991-1999)\***

	1991	1992	1993	1994	1995	1996	1997	1998	1999**
Total	100	82	75	64	68	70	76	76	84
Electric power generation	100	86	77	66	60	56	54	50	49
Fuel	100	87	76	70	71	69	72	72	79
Ferrous metallurgy	100	81	68	60	67	65	70	66	74
Nonferrous metallurgy	100	70	59	57	55	54	61	62	68
Chemicals and petrochemicals	100	76	62	50	57	55	58	56	67
Machinery	100	88	82	64	66	69	76	77	92
Paper and pulp	100	81	73	54	60	54	60	66	77
Construction materials	100	75	65	50	49	45	48	50	55
Light industry	100	81	68	39	33	30	33	33	41
Food processing	100	82	75	62	59	57	58	59	62

(Note) \* The ratio of output to labor force

\*\* Estimates

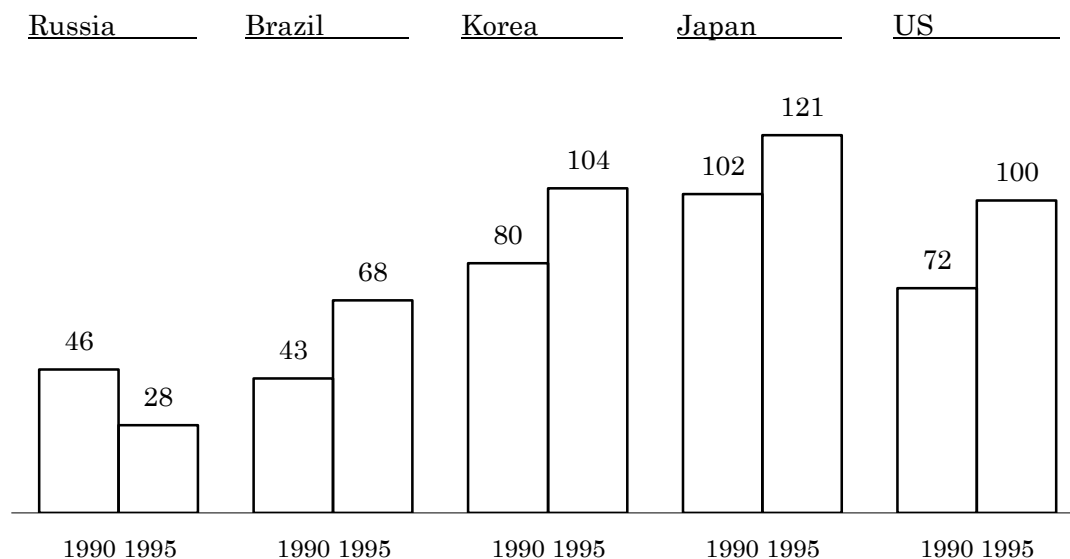
(Source) Russian Federation: Selected Issues, IMF Staff Country Report, p. 32, No. 150, 2000

The labor productivity of the ferrous metallurgy sector is extremely low by the world standard. Graph 1 shows labor productivity of the steel industry sectors of Russia, Brazil, South Korea, Japan and the United States in 1990 and 1996 as against 100 for the U.S. labor productivity in 1995. The graph shows that the labor productivity of only Russia's steel industry sector fell drastically. The downtrend is not limited to the steel sector. Other industrial sectors also saw their labor productivity decline during the same period. This indicates that the decline in productivity is an important point when we discuss the internal environment of Russian corporations. The Russian labor productivity in 1991, which was used as the base year, is not a high level to begin with. On the premise of these facts, I would like to discuss problems of Russian corporations' internal environment relative to the problem of productivity.

Graph 1 Country-by-country labor productivity of steel industry

### Labor Productivity Evolution, 1990-95

Indexed to US = 100 in 1995



Source: "Unlocking Economic Growth in Russia," Mckinsey Global Institute, 1999

## 2. Corruption

### 2.1 Background of "corruption"

Of the problems of external environment of corporations, first, I would like to take up corruption. There can be various definitions of "corruption." Here, I would like to define "corruption" as "an individual's or organization's action (inaction) accompanied by violation of rules in order to seek rents (returns to resource owners exceeding opportunity costs) generated by national adjustments." In this case, the scope of "corruption" varies whether one defines the "rules" as laws or ethics and ideologies. This is because I want to discuss "corruption" in a broad scope, not limiting to "bribe" by public officials. Unless otherwise, it is difficult to discuss the "bribe acceptance" by officials of Gazprom, the state natural gas company, as "corruption."

I believe that corruption during the socialist era included theft by members of socialist owner organizations, activities of *Tolkachi*, activities of private entrepreneurs, and foreign-currency transactions. In addition, bribe acceptance and frauds by

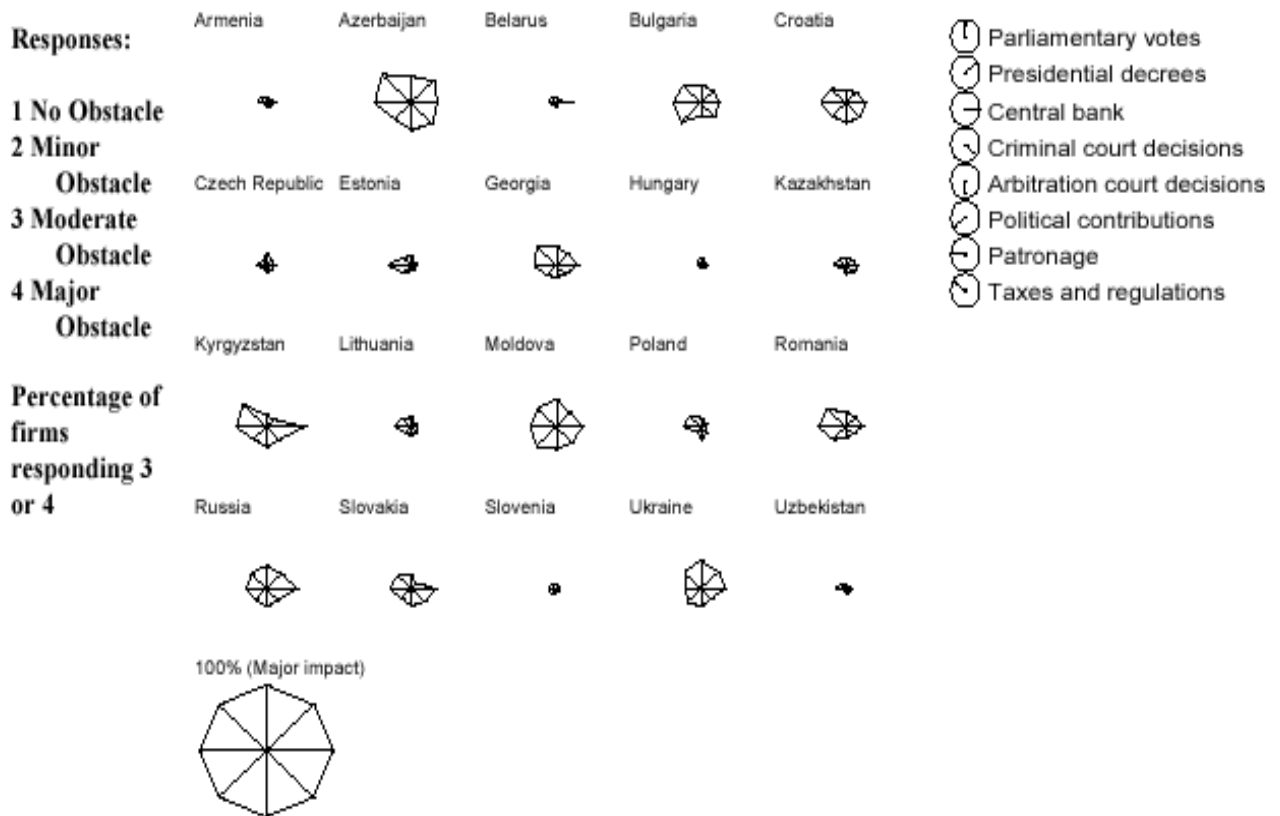
government officials are corruption. Later, activities of private entrepreneurs and foreign currency transactions were legalized during the process of transition to market economy and are no longer regarded as “corruption.” However, social conditions that were created during the socialist era have complicated the Russian “corruption” problem after the switchover to free market. They have remained as the “negative legacies” of the socialist era in such form as 1) weak legal system, 2) people’s undeveloped awareness of rights, 3) the habitual inclination of right protection organizations to protect “national interests” and “whole society ownership,” and 4) traditional obedience not to laws but to senior government officials ([7]). During the process of transition to market economy, there occurred big changes in corruption in that 1) The “corruption” structure underwent a major change, as the transition to market economy has strengthened the function of the “currency” that had been suppressed during the Soviet era, 2) The “corruption” structure became complicated, as the phenomenon called “dollarization” took place at the same time, and 3) “corruption” deepened as a result of inflow of foreign investors and foreign capital. Moreover, since the spread of “corruption” makes it easy to acknowledge agents engaged in corruption and “corruption” feeds on itself, the problem of “corruption” has become more serious.

## **2.2 “state capture”**

In particular, the problem called “state capture” has become serious. This refers to “an act by an individual, group, or public/private enterprise to influence the formation of laws, regulations, and national policies in their favor, by proving private benefits to public officials in an unlawful, dubious way.” In this sense, “state capture” is one form of “corruption.” This form of “corruption” occurred frequently during the period of transition, as changes of systems in diverse fields were necessary in order to make the market economy function. Graph 2 is a summary of a survey concerning corporate governance, “corruption,” etc. conducted on more than 3,000 business owners and managers in 22 transition countries by the World Bank and the European Bank for Reconstruction and Development in 1999. The business owners and managers in 20 of the 22 countries were asked to what extent the following forms of corruption have had an impact on business. Responses were indexed and expressed in octagons. Six of the “corruption” form questions are designed to measure the extent of “state capture.” They are 1) sale of Parliamentary vote on laws to private interests, 2) sale of Presidential decrees to private interests, 3) Central Bank mishandling of funds, 4) sale of court decisions in criminal cases, 5) sale of court decisions in arbitration cases, and 6) contributions paid by private interests to political parties and election campaigns. In

order to measure the extent of administrative corruption, the pollees were also asked concerning public officials' patronage to put their friends or family members on the government payroll and bribes paid to public officials to avoid taxes and regulations. The graph 2 shows that the extent of "corruption" is relatively high in Azerbaijan, Moldova, Kyrgyz Republic, Ukraine and Russia. However, there are two major limits in this survey. First, since the survey was conducted at the business level, we cannot grasp politicians' "state capture" for their private interests. Second, the survey depends on the private sector's degree of development.

**Graph 2 To what extent have the following forms of corruption had an impact on business?**



(Source) Hellman, *et al.*, Mark, Measuring Governance Corruption, and State Capture, p. 21, 2000

Besides the above survey, an organization called Transparency International, which was established in 1993, has been publishing Corruption Perceptions Index (CPI) of the

countries in the world since 1995. The CPI shows that “corruption” is widespread in former Soviet bloc countries (See Table 3). It can be said that behind this lies the “negative legacies” of the socialist era and the problem of “state capture” as mentioned above. The Table 3 is a ranking of perceptions of the degree of corruption as seen by businessmen, experts, etc. and ranges between 10 (highly clean) and 0 (highly corrupt).

The problems of “state capture” are problems concerning enactment of various rules and regulations, such as laws, presidential decrees and government decisions, establishment of licensing and registration systems, and “regulations” concerning their application and execution. If the “regulations” were liberalized, “corruption” would likely decrease. In reality, however, in order to liberalize various judgments, the persons covered must meet the conditions for the liberalization. This is because in order for the market to function, there must be rules to make the market function and, above all, there must be a system under which each “player” can conduct transactions based on their own judgement. The conditions here mean the “players” are aware of not only market rules but also the existence of transaction settlement systems. It is also necessary for the “players” to have funds to conduct economic activities. However, it is difficult to meet all these conditions when the economy is in the process of transition from socialism to capitalism. Simply liberalizing “regulations” would cause a great confusion. Unfortunately, Russia ruthlessly took the course of such liberalization with the support of the IMF and other international financial organizations. To be more precise, the Russian government ventured into such a course on its own will without fully paying attention to the above conditions in its move toward market economy, such as introduction of individual labor activity and revitalization of cooperative associations.

**Table 3 Corruption Perceptions Index (CPI)**

	2000	1999	1998	1997	1996	1995
Finland	10	9.8	9.6	9.48	9.05	9.12
Denmark	9.8	10	10	9.94	9.33	9.32
New Zealand	9.4	9.4	9.4	9.23	9.43	9.55
Sweden	9.4	9.4	9.5	9.35	9.08	8.87
Canada	9.2	9.2	9.2	9.1	8.96	8.87
Iceland	9.1	9.2	9.3	-	-	-
Norway	9.1	8.9	9	8.92	8.87	8.61
Singapore	9.1	9.1	9.1	8.66	8.8	9.26
Netherlands	8.9	9	9	9.03	8.71	8.69
United Kingdom	8.7	8.6	8.7	8.22	8.44	8.57
Luxembourg	8.6	8.8	8.7	8.61	-	-
Switzerland	8.6	8.9	8.9	8.61	8.76	8.76
Australia	8.3	8.7	8.7	8.86	8.6	8.8
USA	7.8	7.5	7.5	7.61	7.66	7.79
Austria	7.7	7.6	7.5	7.61	7.59	7.13
Hong Kong	7.7	7.7	7.8	7.28	7.01	7.12
Germany	7.6	8	7.9	8.23	8.27	8.14
Chile	7.4	6.9	6.8	6.05	6.8	7.94
Ireland	7.2	7.7	8.2	8.28	8.45	8.57
Spain	7	6.6	6.1	5.9	4.31	4.35
France	6.7	6.6	6.7	6.66	6.96	7
Israel	6.6	7.7	7.1	7.97	7.71	-
Japan	6.4	6	5.8	6.57	7.05	6.72
Portugal	6.4	6.7	6.5	6.97	6.53	5.56
Belgium	6.1	5.3	5.4	5.25	6.84	-
Botswana	6	6.1	6.1	-	-	-
Estonia	5.7	5.7	5.7	-	-	-
Slovenia	5.5	6	-	-	-	-
Taiwan	5.5	5.6	5.3	5.02	4.98	5.08
Costa Rica	5.4	5.1	5.6	6.45	-	-
Namibia	5.4	5.3	5.3	-	-	-
Hungary	5.2	5.2	5	5.18	4.86	4.12
Tunisia	5.2	5	5	-	-	-
South Africa	5	5	5.2	4.95	5.68	5.62
Greece	4.9	4.9	4.9	5.35	5.01	4.04
Malaysia	4.8	5.1	5.3	5.01	5.32	5.28
Mauritius	4.7	4.9	5	-	-	-
Morocco	4.7	4.1	3.7	-	-	-
Italy	4.6	4.7	4.6	5.03	3.42	2.99
Jordan	4.6	4.4	4.7	-	4.89	-
Peru	4.4	4.5	4.5	-	-	-
Czech Republic	4.3	4.6	4.8	5.2	5.37	-
Belarus	4.1	3.4	3.9	-	-	-
El Salvador	4.1	3.9	3.6	-	-	-
Lithuania	4.1	3.8	-	-	-	-
Malawi	4.1	4.1	4.1	-	-	-
Poland	4.1	4.2	4.6	5.08	5.57	-
South Korea	4	3.8	4.2	4.29	5.02	4.29
Brazil	3.9	4.1	4	3.56	2.96	2.7
Turkey	3.8	3.6	3.4	3.21	3.54	4.1
Croatia	3.7	2.7	-	-	-	-
Argentina	3.5	3	3	2.81	3.41	5.24
Bulgaria	3.5	3.3	2.9	-	-	-
Ghana	3.5	3.3	3.3	-	-	-
Senegal	3.5	3.4	3.3	-	-	-
Slovak Republic	3.5	3.7	3.9	-	-	-
Latvia	3.4	3.4	2.7	-	-	-
Zambia	3.4	3.5	3.5	-	-	-
Mexico	3.3	3.4	3.3	2.66	3.3	3.18
Colombia	3.2	2.9	2.2	2.23	2.73	3.44
Ethiopia	3.2	-	-	-	-	-
Thailand	3.2	3.2	3	3.06	3.33	2.79
China	3.1	3.4	3.5	2.88	2.43	2.16
Egypt	3.1	3.3	2.9	-	2.84	-
Burkina Faso	3	-	-	-	-	-
Kazakhstan	3	2.3	-	-	-	-
Zimbabwe	3	4.1	4.2	-	-	-
Romania	2.9	3.3	3	3.44	-	-
India	2.8	2.9	2.9	2.75	2.63	2.78
Philippines	2.8	3.6	3.3	3.05	2.69	2.77
Bolivia	2.7	2.5	2.8	2.05	3.4	-
Cote d'Ivoire	2.7	2.6	3.1	-	-	-
Venezuela	2.7	2.6	2.3	2.77	2.5	2.66
Ecuador	2.6	2.4	2.3	-	3.19	-
Moldova	2.6	2.6	-	-	-	-
Armenia	2.5	2.5	-	-	-	-
Tanzania	2.5	1.9	1.9	-	-	-
Vietnam	2.5	2.6	2.5	2.79	-	-
Uzbekistan	2.4	1.8	-	-	-	-
Uganda	2.3	2.2	2.6	-	2.71	-
Mozambique	2.2	3.5	-	-	-	-
Kenya	2.1	2	2.5	-	2.21	-
Russia	2.1	2.4	2.4	2.27	2.58	-
Cameroon	2	1.5	1.4	-	2.46	-
Angola	1.7	-	-	-	-	-
Indonesia	1.7	1.7	2	2.72	2.65	1.94
Azerbaijan	1.5	1.7	-	-	-	-
Ukraine	1.5	2.6	2.8	-	-	-
Yugoslavia	1.3	2	3	-	-	-
Nigeria	1.2	1.6	1.9	1.76	0.69	-

(Source) [www.transparency.org](http://www.transparency.org)

### **3. Specific “restrictions”**

Under the socialist economic system, achieving planned goals was given the top priority. Prices, supply of materials and machinery, and trade were controlled in order to draw up plans and achieve planned goals. And in order to facilitate planning and achieving planned goals, paternalism between the government and state enterprises was rampant over easier-termed subsidiaries, tax collection, credit and price setting. This constituted a hotbed of “corruption.” Even during the transition period, the paternalism remained in place in different forms, such as special treatment in subsidy, taxation, and credit line. Here, I would like to discuss price control, subsidy and tax collection one by one. I would also like to take up privatization, which characterize the transition period, and trade individually from the viewpoint of “restrictions.”

#### **3.1 Price control**

The typical “corruption” that was frequently observed during the period of economic reform implemented by President Gorbachev was purchasing resources and semi-finished goods at fixed low prices and selling products through cooperative associations or leased enterprises that could sell the products at market prices. But, the price controls were largely lifted around the demise of the Soviet Union and it was thought that “corruption” had decreased sharply. However, we need to pay attention to the fact that the price controls remained in place in various forms, especially in local districts. As of July 1993, 33% of the 132 cities in Russia were implementing price controls on milk, 48% of them were controlling prices of bread, 15% on meat products, and 14% on sugar ([2] p. 206). In order to maintain the price controls, it was necessary to provide subsidies. This generated not only the possibility of “corruption” but also the need to prevent the subsidized products from flowing out of the districts. As a result, some local government officials and “Mafia” began to cooperate in order to strictly check the goods transported ([2] p. 206-207). On the other hand, price controls are still maintained at federal and local government levels on electricity, gas, heat supply, railway fares, basic communications services, and housing/public services. These restrictions on monopoly businesses tend to become a hotbed of “corruption.”

The problem of monopolistic enterprises is serious, because they are large and have not only a large number of employees but also big capital. They own so-called “pocket money banks” and form financial-industrial groups, enjoying strong political clout. They can put pressure on the government and guide “restrictions” to their interest. They tend to fall into “state capture.” Gazprom and UES are typical examples of this.

Therefore, breaking up or reducing monopolistic enterprises have become a big problem.

UES has already decided, as the first step, to split its regional power companies into four divisions – power generation, electricity transmission and distribution, electricity sale, and service/maintenance ([16]). Of the power generation division, large thermal power plants are to be transferred to a new “thermal power company” that will be established and placed directly under the control of UES. Similarly, hydroelectric power plants will be transferred to a “hydroelectric power company.” The remaining small thermal power plants are, in principle, to be sold to outside investors or to remain in their respective regional power companies. As to the power transmission and distribution division, the high-voltage transmission lines that form trunk lines are to be transferred to a new nation-wide power-transmission company (100% owned by UES). In principle, only power distribution networks will be left in the regional power companies. The sales divisions are to remain in their respective regional power companies. The service/maintenance divisions are to be completely separated from UES and will be sold to outside investors or transferred to local governments.

In the second stage, a “power wholesale market” is to be created, where almost all power companies will become sellers and almost all regional power sales companies will become buyers. At present, only slightly more than 30% of the total electricity generated are traded on the market. The new power wholesale market is to handle almost all electricity generated. A pricing system based on supply-demand conditions is to be gradually introduced to the market and ultimately the pricing will be completely liberalized. In this process, the pricing system of the socialist era, under which rates for households are set higher than for corporations, will be revised.

Whether this bold reform will actually be implemented or not is anybody’s guess. But it is important as a specific example of dissolving a monopoly. In reality, however, regional power companies have close relationship with regional governments, as the authority to set electricity rates for consumers belong to commissions under the jurisdiction of regional governments. As such, it is not clear if the painful reform for both enterprises and households can actually be implemented. Moreover, there has emerged a problem of lowering the high reliance on gas turbines and substituting them with coal. The dispute over the power generation method may become a stumbling block to the planned abolition of UES.

As for Gazprom, although there was an extensive debate on splitting the natural gas company in 2000, it is not clear how it will be handled. As for railway, the government approved a railway transportation reorganization program in April 2001.

In the first stage, the railway freight rate that is now temporarily monopolized is to be liberalized and “Russia Railway,” a joint-stock company, is to be set up by the end of 2002. The stock of the “Russia Railway” is to be held 100% by the State and the 17 railways now under the jurisdiction of the Railway Ministry will be transferred to the company. At the same time, the Railway Ministry is to separate its management and adjustment functions and transfer the rate adjustment function to a different organization. The program also calls for splitting the businesses of “Russia Railway” within its organization after 1-2 years. However, it is not clear to what extent the management autonomy of individual railway companies will be expanded by this. Although, given the public utility nature of railway business, “restrictions” by the government cannot be avoided to some extent, it is not clear how the “restrictions” will be reduced and made transparent. It is necessary to announce a plan showing how to sell stocks of individual railway companies and how to promote their privatization. Moreover, there are problems of how to ensure competition among railway companies and with airplanes and trucks.

Anyway, prices of goods and services provided by monopolistic public utilities are still controlled by the central and local governments through special commissions. In order to discuss price problems more objectively, it is necessary to establish a system that respects not only interest of industry but also regional public utilities.

Besides the above monopoly, we should not forget the problem of “monopoly of lawful violence,” such as police, the Federal Security Service, and the Federal Tax Police Service. Former members of the former KGB and police, for example, have set up private security guard companies to offer so-called “roof” services (security services). It is problematic that these private companies are offering not only “roof” services but also guarantee of contract maintenance, settlement of conflicts, and consulting concerning various organizational problems, disregarding the rules, such as laws and ordinances. They are engaged in such acts as driving the new entrants out, tax evasion, and unlawful collection of debts. Behind this lies close reciprocal relationship with the present police and Federal Security Service. Meanwhile, the security guard companies established by conventional crime organizations have been officially registered and are pretending to be legitimate private companies. The former is said to be more reliable than the latter and offers lower prices. But both resemble “Mafia” in that they are likely to use violence to settle problems. When the State is weakened and the security services by the State has declined, the rise of such “Mafia” is not necessarily “evil” ([1] p.29, [12] p. 210). They may transform themselves into legal business ([12] p. 214-215, [21] p.59). Nevertheless, the nonchalant dissolution of the “monopoly of lawful violence”

of the socialist era appears to have brought about more complicated situations to the whole society of Russia in transition. It also resulted in reinforcing the “monopoly of lawful violence” created by such organizations as the Federal Tax Police Service and the Presidential Security Service. It is hoped that measures will be taken to re-educate the officials of the Interior Ministry and the Federal Security Service with regard to the “monopoly of lawful violence” and sever ties with it.

### 3.2 Subsidy

In order to investigate the relations between subsidy and “corruption,” I would like to take up the issue of high proportion of settlements using non-monetary transactions, such as settlements by near money, like barter, mutual netting and “bills.” Table 4 shows the composition of payment forms in Russia compiled by the OECD as of December 1998. The table shows that it is not barter, but mutual netting that accounts for the largest proportion of non-monetary transactions by Russian industry, followed by “bills.” By industry, the proportion of cash settlements is high in “commerce/public services,” “agriculture,” and “light industry/foods” that have lots of transactions with consumers. On the other hand, the proportion of non-monetary transactions is high in “electricity,” the basic industry, and in the “machinery/metal” and “construction/construction material” industries that trade a lot of intermediate goods.

**Table 4 Industry-by-industry composition of payment forms in Russia  
(December, 1998 in %)**

	Cash	Mutual netting	Securities	Barter	Others
All industry	43.4	29.5	11.5	7.5	8.1
Electricity	19.5	45.2	16.7	4.1	14.5
Fuel	39.4	36.5	15.2	4.7	4.2
Machinery/metals	14.1	37.4	31.3	13.5	3.7
Construction/construction materials	26	44.6	7.8	18.5	3.1
Transportation	37.4	45.8	11	0.3	5.5
Light industry/foods	69.8	12.7	4	7.6	5.9
Agriculture	65.1	3.3	0.5	28.6	2.5
Commerce/public services	84.4	11.6	3.2	0.3	0.5

(Source) OECD Economic Survey, Russian Federation, 2000, p.87

Of the non-monetary transactions, mutual netting increased remarkably in and after 1995. But, when the financial crisis surfaced in August 1998, non-monetary transactions began to decrease and along with it, mutual netting also began a

downward trend. However, this does not mean that the problem of high proportion of settlements by near money was dissolved. Here, I would like to discuss the problems of mutual netting and so-called “implicit subsidies.”

The most important factors behind mutual netting are a underdeveloped financial system and the use of non-monetary transactions in the form of “implicit subsidies” based on “collusion” relations instead of “trust.” Since mutual netting takes the form of offsetting the claims of A who provided goods and services to B by B’s credits to A (A’s debts to B), such transactions usually take place on the assumption that either credits or debts to be offset, or both of them, are to be accumulated for a certain period. This is because unless both A and B have credits and debts each other, they cannot be offset on the book. Therefore, there needs time to accumulate credits and debts. In the meantime, the debts remain “unpaid.” It looks like a kind of commercial credit in the sense it is a kind of credit sales. But, while commercial credit is based on “trust,” the “unpaid” is based on “collusion,” not “trust” established on the basis of market economy. Mutual netting has an aspect of rescuing an unprofitable enterprise to ensure employment. But, it also has an aspect of being a hotbed of bribery resulting from the opacity of transaction. There exists a relationship that can be called “collusion.” Since the financial system is underdeveloped, the parties concerned establish a relationship of “collusion” instead of “trust,” on conditions that they settle transactions by mutual netting, and mutually allow debts to remain unpaid. They provide, as it were, “implicit subsidies” to each other.

Table 5 shows to what extent mutual netting was used at the federal government level. It reveals that mutual netting, under which federal government’s credits concerning tax payment are offset by its debts to enterprises, accounted for 10-20% of the federal budget revenues. The ratio began to increase after 1995 and hit a high of 23.9% in 1997. Mutual netting covers taxes collected within a period, but sometimes covers taxes that were not paid within the period. It also covers fines and surcharges on unpaid taxes.

**Table 5 Cash-based netting in federal budget (1 billion rubles)**

	Tax-exemption certificate	Direct fund netting	Reverse fund netting	Targeted fund provision	Unknown	Total netting	Total revenues	Ratio of netting to revenue (%)
1994	9					9	81.7	11
1995	21.8					21.8	210.6	10.4
1996	30.9	23.9			2.7	57.5	287.6	20
1997		62	24.5		2.1	88.6	371.2	23.9
1998			19	21.8		40.8	320.8	12.7

(Source) Pinto. B., Drebensov, V., Morozov, A. “Dismantling Russia’s Nonpayments System: Creating Conditions for Growth,” World Bank Technical Paper, No. 471, p. 9, 2000

(Note) “Tax-exemption certificate” was issued by the Ministry of Finance to the providers of goods and services to the federal government. It granted the right to offset taxes and taxes in arrears to the federal government. “Direct fund netting” is an arrangement to carry out a chain of settlements by using an account with a commercial bank without causing any outflow of funds from the bank. For example, a commercial bank provides loan to an electric power company and has its taxes in arrears offset in the amount equal to the loan. Meanwhile, the government pays for the same amount of orders to the defense industry and the defense industry pays electricity bills to the electric power company and the electric power company uses the money for repayment of the loan. Under the “reverse fund netting,” federal budget funds are infused into commercial banks and the commercial banks provide loans to enterprises and the enterprises offset their overdue taxes. “Targeted fund provision” is the national treasury taking over the above function of commercial banks.

The netting has an aspect of “subsidy.” For example, by offsetting a 100-ruble tax debt by the goods and services with a market value of 60-70 rubles that were provided to the federal government, the government can provide “implicit subsidies.” In other words, a subsidy is provided to the supplier of goods and services by assessing the goods and services higher. According to the result of investigations of mutual netting at the federal level in 1995 that was made available to the Central Auditing Commission in January 2000, the Ministry of Finance offset 45 billion ruble worth of deals with oil company Yukos but the federal government did not owe 40.6 billion of the 45 billion rubles to Yukos, or 90.2% of the netting (“Profile” p. 61, No. 12, 2000). In other words, the government conducted the netting after discounting taxes by 90% or after excessively overestimating the debts to Yukos. It is highly likely that through the dubious netting there was an illegal flow of funds among the high government officials,

company executives and bank officials involved in the deal. It is on this ground that we believe the netting was conducted on the basis of “collusion” of the parties involved. “Implicit subsidies” increased after 1995, when the federal government, in a bid to reduce fiscal deficits, began to strictly restrict subsidies to enterprises. On the surface, “implicit subsidies” increased in a way to make up for the cut in subsidies to enterprises. But, as Table 5 shows, mutual netting decreased drastically in 1998 as mutual netting at the federal level was banned in the beginning of the year.

The proportion of cash in local governments’ budgets is low, as mutual netting is more frequently used at the local government level than at the federal government level. We, therefore, assume that a structure of corruption based on “collusion” among local government officials, corporate executives and bank officials has been established at the local level as well. According to surveys conducted in Leningrad Oblast and Nizhegorod Oblast, the goods and services provided to the local governments were assessed 40-70% higher than their market prices in mutual netting. The commissions that the intermediaries of the above mutual netting received are said to have accounted for 3-30% of the total netting, higher than at the federal level.

Next, I would like to discuss “implicit subsidies” related to gas supply. The gas exploration and distribution are basically handled by subsidiaries of Gazprom, but low-pressure gas to end-users is distributed by local gas distribution companies (GDCs). Since most of the GDCs are controlled by local authorities, it is legally and technically difficult to suspend gas supply on the ground of unpaid gas bills. In the spring of 1997, Gazprom established a subsidiary, Mezhhregiongaz, and began groping for a way to sell gas directly to customers on a contract basis. As of autumn of 1999, however, most of low-pressure gas is not supplied in such a way.

Under the circumstances, Gazprom provides “implicit subsidies” to customers by allowing non-payment of gas bills (if inflation is taken into account, simply leaving the bill unpaid means discounting the gas rate) and assessing the value of goods and services provided to Gazprom higher than their market prices in barter transactions and mutual netting. Table 6 shows changes in such subsidies provided by Gazprom. The former of the above two kinds of subsidies is expressed by “Via a delay” and the latter by “Via a barter.” After it became difficult to provide explicit subsidies in 1995, “implicit subsidies” have increased their importance.

Meanwhile, Gazprom delays payments to budget and funds and also to its suppliers. The delay in payments of taxes and social insurance premiums, in particular, shows federal government’s tolerance of Gazprom in recognition of the gas company’s “implicit subsidies” to domestic customers. The government also supports Gazprom’s provision

of “implicit subsidies” indirectly, by offering a special tax treatment to the company. Therefore, it is believed that there exists a relationship of “collusion” among Gazprom, corporate customers and the federal government over “implicit subsidies.” A similar relationship exists with regard to electricity supply. But I want to omit it for want of space.

**Table 6 Implicit domestic subsidies by Gazprom**

	Via a delay (\$1 billion)	Via a barter (\$1 billion)	Ratio of total implicit subsidies to GDP (%)
1993	1.4	1.4	1.4
1994	1.6	1.7	1.3
1995	3.4	3.7	1.8
1996	3.6	3.7	1.8
1997	3.3	3.5	1.6
Total	12.7	13.5	

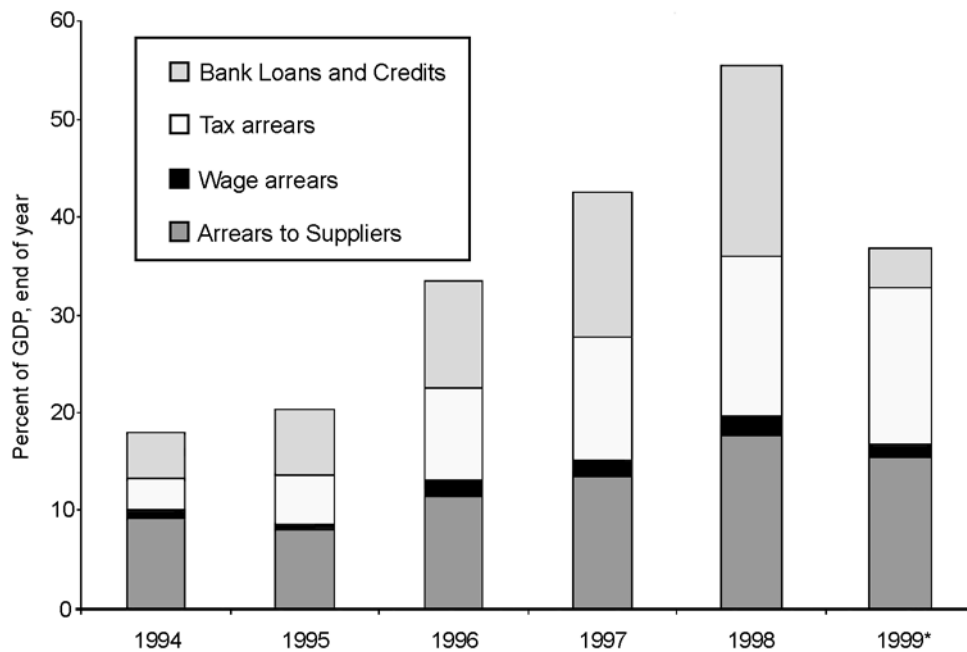
(Source) Pinto, B., Drebenstov, V., Morozov. A. “Dismantling Russia’s Nonpayments System: Creating Conditions for Growth,” World Bank Technical Paper, No. 471, p. 19, 2000

In order to dissolve the “cozy relationship” between government officials and private enterprises, it is essential to cut the relationship of “collusion.” To that end, it is necessary to improve the relationship between local governments’ budgets and local enterprises to which subsidies are directly provided. At present, the lower the tax collection rate is in local budget revenues, the more subsidies the local government gets. Under such circumstances, there is no incentive for local governments to increase their tax collection rate ([4] pp.130-131). If local governments intensify tax collection, leading local enterprises may go bankrupt. So, it is necessary to work out a comprehensive measure by taking such a situation into account.

### **3.3 Tax collection**

With regard to tax collection, nonpayment of taxes by enterprises is a big problem as Graph 3 shows. Although the situation improved slightly in 1999, it still causes enterprises to have the surcharges and fines on overdue taxes as well as the overdue taxes reduced by directly bribing government officials (agents). Nonpayment of taxes stems from the fact that enterprises are strongly inclined to avoid taxes as the tax rate is too high. It also stems from enterprises’ desire to get “implicit subsidies” by having their tax virtually reduced through netting.

**Graph 3 Trends of Russian enterprises' liabilities in 1994-1999**



Source: *Russian Economic Trends*

\* As of March, 1999

As to tax, it is possible for enterprises to get a preferential tax treatment or tax breaks by taking advantage of “corruption” with highly placed politicians or high-ranking government officials (principals). Or, it is possible for the politicians and government officials to extort money from enterprises by threatening to introduce a new taxation system or raise the tax rate. As such, tax collection could be an extremely big hotbed of “corruption.” In order to keep tax collection away from “corruption,” it is necessary to make tax collection standard clear, ensure the transparency of tax collection procedures, and establish conformity of local tax systems to the federal tax system. However, they have yet to be established in Russia and this constitutes an important factor that increases “corruption.” With nonpayment of taxes by enterprises becoming the norm, negotiations to set the tax amount (tax amount plus fines and surcharges for a certain period of time) for each enterprise are frequently held. Since the tax rate for each enterprise is virtually determined through the negotiations, there is a strong possibility of such negotiations generating “corruption.” According to Яковлев that analyzed in details small enterprises’ tax evasion through the use of dummy companies, local governments, in return for overlooking tax evasion, compel the enterprises to make “voluntary contributions” to any of the funds affiliated with the local governments ([9]). This is a typical example showing that the problem of “corruption” is institutionalized and worsening.

In addition, we should not forget the systemic problem that many of tax collectors being women is having bad effects on actual tax collection ([4] p.135). Tax collection is not fully implemented as woman tax collectors are made light of, reflecting the tendency to look down on women since the Soviet era. This systemic problem must be addressed and reformed drastically.

### 3.4 Privatization

As can be seen from Table 7, the privatization of enterprises in Russia has already passed the peak. As of Jan. 1, 1999, private enterprises and organizations accounted for 74% of the total of 2,901,000 enterprises and organizations in the country. Already many state enterprises have been privatized in one way or another and what remains are mostly those that are difficult to privatize for strategic reasons. Even before 1993, many of the former state assets were transferred to the control of Nomenklatura in the process of privatization under the “privatization of Nomenklatura.” Even in the large-scale privatization movement that was carried out by distributing privatization checks to the people, we know that there were many dubious transactions, judging from the final destination of the checks. Moreover, it is well known that, in the “mortgage auctions,” a privatization move, that were held from November to December 1995, injustice was done by “agents,” or public officials, and “clients,” or auction participants. The Onexsim Bank group and the Menatep Bank group made behind-the-scenes deals to successfully bid in the auctions.

**Table 7 Privatization in 1993-1999**

	1993	1994	1995	1996	1997	1998	1999
Total number of privatized enterprises	42924	21905	10152	4997	2743	2129	1536
Enterprises formerly held by federal government	7063	5685	1875	928	374	264	104
Formerly held by federal republics	9521	5112	1317	715	548	321	298
Formerly held by local governments	26340	11108	6960	3354	1821	1544	1134
Composition by type of privatization (%)	100	100	100	100	100	100	100
Securitization	31.1	44.8	27.7	22.5	18.1		
Sales by auctions	6.3	4.4	4.2	3.9	5.5	12.1	9.2
Commercial contest	30.4	24	15.9	8.9	9.6	11	12.4
Investment contest	1.3	1.2	1.1	0.7	0.5		
Purchases of assets held by leased enterprises	29.5	20.8	29.8	32.1	14.6		
Sales of bankrupt assets/enterprises and unfinished construction	0.4	1.5	4.2	5.7	9.1		
Others	1	3.3	17.1	26.2	42.6		

(Source) [Statistical Yearbook of Russia, 1999], The State Committee for Statistics, p. 285; [Statistical Yearbook of Russia, 2000], The State Committee for Statistics, p. 290.

There were also moves to put specific bidders in an advantageous position in the “investment contest.” For example, the contest was made complicated through the combination of the purchase price of an enterprise to be privatized and investment terms in order to give an advantageous treatment to specific bidders.

And as can be seen from Table 8, as a result of privatization, the weight of state organizations in the capital of privatized enterprises decreased. But local organizations have maintained strong influence on privatized enterprises as their main shareholders, with their weight as domestic legal entities staying above 20% in 1995-1999. This leaves the impression that local governments have come to influence corporate governance in place of the federal government. There is a strong possibility of “soft budgetary constraints” arising between local governments and local enterprises and “a cozy relationship” being established between the two. Therefore, it has become an important issue to privatize the shares held by local organizations.

**Table 8 Composition of the owners of Russian enterprises in 1994-1999 (% in capital)**

	<i>1994</i>	<i>1995</i>	<i>1996</i>	<i>1997</i>	<i>1999<sup>1</sup></i>
<i>Employees</i>	44-56	39-49	26-43	23-40	36
<i>Managers</i>	9-17	10-17	12-18	12-36	15
<i>Domestic Legal Entities<sup>2</sup></i>	7-11	20-23	23-25	22-24	23
<i>Domestic Individuals</i>	3-6	9-11	8-12	11-13	16
<i>Foreign Owners</i>	1-2	1-2	1-2	4-5	8
<i>State Agencies</i>	12-20	11-13	9-11	7-14	3

1. No survey undertaken in 1998.
2. Includes investment funds, all other firms (including holding companies and financial-industrial groups), and banks.

(Source) Desai, Raj, M., Goldddberg, Itzhak, “The Vicious Circles of Control: Regional Governments and Insiders in Privatized Russian Enterprises,” World Bank Working Paper No. 2287, p. 6, 2000.

Here, I would like to discuss briefly the stock registration system that provides a fundamental support to privatization. In Russia, the evidence to prove the ownership of an enterprise is to have one’s name listed in the shareholder register. In order to receive dividends, it is also necessary to have one’s name registered ([41] p.583). In order to complete a stock transaction, it is necessary to re-register the ownership by changing the name of the shareholders in the register. The registration system, as it were, guarantees the fundamental right to private property. Under Russian laws, all enterprises with shareholders of more than 500 are required to consign registration

work to other organizations. However, many of the registration organizations for big enterprises are said to be directly controlled by the big enterprises or located in the head offices of the big enterprises ([20] p.584). Even when a bank is entrusted with the registration work for an enterprise, the bank often turns out to be the ruler of the enterprise or ruled by the enterprise. The objectivity of the registration work is not necessarily guaranteed. The situation looks very strange to foreign investors.

During the chaotic transition period, many enterprises took illegal steps in procedures for holding shareholders' meetings and increased capital without allowing hostile shareholders to attend the meetings, and thus reducing the hostile shareholders' stake in the enterprises. It is possible to take such illegal steps, because the above system that provides fundamental support to private property is not adequate. It is hoped that a transparent and secure system will be established.

### **3.5 Trade restrictions**

The Russian Federation Presidential decree No. 1007 dated March 23, 1994 and titled "About the Abolition of Quota and License on Goods and Services Bound for Exports" abolished all preferential treatments concerning taxes on exports effective July 1, the same year, except for those granted under the Tariff Law and Value Added Tax Law. However, the Presidential decree No. 1385 dated July 1, 1994 and titled "About the Supply of 1994 Oil and Oil Products Exports" extended the preferential treatments for the exports of oil/oil products and their tariffs that were allotted based on the license granted by the External Economic Relations Ministry until Jan. 1, 1995, as an exception to the above decree. Further, the government decision No. 758 dated July 1, 1994 and titled "About Measures to Implement State Adjustment of Exports of Goods and Service" made strategically important goods (natural gas, electricity, fertilizers, lumber, non-ferrous metals, etc.) subject to special registration procedures at the External Economic Relations Ministry, which granted the right to export such goods only to specific exporters ([22] p. 3). In short, the decision took the teeth out of the presidential order. There exists a power relationship between the industry (client) and the authority (agent). This leaves room for discretion and generates cozy relations, which in turn could lead to "corruption." Similar cozy relations also exist with regard to regulations on exports and foreign exchange transactions and they constituted a breeding ground for "corruption."

These restrictions may be unavoidable. But, it is essential to ensure the transparency of the procedures for enacting and implementing restrictions. It is also necessary to restrict contacts as much as possible between those who regulate and

those who are regulated. Establishing a system is the prerequisite for curbing “state capture,” or “corruption.”

## **4. Low productivity**

### **4.1 What is productivity?**

Productivity is normally measured as a ratio of output to input. If we limit the input to the labor force measured by hours worked or the number of employees, we get so-called labor productivity. If we include the amount of capital or operating rate to the input, we get capital productivity. It is also possible to measure total factor productivity by multiplying the capital productivity that takes account of the ratio of capital to values added by labor productivity. As to output, production can be measured by quantity, in monetary value, or by values added. When we make international comparison of output, there arises a question as to whether it should be evaluated by purchasing power parity or by foreign exchange rate. In any way, productivity is a ratio of output produced in accordance with input and is an important indicator that shows production efficiency.

### **4.2 Factors behind low productivity**

What characterize Russia’s productivity is its low productivity as was shown in Table 2 and Graph 1. The low productivity is due to the combined effect of such factors as 1) excessive employment, 2) outdated fixed capital, 3) low capacity utilization rate, 4) bankruptcy/delay in restructuring, and 5) decreasing investment. Here, I would like to confine my discussion to 4) and 5) because of limited space.

### **4.3 Bankruptcy**

In order to raise productivity, there has to be a system in place to promote restructuring of inefficient divisions or make money-losing enterprises go bankrupt and sell their assets so that creditors can be compensated. Due to limited space, I would like to leave out the question of restructuring and consider only the problem of bankruptcy for want of space. When we consider the problem of bankruptcy, we must also consider establishing a system to find employment, through unemployment insurance schemes and vocational training, for people who lose their jobs due to bankruptcy. In other words, the problem of bankruptcy must be considered in a set with such safety net, or a social security system.

First, I would like to study bankruptcy proceedings. Table 9 shows the status of bankruptcy proceedings by Russian enterprises. As can be seen from the Table, the number of bankruptcy in Russia began to increase only after the New Bankruptcy Law was implemented in 1998. But, the number is by no means high, given the fact that the number of Russian private enterprises/organizations stood at 2,147,000 as of Jan. 1, 1999. Let me briefly discuss changes of the bankruptcy system in Russia first, and then its problems.

**Table 9 Status of bankruptcy proceedings of all enterprises (including financial sector)**

	1993	1994	1995	1996	1997	1998
Application for bankruptcy proceedings	n/a	n/a	n/a	about 4000	about 6000	12781
Start of bankruptcy proceedings	< 100	240	1108	2618	4320	8337
Liquidation order	50	n/a	469	1035	2200	4747
Outside control order	n/a	n/a	135	413	850	1041
Rejection of bankruptcy applications	n/a	n/a	n/a	n/a	800	4444

(Source) A. Lambert-Mogiliansky, C. Sonin, E. Zhuravskaya, "Capture of Bankruptcy: A Theory and Evidence from Russia," p. 32, 2000

The following are eight major laws related to bankruptcy

- 1) "About enterprise's insolvency (bankruptcy)": Russian Federation law adopted by the supreme council of the Russian Federation on Nov. 19, 1992 and enacted on March 1, 1993
- 2) "About law implementation measures concerning enterprise's insolvency (bankruptcy)": Russian presidential decree No. 2264 issued on Dec. 22, 1993
- 3) "About some measures on law implementation concerning enterprise's insolvency (bankruptcy)": Government's decision No. 498, dated May 20, 1994
- 4) "About sale of debtor state enterprises": Presidential decree No. 1114, dated June 2, 1994
- 5) Partial revision of "About enterprise's insolvency (bankruptcy)" of the 1995 Russian Federation law
- 6) "About insolvency (bankruptcy)": Russian Federation law; enacted on March 1, 1998
- 7) "About insolvency (bankruptcy) of credit organizations": Russian Federation law; signed by the President on Feb. 225, 1999

- 8) “About reconstruction of credit organizations”: Russian Federation law; signed by the President on July 8, 1999

Table 10 shows differences between the Bankruptcy Law of 1993 ( 1 ) and the New Bankruptcy Law of 1998 ( 2 ). As can be seen from the table, the New Bankruptcy Law has improved the institutional aspects of bankruptcy procedures. But, as will be described later, it contains many problems. According to the new Bankruptcy Law, if a company doesn't pay off a debt of during 3 months after the deadline, this company will be considered as insolvent. If a company's claims to another company are more than 500 times the amount of minimal wages, a petition for bankruptcy can be brought to a court of arbitration. The debtor, creditor, taxation office or other state organization can file the petition for bankruptcy. After the arbitration court accepts the petition, the assets of the debtor will be placed under “superintendence” until a ruling is handed down. The assets will be supervised under the leadership of a temporary receiver appointed by the court. The temporary receiver convenes a meeting of creditors and the creditors adopt one of the following decisions: decision to introduce external management and make a request to the arbitration court accompanied by a petition for the introduction of external management, or decision to make a request to the arbitration court accompanied by a petition for recognizing the bankruptcy of the debtor and carrying out an auction. External management will be undertaken under the leadership of an outside receiver appointed by the arbitration court from among the candidates proposed by the meeting of the creditors. The outside receiver implements measures based on external management programs approved by the meeting of creditors. In this case, leaders of the debtor organization resign. The outside receiver can execute real estate transactions and transactions of other assets whose value is 20% or more of the value of debtor's assets on the balance sheet, only when such transactions are approved by the meeting of creditors. As measures to restore debtor's payment ability, such measures as sale of the enterprise, sale of assets, transfer of the demand right of debtors, and return of debtor obligations by a third party are available. On the other hand, in the case of bankruptcy, the arbitration court appoints bankruptcy administrator to execute auction from among the candidates proposed by the meeting of creditors.

**Table 10 Comparison of old Bankruptcy Law and new Bankruptcy Law**

	<b>Old Bankruptcy Law</b>	<b>New Bankruptcy Law</b>
Obligation of the leader of a debtor organization to file a petition for bankruptcy	Not established	The new law obliges management to appeal to court 1) if debt payments to one creditor makes it impossible to pay back to other creditor(s) and 2) when the asset management organization or the owners of the assets have adopted a decision to do so.
Laws and regulations for the period from the adoption of a petition for bankruptcy to ruling by the court of arbitration	Not established	Superintendence procedures have been established.
Moratorium on debt payments to creditors during the period of external management	Moratorium on fines, surcharges, financial sanctions concerning budgetary payments, interest surcharges on the use of other monetary assets	Moratorium accompanied by interest surcharges based on the official discount rate of the central bank of the Russian Federation
Measures to restore payment ability	Not established	Such measures as sale of the enterprise, sale of assets, transfer of the demand right of debtors, and return of debtor obligations by a third party have been institutionalized.
Conditions for conclusion of composition	The creditors must receive payments not less than 30% of their claims within two weeks after a court of arbitration approved composition	Debt payments by debtors to first and second creditors
Status of arbitration administrator	Not established	Individuals registered as entrepreneur and acting on the basis of the state-issued license concerning bankruptcy problems.

Although the system for bankruptcy has been established at least formally, there are many problems ([10]). First, since the minimum debts required for application for corporate bankruptcy is set low at less than \$5,000, it is likely to lead to abuse of the bankruptcy procedures. In fact, the number of bankruptcy applications increased drastically after the enactment of the new Bankruptcy Law, as shown in Table 9. Second, there are problems concerning governor's use of influence on arbitration court. Governors intervene in bankruptcy procedures for the following reasons: 1) they can acquire rents from the management of corporations with no payment ability in exchange for protecting them from losing jobs in bankruptcy, and 2) they can receive

benefits from profitable companies pretending to be insolvent in order to avoid federal tax and debt payments to creditors outside the region. Some of the governors may be trying to avoid the bankruptcy of large companies that might otherwise lead to social unrest. Still, there remains the fact that local authorities, by intentionally becoming a creditor of a corporation, bring the corporation under its control in the process of court proceedings. Third, there is a problem of former management keeping control of the company even after the company has been put under external management. In fact, former management put pressure on a local court of arbitration in order to keep their influence on the companies. Fourth, even if a ruling is handed down, the ruling is not implemented in many cases. It is reported that only 50% of the rulings on fund collection handed down in 1995 were actually implemented. Fifth, collateral held by creditors are not promptly disposed of due to insufficient legal framework concerning bankruptcy. Moreover, the problem of expanding the safety net, such as unemployment insurance, remains unresolved. Reflecting these problems, the rating of the Russian bankruptcy law by the EBRD is not high, as shown in Table 11.

**Table 11 EBRD valuation index concerning the scope and efficiency of bankruptcy law**

	1999	1998
Albania	1	2
Armenia	2-	3
Azerbaijan	3+	3
Belarus	2	1
Bosnia-Herzegovina	1	2
Bulgaria	4-	4
Croatia	4-	4
Czech Republic	3+	3+
Estonia	4-	4
Macedonia	4	4
Georgia	2-	3
Hungary	4-	3
Kazakhstan	3	3
Kyrgyz Republic	4-	3
Latvia	3+	4
Lithuania	3	2
Moldova	3	1
Poland	3+	2
Rumania	3	3
Russia	3-	3
Slovakia	3	3
Slovenia	4	3+
Tajikistan	na	1
Turkmenistan	na	1
Ukraine	2	2+
Uzbekistan	2	2

(Source) Transition report 1999, EBRD, p. 164

#### 4.4 Investment

Investment is one of the key instruments to raise productivity. First, I would like to explain briefly the basic theory concerning investment, by referring to *Economics, Organization and Management*, a famous book written by Milgrom/Roberts. The classic monetary economics is based on a model that regards a corporation as a flow of income and expenditure. What the management has to decide is which flow stream is good investment, whether the investment should be financed by borrowings or new stock issues, and how much of the profits should be paid to investors as dividends. What the investor has to decide is how much he/she should invest in which company. Demand for various securities is determined after the behaviors of the management and the investor are taken into consideration and this, in turn, determines the reciprocal relationship of profits resulting from various investments. Finally, according to the classic theory, the evaluation of the system as a whole is determined by the efficiency of capital distribution to investment projects.

The main conclusions drawn from the classic theory are the following three: First, in an ideal condition where a corporation can borrow or save at the same interest rate, the corporation can determine its investment, separate from the consumption decision of the owner and without regard to the preference of the owner (Fisher factorization theorem). Second, when the present value (this can be defined as the maximum amount of loans payable by the cash flow) of the cash flow (sales revenue minus operation expenses) produced by investment exceeds the initial capital invested, the investment produces profits and therefore should be made. In other words, the net present value (the amount over and above the initial capital invested) of the cash flow produced by investment must be positive. Third, in the case of strategic investment decision, even if the net present value of a project is calculated correctly, it is likely to lead to a wrong answer if the calculation is based only on the cash flow that is directly produced by the project. This is because most of the values produced by the project may have been produced as a result of indirect effects of other division or other project of the same organization.

As is shown above, there are many points at issue even in simply studying investment problems theoretically. Here, I would like to take up only the two points that seem important in studying the Russian problem that prolonged the downward trend of investment during the transition period. The first point is the problem of raising investment funds and the second point is the problem of corporate governance in relation to inducing foreign investors.

As Table 12 shows, total investment in Russia had been on a downward trend for a

long time. As to the composition of funds, the weight of own funds of corporations and organizations is relatively high. Own funds include depreciation allowances, in addition to profits. Although it is not shown in the table, the composition of borrowed funds was only 2.6% in 1997. In short, the composition of investment by funds borrowed from banks is extremely low.

**Table 12 Investment source in Russia**

	1992	1993	1994	1995	1996	1997	1998*	1999*
Changes in total investment (%)	-40	-12	-24	-10	-18	-5	-12	5
Composition of investment	100	100	100	100	100	100	100	100
Funds from budget	26.9	34.3	26	21.8	20.1	20.7	19.1	17
Federal budget	16.6	19.2	15.4	11.5	9.9	10.2	6.5	6.4
Federation republic/region budget	10.3	15.1	10.6	10.3	10.2	10.5	12.6	10.6
Funds other than from budget	73.1	65.7	74	78.2	79.9	79.3	80.9	83
Own funds				49	52.3	60.8	53.2	52.4
Profits				20.9	15	13.2	13.2	15.9

(Source) "Russia statistical yearbook 2000" pp. 546, 548

(Note) \*Large and medium-sized corporations and organizations

Here, I would like to study the present state of Russia where bank borrowings are not one of the important investment sources. When we consider this problem, Tompson is very helpful ([17]). According to him, from a macro-economic point of view, the following factors weakened the financial institution's intermediary function: 1) inflation, 2) huge amount of fiscal deficits and huge amount of borrowings by the government, and 3) political instability and weakened state. From a micro-economic point of view, the bank's intermediary function has been weakened due to the following factors: 1) lax discipline (weak budgetary restraints), 2) interdependence between commercial banks and the state in decentralization (intermediation of state credit to real economic sector, handling of fiscal funds by commercial banks, and etc.), 3) non-competition (protection of government-affiliated Sberbank and commercial banks' regional semi-monopoly by taking advantage of political ties), 4) insufficient information (inadequate Russian-style accounting), and 5) legal loopholes (difficulties to sell collateral, injustice in arbitration court rulings, and etc.). Conversely, if these problems are resolved, it is possible to increase bank lending to corporations. In particular, introduction of the international accounting standard to bank accounting is extremely important in correctly understanding the present business conditions of corporations as well as banks.

In order to increase bank lending to corporations, it is also necessary to enhance banks' function to monitor the present business standing of corporations. To that end,

it is necessary to train bankers to enhance their management diagnosis capabilities. In addition, it is necessary to establish a system, under which banks, as creditor or shareholder, can be actively involved in the management of corporations, a system that allows banks, if necessary, to take over the right of management temporarily and engage in reconstruction of the company. This is because, in a transition country like Russia, due to the underdevelopment of stock market, it is difficult to enhance the efficiency of corporate management through competition by simply monitoring their operations through the stock market. As corporations tend to conceal their information, it is difficult for outsiders, including shareholders, to gain access to corporate information. In order to help overcome this asymmetry of information, it is necessary for banks to frequently monitor operations of corporations and check their businesses. There may be cases where it is necessary for a bank to launch reconstruction of a corporation as a representative of shareholders.

## **5. Conclusion**

Corporations have many problems both in terms of external and internal environments. These problems are inter-related and complicated. Therefore, in order to solve the various problems at the corporation level, it is necessary to take the kind of approach that addresses the problems discussed here in a comprehensive manner. In particular, it is essential for the federal and local governments to cooperate in dealing with the problems.

### **Discussion themes**

1. Discuss how corruption should be prevented.
2. Discuss what corporations should do to raise labor productivity both from long- and short-term perspectives.
3. Discuss to whom do corporations belong? Shareholders? The management? Or employees?

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