

# EMPLOYEE OWNERSHIP AND CORPORATE GOVERNANCE IN POST-PRIVATIZATION RUSSIA

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## ABSTRACT

This article focuses on the impact of employee buyouts on corporate governance in transition, ten years after large-scale privatization took place in Russia. The analysis shows that although privatization through employee buyouts helped reduce unemployment and prevent major social conflicts, it has otherwise negatively affected corporate governance and firms' productivity. Moreover, an excessively large labor force and management's tendency to preserve the old Soviet-style corporate governance hampered the long-term growth of privatized enterprises in Russia. Unlike in many other transition countries, employees in Russia were obedient to corporate directors who ruled enterprises in the absence of any meaningful system of checks and balances. At present, employee ownership remains a popular idea in Russia, but contemporary attempts of the Russian government to isolate enterprises from outside investors in the form of "people's enterprises" have proved to be a failure.

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## INTRODUCTION

Russian corporate governance is full of contradictions. For instance, trade unions in Russia have traditionally been tools of corporate management rather than of employees. In effect, managers in the Soviet period were like feudal lords of their enterprise, despite the highly centralized economic system. Workers usually did not play any active role in management, although they had significant blocks of shares in them. Nonetheless, Russian employees ended up better protected from unemployment than their cohorts in other transition economies. These are just a few puzzles of the Russian post-Soviet transition that this Article analyzes.

For various historical reasons, the idea of employee ownership has traditionally been very popular in Russia. The Soviet system, beginning with the October Revolution, aimed at establishing “the dictatorship of proletariat,” was built on the rhetoric that a working man is the center of all government policies. Despite the fall of communism, this Soviet mentality persisted in post-Soviet economy. The designers of Russian privatization, in addition to transferring ownership, also sought to prevent communists from returning to power. To this end, it was necessary to secure wide public support for privatization. Therefore, employee buyouts as the main method of privatization were determined more by political necessity and pressure from directors’ and employees’ groups rather than by considerations of effective economic policy. As a result, employees gained the controlling stakes in most state enterprises.

Russian privatization achieved its main goal—more than half of state enterprises became private and privatization occurred with relatively little social conflict. However, this Article shows that the redistribution of property via employee buyouts failed to create a new class of effective owners and did not improve corporate governance. While some described government concessions to workers as “the most generous of any privatization in the world,”<sup>2</sup> in practice directors of enterprises became the sole decision-makers while employees remained passive observers. Moreover, most employees ended up deeply dissatisfied with the privatization process, primarily because of low salaries and extreme inequality between the rich and the poor in post-Soviet Russia.

As a result of privatization, directors appointed during the Soviet-era often retained their positions and took on enormous responsibility for production and distribution. Directors maintained Soviet tradition and continued to act in a paternalistic role towards employees, who were prepared to obey. Deep economic crises weakened both the Russian state and the

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<sup>2</sup> ANDREI SCHLEIFER, *A NORMAL COUNTRY: RUSSIA AFTER COMMUNISM* 45 (2005).

controlling market mechanisms that existed in the Soviet-era. This created a fertile ground for directors to manipulate and abuse their position of power. Employee ownership helped alleviate social conflicts and reduced unemployment, but the majority of Russian Enterprises continued to be over staffed, which had a negative impact on their profit and competitiveness.

This Article begins by briefly discussing the main goals and mechanisms of Russian privatization and explaining why employee buyouts became the main method of privatization.<sup>3</sup> Part II of this Article explains the historical and economic reasons why employee ownership did not work in Russia and why employees failed to play any independent role in Russia's transition.<sup>4</sup> Part III addresses a contemporary attempt to create employee-owned enterprises in the form of people's enterprises.<sup>5</sup> Part IV analyzes the lessons learned from employee buyouts and employee ownership in Russia.<sup>6</sup> This Article concludes with a number of policy recommendations to enable more efficient privatization in transition economies.<sup>7</sup>

## I. EMPLOYEE BUYOUTS IN POST-COMMUNIST RUSSIA

### A. *The Goals and Mechanism of Russian Privatization*

Russian privatization was unique in its enormous scale and speed. These characteristics were necessary to achieve state goals of privatization<sup>8</sup>—to raise funds for the state budget and to generate investments for restructuring enterprises.<sup>9</sup> The overarching goal of privatization was a massive redistribution of property to individual citizens with the aim of securing rights in that property with minimum social conflict.<sup>10</sup> A subsequent redistribution of property to effective and responsible owners was to follow.<sup>11</sup> The government intended to implement this secondary redistribution through the financial markets.<sup>12</sup>

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<sup>3</sup> See *infra* pp. 5-16.

<sup>4</sup> See *infra* pp. 16-28.

<sup>5</sup> See *infra* pp. 28-31.

<sup>6</sup> See *infra* pp. 31-35.

<sup>7</sup> See *infra* p. 35.

<sup>8</sup> Audit Chamber of Russia is the main federal supervisory body of the Russian Government. See Federal Law on the Accounts Chamber of the Russian Federation, art. 3 (Jan. 11, 1995).

<sup>9</sup> Schotnaua Palata Rossiiskoi Federacii [Audit Chamber of the Russian Federation], ANALIZ PROCESSOV PRIVATIZATSII GOSUDARSTVENNOI SOBSTVENNOSTI V ROSSIISKOI FEDERATSII ZA PERIOD 1993-2003 GODY [ANALYSES OF PROCESSES OF PRIVATIZATION OF STATE OWNERSHIP FOR THE PERIOD FROM 1993 TO 2003] 20 (2004).

<sup>10</sup> ALEKSANDER RADYGIN, REFORMA SOBSTVENNOSTI V ROSSII: NA PUTI IZ PROSHLOGO V BUDUSHEE [PROPERTY REFORM IN RUSSIA: ON THE WAY FROM PAST TO FUTURE] 12 (1994).

<sup>11</sup> *Id.*

<sup>12</sup> *Id.*

Reforms also aimed to make democratic and market changes irreversible to prevent the old communist guard's return to power.<sup>13</sup> A significant number of Soviet citizens were unhappy with hyperinflation, impoverishment, and the criminalization of society as many people felt nostalgic about "the good old—Soviet—times."<sup>14</sup> Former Soviet elites, especially former Communist Party officials, tried to reinstall the old regime and their status by all possible legal and illegal means.<sup>15</sup> One of the means to achieve permanent reforms was to ensure that new private owners would defend their property rights as well as the rule of law and democracy in Russia.

There were other important reasons for Russia's sweeping and swift privatization. Gradual Chinese-style reforms would not have worked in Russia primarily because Russian authorities lacked credible control over the economy, which was in deep crisis. In addition, market-oriented corporate and finance law was effectively nonexistent in the Soviet period.<sup>16</sup> It was also important to minimize the volatile transitional period between state control and private ownership.

According to the designers of the Russian privatization program, there was almost no disagreement over the development of a privatization scheme in Russia.<sup>17</sup> The only exception was employee buyouts.<sup>18</sup> Some preconditions for giving special privileges to employees of state-owned enterprises already existed under Soviet legislation, such as regulations on joint stock companies, leasing, and property.<sup>19</sup> The Soviet government based these regulations on the premise that employees had privileges in their "own"

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<sup>13</sup> *Id.*; see also *infra* notes 14-15 and accompanying text.

<sup>14</sup> See Arthur Miller, William Reisinger & Vicki Hesli, *Understanding Political Change in Post-Soviet Societies: A Further Commentary on Finifter and Mickiewicz*, 90 AM. POL. SCI. REV. 153, 153-56 (1996).

<sup>15</sup> In 1993, the Russian Parliament impeached President Boris Yeltsin in an attempt to stop liberal reforms, which resulted in the most deadly street fighting in Moscow since the Bolshevik Revolution in 1917 and tanks bombarding of the Russian Parliament building. See, e.g., Stephen White, *Russia: Presidential Leadership under Yeltsin*, in POSTCOMMUNIST PRESIDENTS 57, 58-61 (Ray Taras ed., 1997).

<sup>16</sup> See Bernard Black, Jonathan Hay & Reinier Kraakman, *Corporate Law from Scratch*, in CORPORATE GOVERNANCE IN CENTRAL EUROPE AND RUSSIA, VOL. 2, INSIDERS AND THE STATE 245, 247 (Cheryl Grey, Roman Frydman & Andrzej Rapacznski eds., 1996) (discussing subsequent development of Russian corporate law).

<sup>17</sup> Piotr Mostovoi, *Kak Sozdavalas Programma [How the Program Was Drafted]*, in PRIVATIZATSIA PO-ROSSIISKI [RUSSIAN PRIVATIZATION] 67, 71 (Anatoly Chubais ed., 1999).

<sup>18</sup> *Id.*

<sup>19</sup> See, e.g., Fundamentals of Legislation of the USSR and the Union Republics on Lease (1989), Decree of the Presidium of the Supreme Soviet of the USSR on Lease and Lease Relations in the USSR (1989).

enterprises. Therefore, leasing with subsequent buyout naturally emerged as the preferred method for restructuring at the strongest enterprises.<sup>20</sup>

Anatoly Chubais, chief architect of Russian privatization, pointed out that the idea of giving property to employees was initially met with resistance. Opponents of employee property rights argued that enterprises in the context of state ownership were a result of the work of all citizens, not just workers.<sup>21</sup> Therefore, distributing ownership among employees at non-market prices would deprive other people from having a share of the state ownership pie and lead to a rapid re-sale of shares to third parties.<sup>22</sup> This would leave the state without much needed money necessary for political reforms. Intuition suggests that auctioning shares to the highest bidder was hardly possible in the absence of strong law enforcement and poor information about enterprises and their performance. Moreover, the banking system functioned poorly, making leveraged buyouts by outsiders equally impossible.<sup>23</sup>

In other post-communist countries, employees were the most vocal opponents of privatization and restructuring namely because privatization was associated with massive layoffs and unemployment.<sup>24</sup> However, the Russian government implemented privatization under pressure from employees and often in opposition to corporate directors and government ministries.<sup>25</sup> Therefore, the decision to grant additional privileges to Russian employees resulted from political pressures, such as preventing opposition to reforms and playing on the contradictory interests of employees and directors. As a result, the government rewarded Russian employees with “the most generous of any privatization in the world.”<sup>26</sup>

The privatization process, as approved by the Parliament, consisted of three major steps. First, the government divided enterprises into those that would be sold primarily for cash and those that would become part of the mass privatization scheme.<sup>27</sup> Some enterprises were subject to mandatory privatization while others were privatized with the permission of the

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<sup>20</sup> Mostovoi, *supra* note 17, at 93 (mentioning Saratov Aviation plant as successful example of employee buyouts).

<sup>21</sup> *Id.* at 92.

<sup>22</sup> *Id.* (noting re-sale resulted since workers were often not paid their salaries and needed money for survival). As it turned out, voucher privatization had this effect too. *See* SHLEIFER, *supra* note 2, at 40.

<sup>23</sup> *See generally* MICHAEL BERNSTAM & ALVIN RABUSHKA, *FIXING RUSSIA’S BANKS: A PROPOSAL FOR GROWTH* (1998) (discussing problems of Russian banks in early 1990s, which were not reliable and often went bankrupt after several years in operation).

<sup>24</sup> *See generally* Zeljko Bogetic, *The Role of Employee Ownership in Privatization of State Enterprises in Eastern and Central Europe*, 45 *EUR.-ASIA STUD.* 463 (1993).

<sup>25</sup> *See* Mostovoi, *supra* note 17, at 72.

<sup>26</sup> SCHLEIFER, *supra* note 2, at 45.

<sup>27</sup> *Id.* at 37.

privatization ministry.<sup>28</sup> Second, existing state enterprises were transformed into joint stock companies wholly owned by the government, adopted a corporate charter and appointed a board of directors.<sup>29</sup> Finally, enterprises offered their shares for sale to private owners.<sup>30</sup>

The State Program of Privatization provided three basic variations of privatizing state enterprises, to be selected by enterprise employees at their general meeting.<sup>31</sup> Under Variant One, employees obtained twenty-five percent of the non-voting shares free of charge, and a right to buy an additional ten percent of their enterprise's shares at a thirty percent discount.<sup>32</sup> Variant One left open the possibility that individuals and companies from outside of the enterprise could seize control by purchasing undesigned shares. Not surprisingly, only seventeen percent of the country's managers and employees chose Variant One.<sup>33</sup>

Managers and employees heavily influenced Russian privatization through lobbyists who controlled the Russian Parliament and state-owned enterprises.<sup>34</sup> Concern over an outside takeover under Variant One mobilized directors and trade unions to lobby for greater privatization options. Both employees' and directors' groups threatened the government with nation-wide strikes.<sup>35</sup> As a result, the developers of privatization amended the legislation to introduce additional options in June 1992. Variant Two provided for a buyout of fifty-one percent of shares by the workforce.<sup>36</sup> Therefore, as long as insiders remained united, Variant Two effectively prevented outsiders from gaining control. If an enterprise failed to submit its privatization plan to the authorities in due time, it had to be privatized according to Variant One, which created additional incentives for insiders to choose Variant Two.<sup>37</sup> Consequently, about seventy-five percent of enterprises chose this option.<sup>38</sup> As it will be shown this option allowed factory directors to seize control at a

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<sup>28</sup> *Id.*

<sup>29</sup> *Id.*

<sup>30</sup> *Id.*

<sup>31</sup> See Gosudarsvennaia Programma Privatizatsii Gosudarsvennykh I munitsipalnykh predpiatii v Rossiiskoi Federacii na 1992 god [State Program of Privatization of State and Municipal Enterprises in the Russian Federation for the Year 1992] (June 11, 1992).

<sup>32</sup> *Id.*

<sup>33</sup> MARSHALL GOLDMAN, *THE PRIVATIZATION OF RUSSIA: RUSSIAN REFORM GOES AWRY* 80 (2003).

<sup>34</sup> See SCHLEIFER, *supra* note 2, at 36.

<sup>35</sup> ANDREI SHLEIFER & DANIEL TREISMAN, *POLITICAL TACTICS AND ECONOMIC REFORM IN RUSSIA* 28 (2000).

<sup>36</sup> *Id.*

<sup>37</sup> *Id.*

<sup>38</sup> See GOLDMAN, *supra* note 33, at 81, for a discussion of the final privatization option—Variant Three—where twenty percent of an enterprise's shares could be sold to employees at a nominal value, and an additional twenty percent could be sold under the conditions provided by Variant Two.

minimum cost.<sup>39</sup> However, any benefit to the public under Variant Two, such as taxes or improved management and capital investments, was negligible.<sup>40</sup>

### B. *Costs and Benefits of Employee Buyouts*

Before discussing the factors specific to employee ownership in Russia, it is helpful to have a broader look at corporate governance theories addressing the issue of employee ownership. Usually the interests of owners, managers, and employees do not exactly coincide. Owners therefore have to monitor managers and workers to ensure the firm operates to the owners' interest. When managers and employees are also owners, they theoretically have a greater incentive to improve performance because they share in the benefits of that improvement. Moreover, employee ownership internalizes the costs of shirking while horizontal monitoring by co-workers is likely to minimize the incidence of shirking. Conversely, asymmetric information is more likely to be a problem when outsiders own the firm rather than workers.<sup>41</sup>

Other advantages of employee ownership include improved productivity, better communication of employee preferences, and reduction or elimination of costs related to strikes and lockouts.<sup>42</sup> Employee ownership improves incentives by giving workers a vested interest in the firm and its productivity. Similarly, employee ownership contributes to better welfare by allocating workers a portion of profits and making employment more secure. Worker ownership also provides significant advantages as compared to outside ownership, such as better monitoring and enhanced access to decision-making information.<sup>43</sup> The general absence of managerial skills and experience with governance of workers can explain these inefficiencies.<sup>44</sup>

Employee buyouts as a method of privatization have two positive features. First, they unify principals and agents in the firm. Second, employee buyouts reduce the risk of vertical and horizontal agency problems. As already discussed, employees, being their own principals, are less likely to steal from the enterprise. The horizontal agency problem (i.e., between the controlling stockholder and minor shareholders) decreases because a controlling shareholder is unlikely to emerge. Thus, in theory employee

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<sup>39</sup> See *infra* p. 12.

<sup>40</sup> See GOLDMAN, *supra* note 33, at 81.

<sup>41</sup> See George A. Sharpley, *Labor-Management in the Russian Transition* 5 (1996) (unpublished Ph.D. dissertation, University of Delaware) (on file with Morris Library, University of Delaware).

<sup>42</sup> See Douglas Kruse & Joseph Blasi, *Employee Ownership, Employee Attitudes, and Firm Performance* 5-8 (Nat'l Bureau of Econ. Research, Working Paper No. W5277, 1995), available at <http://ssrn.com/abstract=225341>.

<sup>43</sup> *Id.*

<sup>44</sup> See Henry Hansmann, *When Does Worker Ownership Work? ESOPs, Law Firms, Codetermination, and Economic Democracy*, 99 YALE L.J. 1749, 1806-08 (1990).

ownership will eliminate the aforementioned problems by both preventing managers from diverting value into their own pockets and reducing the ability of controlling shareholders to extract excessive rents.

Generally, employee ownership is considered poorly suited for capital-intensive industries.<sup>45</sup> This is why employee-owned firms are relatively rare in the industrial sector, but quite common in the service sector (e.g., law, accounting, transportation, etc.). Industrial employees lack managerial skills and corporate governance experience because of different levels in education and training. Another disadvantage of employee ownership is poor risk sharing. Workers usually lack the ability to diversify risk by taking on jobs simultaneously whereas most investors seek to avoid risks, leading to fluctuating residual returns.<sup>46</sup>

Over time, the share of employees-shareholders in an enterprise usually declines.<sup>47</sup> When a successful employee-owned firm takes on additional employees, it has a strong incentive to hire them on a salary basis rather than make them owners. Consequently, with the progression of time the share of employee owners will steadily decline until ownership is concentrated in the hands of a small group. This effectively transforms the firm into one with many of the characteristics of an investor-owned firm.

### C. *Firms' Ownership and Performance after Privatization*

A typical privatization outcome in Russia resulted in sixty to sixty-five percent of enterprise shares going to managers and employees and about twenty percent of shares going to individuals and investment funds.<sup>48</sup> The state retained the remaining fifteen to twenty percent to sell for cash in the future.<sup>49</sup> Except for fairly concentrated management stakes, the remaining shares appear scattered among employees, voucher investment funds, and small outside investors.<sup>50</sup>

The subsequent redistribution of corporate ownership led to a decline in employee ownership, as directors and outsiders bought employee shares.<sup>51</sup> Within a few years, employee ownership in Russia declined from 48% in 1994 to 38.7% in 1997, while total outside ownership increased from 20% to

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<sup>45</sup> *Id.* at 1771.

<sup>46</sup> However, as it has been noted before, workers in Russia often worked for several employers in the transition period.

<sup>47</sup> Avner Ben-Ner, *On the Stability of the Cooperative Type of Organization*, 8 J. COMP. ECON. 247, 255 (1984).

<sup>48</sup> See Bernard Black, Reinier Kraakman & Anna Tarassova, *Russian Privatization and Corporate Governance: What Went Wrong?*, 52 STAN. L. REV. 1731, 1735 (2000).

<sup>49</sup> *Id.*

<sup>50</sup> See Bogdan Lissovlik, *Rapid Spread of Employee Ownership in the Privatized Russia*, in PRIVATIZATION SURPRISES IN TRANSITION ECONOMIES 204, 220 (Milica Uvalic & Daniel Vaughan-Whitehead eds., 1997).

<sup>51</sup> See sources cited *infra* notes 52-53 and accompanying text.



39.7%.<sup>52</sup> This trend only continued to accelerate; by the beginning of 2001, workers owned only 27.2% of enterprises.<sup>53</sup> Nevertheless, this is still a very high proportion of employee ownership.

Studies on the relationship between the structure of corporate ownership and performance at privatized enterprises gave mixed results. In one study by Filatov et. al., results indicated that large-block shareholding in Russia is negatively associated with a firm's investment and performance.<sup>54</sup> Another study showed that most Russian enterprises in the 1990s had difficulties raising external funds.<sup>55</sup> On the other hand, an analysis of the corporate performance of "blue chip" Russian firms found a weak correlation between ownership and firm performance.<sup>56</sup> Surveys in Saint Petersburg also revealed that employee ownership was not a significant factor in the performance of those firms.<sup>57</sup> Rather, the success of enterprises in transition depended largely upon the ability of managers to improve discipline and perpetuate a climate of common goals between workers and managers.<sup>58</sup> This is not surprising taking into account the relationship between labor and management at Russian enterprises, as this study will discuss below.

#### D. Russian Labor Market after Privatization

Russian employees had an important effect on the labor market and showed surprising ability to adapt to new economic realities in the privatization period. During privatization, roughly a quarter of the labor force suffered reduced working time arrangements or unpaid leave, and a fifth was involved in informal labor activities or worked part-time.<sup>59</sup> Additionally, three-quarters of all employers delayed payments of salaries for up to several

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<sup>52</sup> Trevor Buck, Igor Filatov, Mike Wright & Vladimir Zhukov, *Corporate Governance and Employee Ownership in an Economic Crisis: Enterprise Strategies in the Former USSR*, 27 J. COMP. ECON. 459, 460 (1999).

<sup>53</sup> T.A. Mironova, *O Praktike Sozdania i Funkcionirovaniya Aktsionnykh Obshchestv Rabotnikov (Narodnykh Predpriyatiy v Rossii)* [On Practice and Functioning of Joint Stock Companies of Employees (People's Enterprises) in Russia] in 10 ANALITICHESKI VESTNIK SOVETA FEDERATSII 5, 18 (2005).

<sup>54</sup> Igor Filatov, Rostislav Kapelyushnikov, Natalya Dyomina & Sergey Aukutsionek, *The Effects of Ownership Concentration on Investment and Performance in Privatized Firms in Russia*, 22 MANAGERIAL AND DECISION ECON. 299, 300 (2001).

<sup>55</sup> See Lissovolik, *supra* note 50, at 226.

<sup>56</sup> See PYOTR KUZNYETSOV & ALEKSANDER MURAVYOV, STRUKTURA AKTSIONYERNOGO KAPITALA I REZULTATY DEYANETLOSTI FIRM V ROSSII [THE STRUCTURE OF STOCK OWNERSHIP AND FIRM PERFORMANCE IN RUSSIA] 2 (2002).

<sup>57</sup> *Menedzhment Rosta. Opyt Uspeshnykh Rossiiskikh Promyshlennykh Predpriyatii* [Management of Growth. Experience of Successful Russian Industrial Enterprises], June 3, 1996.

<sup>58</sup> *Id.*

<sup>59</sup> *Id.*

months.<sup>60</sup> However, the unemployment rate in Russia was not particularly responsive to the shock of the transitional period. For instance, in the 1990s employment declined only twelve to fourteen percent.<sup>61</sup> This was greatly disproportionate to the decline in GDP,<sup>62</sup> which dropped by about 42.5% between 1990–1998.<sup>63</sup> By comparison, Central and Eastern European countries that suffered a similar decline in GDP saw employment decline twenty to twenty–five percent.<sup>64</sup> This was certainly a positive result of market reforms in Russia.

On the other hand, by 1996 about sixty percent of industrial enterprises suffered from over–employment (as defined by managers in those enterprises).<sup>65</sup> The Russian Economic Barometer similarly reiterated that during the period of privatization, a majority of Russia’s enterprises employed an excessive labor force. However, stable economic growth helped to decrease the number of excessive workers and by 2002 and the number of over–employed enterprises dropped to thirty percent.<sup>66</sup> Consequently, productivity in these enterprises improved from a more efficient use of human resources.<sup>67</sup> Empirical studies also suggested that wages at privatized companies were higher than at state enterprises,<sup>68</sup> evidencing more effective functioning by privatized companies.

Another noticeable characteristic of the Russian labor market during privatization was low worker turnover. The general number of Russian employees moving from less effective to more effective enterprises was significantly lower than in other transition countries.<sup>69</sup> This inevitably had a negative effect on enterprises’ performance, because efficiency would be better served if workers reacted appropriately to market changes.

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<sup>60</sup> ROSTISLAV KAPELIUSHNIKOV, ROSSIISKI RYNOK TRUDA: ADAPTACIYA BEZ RESTRUKTURIZACII [RUSSIAN LABOR MARKET - ADAPTATION WITHOUT RESTRUCTURING] 21 (2003) (published summary of Ph.D. dissertation).

<sup>61</sup> *Id.*

<sup>62</sup> *Id.* at 16.

<sup>63</sup> By way of comparison, the GDP of the United States during the Great Depression never fell more than 30 percent. *Great Depression*, Encyclopædia Britannica Online, <http://www.britannica.com/eb/article-234440> (last visited Mar. 17, 2008).

<sup>64</sup> For example, unemployment in Poland in 1993 was 15.7%. Philippe Aghion & Olivier Blanchard, *On the Speed of Transition in Central Europe*, in *TRANSITION TO THE MARKET ECONOMY: CRITICAL PERSPECTIVES ON THE WORLD ECONOMY* 63, 64 (Paul Hare & Junior Davis eds., 1997).

<sup>65</sup> See Sergey Aukutsionek & Rostislav Kapelyushnikov, *Labour Hoarding in Russian Industry*, 2 *RUSS. ECON. BAROMETER* 3, 3 (1996).

<sup>66</sup> See KAPELIUSHNIKOV, *supra* note 60, at 32.

<sup>67</sup> *Id.*

<sup>68</sup> LEONID KOSALS & ROZALINA RYVKINA, *SOTSIOLOGIYA PEREKHODA K RYNKU V ROSSII* [SOCIOLOGY OF MARKET TRANSFORMATION IN RUSSIA] 75 (1998).

<sup>69</sup> KAPELIUSHNIKOV, *supra* note 60, at 24.

According to a special report published by the Russian Audit Chamber, privatization did not strengthen social protections for employees in privatized enterprises.<sup>70</sup> Rather, in many instances it caused the destruction and looting of company assets.<sup>71</sup> Moreover, the scope, and therefore the benefits, of privatization were limited. While industrial employees could buy property or shares at a substantial discount, other areas of the economy (health care, science, education, social care, government etc.) were beyond the government's privatization plan. Therefore, the government effectively deprived employees in these sectors from a share of the national wealth.<sup>72</sup>

While theoretically advantageous, in reality employee ownership failed to improve working conditions, employee discipline, and quality of work.<sup>73</sup> For instance, there were numerous violations of labor legislation in privatized enterprises, especially in the area of occupational safety.<sup>74</sup> Similarly, opinion polls suggested that even though employees in joint stock companies became part of management, they still felt like hired labor force rather than co-owners. As a result, employee participation in enterprise management was minimal.<sup>75</sup> Neither the new nor the former owners had appropriate skills for managing enterprises under market economy conditions. The result was a substantial decrease in productivity.

## II. WHY EMPLOYEE OWNERSHIP DOES NOT WORK IN RUSSIA

In order to understand why traditional expectations associated with employee ownership did not work in Russia it is necessary to examine the historical and social context in which employee buyouts took place.

### A. *Weak Sense of Private Property*

Large-scale industrialization in Russia began much later than in most Western European countries for various historical and cultural reasons.<sup>76</sup> The Tsarist government of the late Nineteenth Century feared the consequences of the "proletarianization" of peasants and therefore sought to discourage peasant

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<sup>70</sup> See Audit Chamber of the Russian Federation, *supra* note 9, at 132.

<sup>71</sup> *Id.*

<sup>72</sup> KAPELIUSHNIKOV, *supra* note 60, at 15.

<sup>73</sup> Leonid Kosals & Rozalina Ryvkina, SOTSIOLOGIYA PEREKHODA K RYNKU V ROSSII [SOCIOLOGY OF TRANSFORMATION TO THE MARKET IN RUSSIA] 75 (1998).

<sup>74</sup> *Id.*

<sup>75</sup> See A. VASILEV, V. KUKUSHKIN & A. TKACHENKO, PRIVATIZACIJA: SRVNIITELNII ANALIZ: ROSSIIA, TSENTRALNAIA AZIIA, ARABSKIE STRANY [PRIVATIZATION: COMPARATIVE ANALYSIS: RUSSIA, CENTRAL ASIA, ARAB STATES] 254 (2002).

<sup>76</sup> Haim Barkai, *The Macro-Economics of Tsarist Russia in the Industrialization Era: Monetary Developments, the Balance of Payments and the Gold Standard*, 33 J. ECON. HIST. 339, 340 (1973).

migration from rural areas.<sup>77</sup> Many features of an agrarian society based on communes and patrimonial relations were still present in Russia at the beginning of the Twentieth Century.

The Russian Tsars and the Russian Orthodox Church traditionally promoted the idea of collectivism while opposing individualism.<sup>78</sup> A typical Russian peasants' land had been subject to repatriation by a "commune council."<sup>79</sup> However, under Prime Minister Petr Stolypin in the early Twentieth Century, the Tsarist government changed course and sought to transform the country's peasant population into individual and independent landowners.<sup>80</sup> Nevertheless, there was almost no tradition of private property among the vast majority of the population.

When Bolsheviks seized power in November 1917, peasants represented approximately eighty percent of Russia's population and held nine-tenths of the country's agricultural land.<sup>81</sup> Ironically, the new Soviet leadership recognized Tsarist communal ideology as consistent with its own goals.<sup>82</sup> Propaganda played on this tradition and included slogans such as "The Land to the Peasants!" and "The Plants to the Workers!"<sup>83</sup> However, a Bolsheviks' understanding of these phrases was markedly different from a market economy's concept of ownership because they generally did not recognize private property.

At the conclusion of the Russian Civil War, the Bolshevik government instituted a liberal New Economic Policy.<sup>84</sup> However, this policy was short lived; under Joseph Stalin, the Soviet state nationalized industry and collectivized agriculture. In the late 1950s, Nikita Khrushchev instituted new policies and a Soviet conception of a "social contract" emerged.<sup>85</sup> Under

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<sup>77</sup> DAVID KERANS, *MIND AND LABOR ON THE FARM IN BLACK-EARTH RUSSIA, 1861-1914*, 307 (2001).

<sup>78</sup> See URIEL PROCACCIA, *RUSSIAN CULTURE, PROPERTY RIGHTS, AND THE MARKET ECONOMY* 61 (2007) (discussing attitudes towards individualism in Russia).

<sup>79</sup> See STEPHEN F. WILLIAMS, *LIBERAL REFORM IN AN ILLIBERAL REGIME: THE CREATION OF PRIVATE PROPERTY IN RUSSIA, 1906-1915*, at 3 (2006) (discussing how in tsarist Russia, peasants held their land in communal ownership. Arable land was divided in sections based on soil quality and distance from village. Each household had right to claim one or more strips from each section depending on number of adults in household.).

<sup>80</sup> *Id.* at 2.

<sup>81</sup> See Lissovolik, *supra* note 50, at 208.

<sup>82</sup> Dmitry Vasiliev, *Kak my provodili chekovuiu privatizaciiu* [*How we Conducted Privatization*], in *PRIVATIZATSIA PO-ROSSIISKI* [PRIVATIZATION RUSSIAN-STYLE] 130, 140 (Anatoly Chubais ed., 1999).

<sup>83</sup> VLADIMIR LENIN, 31 *POLNOE SOBRANIE SOCHINENII* (FULL COLLECTION OF WRITINGS) 113-18 (1962).

<sup>84</sup> Under the New Economic Policy, the Russian authorities partially restored private ownership and allowed private entrepreneurship. See ROBERT SERVICE, *A HISTORY OF TWENTIETH-CENTURY RUSSIA* 124-25 (1997).

<sup>85</sup> DONALD FITZER, *SOVIET WORKERS AND DE-STALINIZATION* 5-6 (1992).

these new policies, employees gained full and secure employment and egalitarian wage policies. Additionally, the government provided workers with most essential goods, such as food and clothes, at subsidized prices.<sup>86</sup>

After oil prices fell in the late 1980s, Mikhail Gorbachev implemented dramatic political and economic reforms aimed at liberalizing the stagnant Soviet economy. Collectively known as “perestroika,” these reforms included promulgation of the 1983 Law on the Labor Collective<sup>87</sup> and the 1987 State Enterprise Law.<sup>88</sup> These laws gave workers’ collectives control over many decisions made at the enterprise level. Perestroika also allowed workers to form private cooperatives, pursuant to the law on cooperatives.<sup>89</sup> Within a short time, these quasi-private organizations accounted for about five percent of employment in the Soviet Union.<sup>90</sup> However, many reforms existed only on paper. Directors and ministry personnel sought to maintain the existing enterprise management system under which they exercised dominant roles.<sup>91</sup>

In the early 1990s, Russians held no positive feelings about private property as a result of more than half a century under a non-market economy. Moreover, Communist propaganda promoted a negative attitude towards a market economy, mass consumerism, and the uncertainty of unemployment. Communists saw little to be gained by instituting an economic system that had at its heart, “private property.” This is in contrast to Poland, or even western parts of Belarus or Ukraine, where communism came only after the Second World War, i.e., almost a generation later.

Furthermore, the memory of Stalin’s massive repression against the so-called *kulaks* (fists), or well-off peasants in the late 1930s, remained at the forefront of the population’s collective consciousness. After all, the main reason Stalin prosecuted and deported *kulaks* to Siberia was because they owned substantial private property and employed farm laborers.<sup>92</sup> The negative attitude of authorities towards consumerism and private property persisted in the Soviet Union for decades.<sup>93</sup> Thus the Russian population,

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<sup>86</sup> *Id.*

<sup>87</sup> Law of the Union of Soviet Socialist Republics on Labor Collectives and Enhancing their Role in Managing Enterprises, Establishments and Organizations (Jan.17, 1983).

<sup>88</sup> Law of the Union of Soviet Socialist Republics on Cooperation in the USSR (May 26, 1988); Law of the Union of Soviet Socialist Republics on State Enterprise (Amalgamation) (June 30, 1987).

<sup>89</sup> Law of the Union of Soviet Socialist Republics "On Cooperation in the USSR" (May 26, 1988).

<sup>90</sup> SCHLEIFER, *supra* note 2, at 11.

<sup>91</sup> *Id.*

<sup>92</sup> Lazar Volin, *Soviet Agricultural Collectivism in Peace and War*, 41 AM. ECON. REV. 465, 470 (1951).

<sup>93</sup> See Libor Roucek, *Private Enterprise in Soviet Political Debates*, 40 SOVIET STUD. 46, 48-50 (1988).

unlike the vast majority of other Europeans, had no living memory of private property or a market-based economy. Therefore, most Russians were not yet ready to become effective private owners under the market economy conditions that resulted from privatization.

### B. *Highly Centralized Decision-Making*

Another important characteristic of the Soviet economic system was a high level of centralization of economic decision-making. This economic system had different incentives compared to a capitalist system.<sup>94</sup> Specifically, the Soviet economy focused on centralized planning and expected all enterprises to make an *ex-ante* specified contribution to meet the state plan. The government expected managers to meet, and often exceed, the state plan requirements in exchange for bonuses and career growth opportunities.<sup>95</sup> To meet plan requirements, managers sometimes required workers to work longer hours and participate in *subbotniks*—unpaid work on Saturdays. Although such work was supposed to be voluntary, in reality it was obligatory. Such practices failed to develop real incentives for workers to innovate or become independent and responsible decision-makers. Moreover, exceeding the plan's requirements by a significant amount had risks, such as higher production quotas for subsequent years.

A hierarchical principle formed the basis of Soviet economic planning: the ministry gave orders to the plant director and the director gave commands to lower-level subordinate employees.<sup>96</sup> Each individual worker constituted a part of the "labor collective," which included all those with a right to work in the enterprise. The labor collective took priority over individual workers. Meanwhile, the enterprise director personalized and personified the collective, serving as the central figure in battles for resources with state ministries.<sup>97</sup> By the early 1990s, former Soviet enterprises had changed little; the enterprise administration continued to act on behalf of, and in the name of, the labor collective.<sup>98</sup>

Although the Soviet system collapsed, features of command and top-down planning still exist in modern Russia. Recent case studies suggest there is a consistent pattern of strictly centralized hierarchical management in

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<sup>94</sup> Managers and workers at each level had the interest in the maximum allocation of resources and the smallest of plant targets from the level above. See Simon Clarke, *Labour Relations and Class Formation*, in *LABOUR RELATIONS IN TRANSITION: WAGES, EMPLOYMENT AND INDUSTRIAL CONFLICT IN RUSSIA* 1, 5 (Simon Clarke ed., 1996).

<sup>95</sup> *Id.*

<sup>96</sup> See Marina Kiblitckaya, *We Didn't Make the Plan*, in *MANAGEMENT AND INDUSTRY IN RUSSIA: FORMAL AND INFORMAL RELATIONS IN THE PERIOD OF TRANSITION 198, 198* (Simon Clarke ed., 1995).

<sup>97</sup> Simon Clarke, *The Contradictions of State Socialism*, in *WHAT ABOUT THE WORKERS? WORKERS AND THE TRANSITION TO CAPITALISM IN RUSSIA* 5, 26 (Clarke et al. eds., 1993).

<sup>98</sup> *Id.* at 28.

contemporary Russia.<sup>99</sup> Management maintains many features of the traditional Soviet system of administrative control, with production subordinate to projected sales and limited change in the traditional forms of personnel and production management.<sup>100</sup> In sum, the legacy of a centrally planned economy negatively affected employees' incentives and their ability to make independent decisions.

### C. Managerial Paternalism

Historically, paternalism served an important role in the management of socialist enterprises. As Stephen Williams described it, "in a state without effective property rights, citizens and firms can protect their interests from predation only through patrimonial relationship—informal personal links between politically powerful individuals and their de facto dependants."<sup>101</sup> Paternalism was especially strong in those enterprises controlled by directors with great experience and who had devoted their whole lives to a factory.<sup>102</sup> Socialist "[p]ropaganda [also] gave a great deal of attention to creating the ideal journalistic image of the strict but just manager, concerned not only about production, but also about the needs of the people, day and night, at the expense of his own health, untiringly thinking about the situation in the factory and about people's lives."<sup>103</sup>

The Soviet government tried to determine and satisfy citizen's most important needs. State enterprises were the main agents of this guardianship policy. Not only did an enterprise pay wages and provide work, it often provided free or subsidized housing to employees, access to kindergartens, recreation facilities, and even groceries from auxiliary plants.<sup>104</sup> While most enterprises fixed wages in accordance with the law, directors had significant discretion over these non-monetary benefits.<sup>105</sup> Moreover, directors were not constrained by independent audit firms or activist shareholders, because such institutions did not exist in the Soviet Union. In Soviet times, directors of large enterprises, especially of so-called "city-forming" enterprises,<sup>106</sup> were

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<sup>99</sup> See Simon Clarke, *A Very Soviet Form of Capitalism? The Management of Holding Companies in Russia*, 16 POST-COMMUNIST ECON. 405, 410-11 (2004).

<sup>100</sup> *Id.*

<sup>101</sup> See Williams, *supra* note 79, at 14.

<sup>102</sup> See generally Tanya Metalina, *Employment Policy in an Industrial Enterprise*, in LABOUR RELATIONS IN TRANSITION: WAGES, EMPLOYMENT AND INDUSTRIAL CONFLICT IN RUSSIA 119 (Simon Clarke ed., 1996).

<sup>103</sup> Petr Bizyukov, *The Mechanism of Paternalistic Management of the Enterprise: The Limits of Paternalism*, in MANAGEMENT AND INDUSTRY IN RUSSIA: FORMAL AND INFORMAL RELATIONS IN THE PERIOD OF TRANSITION 99, 111 (Simon Clarke ed., 1995).

<sup>104</sup> *Id.*

<sup>105</sup> *Id.*

<sup>106</sup> City-forming enterprises were usually built in remote areas and worked for the defense or natural resources industries. Some of them were "closed" cities, meaning that getting in and

akin to feudal lords of the Middle Ages. That is, directors were effectively constrained only by regional Communist Party bosses.

The transition to privatization made Soviet directors even more powerful. Hyperinflation, a dysfunctional banking system, and the lack of monetary funds to pay wages served to make non-monetary benefits such as distribution of barter goods and enterprise production increasingly important. In addition, when an enterprise failed to pay employee salaries for an extended period, one of the few tangible rights workers could receive was the right to plunder the enterprise's property and commit technological and disciplinary violations without any punishment.<sup>107</sup>

The collapse of the Soviet system led enterprise directors to exercise enormous power over production and workers. At the same time, most of the old regime controls and state plans "from above" disappeared.<sup>108</sup> This made directors (better known today as CEOs) the main beneficiaries of Gorbachov's perestroika. Many enterprise directors wrested control of their enterprises from both the Party and the state apparatus during transition, and formed ways for personal enrichment even without formally violating the law.<sup>109</sup>

Directors made the decision on which variant of privatization to choose. Workers merely ratified those decisions.<sup>110</sup> Managers viewed shared ownership by outsiders in a much harsher light than shared ownership with employees.<sup>111</sup> As such, enterprise managers strongly favored employee buyouts because it freed directors from state control without losing traditional control over workers.<sup>112</sup>

Once privatization plans were in place, managers quickly removed rank-and-file employee representatives from oversight boards and generally opposed confidential voting at shareholder meetings.<sup>113</sup> Managers also used various kinds of pressure on employees, such as conducting voting by a show

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out of the city was permitted only with prior authorization. The power of directors in these cities was even greater. *See generally V. Ya. Monoprofilnye Goroda i Gradoobrazuyushie Prepriyatiya [Liubovnyi, Monoprofile Cities and City-forming Enterprises]*, 11 CHELOVEK I TRUD 85 (2000) (discussing labor markets in city-forming enterprises).

<sup>107</sup> Bizyukov, *supra* note 103, at 105.

<sup>108</sup> *See id.* at 107.

<sup>109</sup> Simon Clarke, *Privatization and the Development of Capitalism in Russia*, in *WHAT ABOUT THE WORKERS? WORKERS AND THE TRANSITION TO CAPITALISM IN RUSSIA* 199, 215 (Clarke et al. eds., 1993).

<sup>110</sup> *See* Michael McFaul, *State Power, Institutional Change, and the Politics of Privatization in Russia*, 47 *WORLD POL.* 210, 233 (1995).

<sup>111</sup> *See* Sharpley, *supra* note 41, at 27.

<sup>112</sup> *Id.*

<sup>113</sup> Joseph Blasi, *Privatization and Employee Ownership in Russia*, 7 *J. EMP. OWNERSHIP L. & FIN.* 145, 155 (1995).



of hands.<sup>114</sup> If voting did not support their position, employees could be subject to informal sanctions from directors. Management also refused to implement cumulative voting procedures mandated by law, which in effect disenfranchised minority shareholders like employees.<sup>115</sup>

In an unstable environment where employers routinely delayed the payment of salaries, workers often preferred cash to the uncertain value of enterprise shares.<sup>116</sup> Thus, managers often encouraged, or coerced, employees to sell their shares or dilute ownership.<sup>117</sup> Similarly, enterprise directors often illegally “privatized” company funds to buy vouchers at auction, which could later be exchanged for corporate shares.<sup>118</sup> This was the main mechanism for managers to accumulate large shares of stock.

In the early 1990s, about seventy-four percent of Russian workers believed top managers were the real owners of enterprises.<sup>119</sup> Managers controlled companies by various means: (1) maintaining control over salaries and bonuses; (2) operational control; (3) organization of export production; and (4) financial and credit policies.<sup>120</sup> Managers also had substantial power over the timing and procedure of shareholder meetings. There were also instances of direct coercion against workers through the threat of layoffs or manipulation of shareholder registers.<sup>121</sup> In effect, privatization created opportunities for corruption and rent-seeking behavior destroyed already weak social protections of the population.<sup>122</sup>

Although managers did not initially receive significant equity in privatized enterprises, they did receive other important concessions.<sup>123</sup> In addition to the shares managers received under Variants One or Two (around five percent), managers could buy additional shares cheaply at voucher auctions or from employees who often did not realize the true value of their shares.<sup>124</sup> In many companies, actually encouraged workers to buy more

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<sup>114</sup> Bernard Black & Reinier Kraakman, *A Self-Enforcing Model of Corporate Law*, 109 HARV. L. REV. 1911, 1928 (1996).

<sup>115</sup> See Blasi, *supra* note 113, at 156.

<sup>116</sup> Sergey Mitsek, *The State of Employee Ownership in Russia*, 10 J. EMP. OWNERSHIP & FIN. 135, 136 (1998).

<sup>117</sup> *Id.* at 136-37; see JOSEPH BLASI, MAYA KROUMOVA & DOUGLAS KRUSE, *KREMLIN CAPITALISM: PRIVATIZING THE RUSSIAN ECONOMY* 9 (1997).

<sup>118</sup> Black et al., *supra* note 16, at 100.

<sup>119</sup> I. Lipsits, I. Gourkov, & A. Neschadin, *Rossiiskie Predpriatia v Poiskakh “Eliksira Vyzhivania”* [*Russian Enterprises in Search of Survival Elixir*] 75 (1995).

<sup>120</sup> *Id.*

<sup>121</sup> See Lissovlik, *supra* note 50, at 222.

<sup>122</sup> See Black et al., *supra* note 48, at 1766-88 (discussing manager theft and looting in process of privatization).

<sup>123</sup> See SHLEIFER, *supra* note 2, at 40.

<sup>124</sup> *Id.*

shares to consolidate their own control.<sup>125</sup> Therefore, as a result of privatization, managers emerged with substantial control, especially over cash flow, even though employees often had the majority of voting shares.

D. *Alienated Employees and Weak Unions*

The emergence of private employers and diminishing state intervention dramatically changed industrial relations during privatization.<sup>126</sup> Layoffs were inevitable in many privatized enterprises, and there was a general expectation that workers would resist any changes that would lead to layoffs. Employees' time horizons truncated relative to outside shareholders<sup>127</sup> and there were concerns that with collapse of the Russian economy, insider-controlled firms would block any restructuring attempts that would ordinarily accompany privatization.<sup>128</sup>

By the late years of Brezhnev's rule, Soviet methods of creating incentives for employees, such as socialist competitions, were no longer effective.<sup>129</sup> The state's weakened administrative and ideological structure thus alienated workers from participating in civic and political life.<sup>130</sup> This resulted in frequent thefts, poor discipline and quality of work, and a general indifference to work product. While mechanisms were in place to prevent these negative behaviors and tendencies, these mechanisms' nominal existence inevitably affected performance and attitudes of employees.<sup>131</sup>

During the early stages of privatization, employees believed shareholding could help influence corporate decision making.<sup>132</sup> Therefore, workers became the main driving force of privatization.<sup>133</sup> There were no instances when directors favored privatization while employees opposed it, but directors frequently opposed privatization despite the desires of

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<sup>125</sup> *Id.* at 45; see also *supra* note 124 and accompanying text.

<sup>126</sup> Vladislav Egorov, *Privatization and Labour Relations in the Countries of Central and Eastern Europe*, 27 *INDUS. REL. J.* 89, 99 (1996).

<sup>127</sup> Morley Gunderson, Geoffrey Sack, James McCartney, David Wakeley & Jonathan Eaton, *Employee Buyouts in Canada*, 33 *BRIT. J. INDUS. REL.* 417, 419 (1995).

<sup>128</sup> See Nicholas Barberis, Maxim Boycko, Andrei Shleifer & Natalia Tsukanova, *How Does Privatization Work? Evidence from the Russian Shops*, 4 *J. POL. ECON.* 764, 781 (1996).

<sup>129</sup> Other methods of encouragement for workers in the Soviet time were: public boards of honor with pictures of the most hardworking employees, promoting to the membership in the Communist Party, granting honorable certificates or occasionally recreation trips to the sea shore. See generally S.S. Karinsky, *Pravovye Metody Pooshreniia za Uspeshyi Trud v Zarubezhnykh Sotsialisticheskikh Stranakh [Legal Methods of Encouragement for Successful Work in Foreign Socialist Countries]*, 3 *PRAVOVEDENIE* 117 (1958).

<sup>130</sup> See KOSALS & RYVKINA, *supra* note 69, at 16.

<sup>131</sup> *Id.*

<sup>132</sup> See Sharpley, *supra* note 41, at 29.

<sup>133</sup> See SHLEIFER, *supra* note 2, at 31.

employees.<sup>134</sup> In some instances, particularly in military industries, directors even successfully prevented privatization.<sup>135</sup>

Another important reason for workers' active role at the early stages of privatization was the mandatory approval of the privatization plan by enterprise employees.<sup>136</sup> If employees initiated privatization themselves, there was no need for secondary approval by employees.<sup>137</sup> Therefore, many directors encouraged employees to initiate self-privatization.

Russian enterprises were generally willing to restructure since insiders could then retain large stakes in enterprises with the best privatization prospects.<sup>138</sup> On the other hand, enterprises with poor prospects generally allowed outsider involvement, which often resulted in reduced employment.<sup>139</sup> However, workers in the early 1990s were not opposed to layoffs. To the contrary, core groups of workers were eager for layoffs if they would increase wages and the chance for continued employment for the remaining employees.<sup>140</sup>

Unions never played a significant role at the enterprise level in Russia, either in the Soviet or post-Soviet period, for a number of reasons. First, Soviet trade unions never truly represented workers, but rather served as a transmission belt that allowed the Communist Party better control over workers and to provide them with various benefits.<sup>141</sup> This is why Soviet society lacked traditions involving freedom of association and collective bargaining. It also contributed to worker's apathy and general reluctance to organize against management. Second, unions in Russia were structurally incapable of separating themselves from enterprise management. Without the support of the Communist Party, union leaders necessarily relied even more on enterprise administration. Third, and most importantly, unions lacked credibility among workers, who saw them as an arm of administration.<sup>142</sup> Thus, weak unions were unable to help workers effectively deal with the collective action problem and monitor management.

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<sup>134</sup> Piotr Mostovoi, *Kak Raskruchivalsia Makhovik Privatizatsii* [How the Privatization Started], in PRIVATIZATSIA PO-ROSSIISKI [PRIVATIZATION RUSSIAN-STYLE] 117, 118 (Anatoly Chubais ed. 1999).

<sup>135</sup> *Id.*

<sup>136</sup> *Id.* at 119.

<sup>137</sup> *Id.*

<sup>138</sup> Sharpley, *supra* note 41, at 72.

<sup>139</sup> *Id.* at 73.

<sup>140</sup> *Id.* at 9.

<sup>141</sup> See Yaroslau Kryvoi, *Discrimination and Security of Employment in a Post-Soviet Context*, 22 INT'L J. COMP. LAB. L. & INDUS. REL. 5, 8-9 (2006).

<sup>142</sup> Simon Clarke & Peter Fairbrother, *After the Coup: The Workers' Movement in the Transition to a Market Economy*, in WHAT ABOUT THE WORKERS? WORKERS AND THE TRANSITION TO CAPITALISM IN RUSSIA 173, 194 (Clarke et al. eds., 1993).

## III. THE FAILURE OF PEOPLE'S ENTERPRISES

Despite the failure of employee buyouts in the process of privatization, Russian politicians, especially communists and other leftist groups, did not abandon the idea of having enterprises controlled by workers. The existing legal forms of doing business in Russia did not fit widely-owned employee ownership.<sup>143</sup> Therefore, to help retain workers' control over enterprises the Russian Parliament adopted the Law on People's Enterprises in 1998.<sup>144</sup> Proponents of employee ownership greeted the law with hope.<sup>145</sup>

The Russian Parliament adopted the Law on People's Enterprises under pressure from management of enterprises and left-wing parties such as communists and agrarians.<sup>146</sup> Under the law, the people's enterprise became a particular form of closed joint stock corporations. The people's enterprise has several distinctive features compared to a regular closed joint stock company. First, employees of the people's enterprise possess at least seventy-five percent of stock<sup>147</sup> and each individual employee-shareholder cannot possess more than five percent of the stock.<sup>148</sup> Second, employees leaving the enterprise are required to sell their stock to the enterprise.<sup>149</sup> Third, voting on important issues of corporate governance, such as electing a General Director, Board of Directors, audit committee, or approving auditor's reports, is done according to the principle of one shareholder—one vote, rather than one share—one vote.<sup>150</sup>

The original idea behind the people's enterprises—creation of a wide middle class of workers—is not new. Such a middle class would benefit both from an ownership stake in enterprises and from their own work in those

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<sup>143</sup> See *Grazhdanskii Kodeks RF [GK]* [Civil Code of the Russian Federation] which provides that partners in partnerships, art. 107, and members in cooperatives, art. 107, do not have limited liability. Therefore these forms of business organization based on labor contribution of people are not suitable for large-scale industrial organizations.

<sup>144</sup> Federal Law on Particularities of Legal Status of Employees' Joint Stock Companies (People's Enterprises) (June 24, 1998) [hereinafter Law on People's Enterprises].

<sup>145</sup> Sergey Mitsek, *The State of Employee Ownership in Russia*, 10 J. EMP. OWNERSHIP L. & FIN. 135, 137 (1998).

<sup>146</sup> Interview with Adrian Puzanovsky, Chairman of State Duma Sub-Committee on Science and Education, 19 ROSSIISKAIA FEDERATSIA SEGODNIA J. (2002), available at [http://www.russia-today.ru/2002/no\\_23/23\\_federal\\_power\\_6.htm](http://www.russia-today.ru/2002/no_23/23_federal_power_6.htm).

<sup>147</sup> See Law on People's Enterprises, *supra* note 144, art. 2.

<sup>148</sup> *Id.* art. 6, ¶ 1.

<sup>149</sup> *Id.* art. 6, ¶ 4.

<sup>150</sup> *Id.* art. 10.

enterprises.<sup>151</sup> Supporters of this corporate form also argued that the people's enterprise fit into the Russian tradition of community-style work.<sup>152</sup>

In some regions of Russia, people's enterprises are reported to be thriving: employees managed to become effective owners and to prevent outside investors from gaining control by organizing in the form of a people's enterprise.<sup>153</sup> However, the vast majority of people's enterprises are located in one region of Russia—the Kabardino–Balkaria region—situated in the North Caucasus Mountains. Nearly all of these people's enterprises (ninety of ninety-one total) were established with the regional government's support on the basis of collective state farms in 2003–2004.<sup>154</sup> In reality, it was not the participants of collective farms who decided that a people's enterprise was the best choice. Rather the authorities of Kabardino–Balkaria “recommended” reorganization of collective state farms into people's enterprises.<sup>155</sup> Authorities argued collectivization would restrict the unlimited sale of scarce agricultural lands in Kabardino–Balkaria to outside investors.<sup>156</sup> Another, less explicit goal, was preserving incumbent managers' control over enterprises.<sup>157</sup>

Farmers who suddenly became controlling shareholders in people's enterprises had no management skills, especially in planning, business processes, labor organization, and profit distribution.<sup>158</sup> Therefore, directors decided almost all issues in the enterprise.<sup>159</sup> Employees had neither the knowledge nor the skills to stand up against directorial abuses. People's enterprises also faced serious difficulties attracting outside financing, which caused many of them to transform into open joint stock companies.<sup>160</sup> In addition, the law generally fell short in protecting shareholders' interests.<sup>161</sup>

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<sup>151</sup> Interview with Puzanovsky, *supra* note 146.

<sup>152</sup> See Interview with Nikolai Kharitonov, Head of Agro-Industry Group, 22 ROSSIISKAIA FEDERATSIA SEGODNIA J. (2005), available at [http://www.russia-today.ru/2001/no\\_19/19\\_question.htm](http://www.russia-today.ru/2001/no_19/19_question.htm).

<sup>153</sup> See Yuri Govorykhin, *Narodnie Predpriatia: Pri Kakikh Usloviakh Oni Vyzhivut?* [People's Enterprises: Under Which Conditions Will They Survive?], 19 ROSSIISKAIA FEDERATSIA SEGODNIA J. (2005), available at [www.russia-today.ru/2005/no\\_19/19\\_comments.htm](http://www.russia-today.ru/2005/no_19/19_comments.htm).

<sup>154</sup> Victor Bukreev & Emil Rudyk, *Predpriatia Upravliaemie Trudom v Rossii – ot Formy k Soderzhaniiu* [Enterprises Governed by Labor in Russia – from form to substance], 2 J. ALTERNATIVY 5 (2006), available at <http://www.moskvam.ru/2004/10/ashinov.htm>.

<sup>155</sup> *Id.* at 7.

<sup>156</sup> *Id.*

<sup>157</sup> See *infra* notes 158-161 and accompanying text.

<sup>158</sup> Bukreev & Rudyk, *supra* note 154, at 6.

<sup>159</sup> *Id.*

<sup>160</sup> *Id.* at 7.

<sup>161</sup> One of the law's loopholes is absence of ban on gifts of corporate shares. Outside investors who acquired a share which did not exceed 25% of equity as prescribed by the law, but was distributed within a wide group of people (one share per shareholder), this rule allows to elect a new General Director of the enterprise. See Bukreev & Rudyk, *supra* note 154

People's enterprises have turned out to be a failure. The fact that a significant number of them function only in one Russian region is excellent evidence that the market did not accept people's enterprises. The concentration of power in enterprise directors as a result of paternalistic traditions and ambivalence of employees hindered the effective governance of people's enterprises.<sup>162</sup> Coupled with the absence of outside control by investors, people's enterprises were fertile grounds for abuses of power.<sup>163</sup>

The next section summarizes the lessons learned from employee buyouts in Russia.

#### IV. LESSONS LEARNED FROM EMPLOYEE BUYOUTS IN RUSSIA

Arguably Russian privatization achieved its main goal: more than sixty percent of enterprises became private, new market institutions were developed, and privatization occurred with relatively little social conflict.<sup>164</sup> As this Article shows, widespread employee ownership helped to make the Russian labor market flexible to absorb the various negative shocks that accompanied the transition to a market economy. Restructuring has proceeded relatively peacefully in the context of cooperation between management and employees. Employee ownership played a role in curbing unemployment, especially in the so-called "city-forming enterprises." Employee ownership has also been a temporary relief in the transition period. Giving significant stakes to employees helped pacify workers and prevented major social conflicts following the disintegration of the Soviet state.

However, the private benefits obtained by employees during privatization were very high and had adverse consequences on the outcome of privatization. By relieving short-term adaptations of the labor market, employee ownership failed to create adequate preconditions for long-term restructuring and sustainable growth. Consequently, an excessive labor force resulted in a much sharper decline in work productivity than in other transition countries.

De facto corporate control by former Soviet-era enterprise directors, without proportional financial interest, was a classic example of agency problems that led to managerial looting. Another adverse effect of employee buyouts was the unfair distribution of wealth. Employees of privatized enterprises received a majority of wealth when they obtained their enterprises

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(mentioning case when outside investors were able to elect General Director owing only 0.24% of shares).

<sup>162</sup> See *Narodnoie Predpriatie [People's Enterprise]*, 31 SOLIDARNOST 1, 4 (2003).

<sup>163</sup> Reported abuses include transfer of enterprise's assets to bogus firms controlled by director's relatives. See *id.* at 4.

<sup>164</sup> See Audit Chamber of the Russian Federation, *supra* note 9, at 6.

shares, while the government excluded other groups such as military or health care workers from the distribution.

The Russian case bears out what Henderson and Clark term “routinization theory.”<sup>165</sup> Firms tried to adapt pre-existing methods of operation to new market conditions, resisted change and still tried to preserve wages and employment. Not surprisingly, privatized firms dominated by Soviet-era teams of workers and managers were less likely to restructure than firms dominated by outside owners.<sup>166</sup>

The share give away process weakened the motivation of employees as shareholders<sup>167</sup> because workers received shares without any financial sacrifice. Workers’ lack of financial risk consequently weakened the discipline of possible loss of shareholder value.<sup>168</sup> These considerations favored selling enterprises to outside investors free from such habits and who would pay for shares by contributing needed funds to the state budget. Moreover, outside investors would pay market value for shares. One of the main reasons for the passivity of workers and their poor monitoring ability was that there were almost no provisions in Russian law regarding participation of employees in managing enterprises. In the post-privatization period, management excluded employees from any participation and employees felt more like a “cheap labor force” rather than like co-owners<sup>169</sup> and therefore lacked incentives to work productively.

In an environment characterized by a high degree of uncertainty and intractability, such as Russia, concentrated ownership through tighter management control would achieve greater efficiency.<sup>170</sup> Selling state enterprises to foreign investors would also garner additional advantages. For

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<sup>165</sup> Rebecca Henderson & Kim Clark, *Architectural Innovation*, 35 ADMIN. SCI. Q. 9, 9-20 (1990).

<sup>166</sup> Simeon Djankov, *Ownership Structure and Enterprise Restructuring in Six New Independent States* 15 (World Bank Policy Research, Working Paper No. 2047, 1999).

<sup>167</sup> Moscow city authorities tried to organize employee give-outs rather than buyouts (i.e. they gave employees their enterprises at depreciated cost) which were in reality very small sums of money. However, the experiment was not successful because of overwhelmingly high demand for such privatization. See Anatoli Chubais, *Kak My Zashishali Privatizaciiu [How We Defended Privatization]*, in PRIVATIZATSIA PO-ROSSIISKI [PRIVITIZATION RUSSIAN-STYLE] 143, 155 (Anatoly Chubais ed., 1999).

<sup>168</sup> Maxim Boycko, Andrei Shleifer & Robert Vishny, *Voucher Privatization*, 35 J. FIN. ECON. 249, 253 (1994).

<sup>169</sup> See Audit Chamber of the Russian Federation, *supra* note 9, at 134.

<sup>170</sup> See Harold Demsetz & Kenneth Lehn, *The Structure of Corporate Ownership*, 93 J. POL. ECON. 1155, 1160 (1985) (discussing relationship between instability and corporate governance).

instance, foreigners are more likely to pay for shares, invest capital, provide expertise, and facilitate better access to goods on the markets.<sup>171</sup>

However, selling enterprises to foreigners when there was an imminent threat of communist resurgence and a general anti-western outlook among the Russian population would have been political suicide for privatization reformers. Reformers also struggled to reconcile concentrated corporate ownership with the necessity to secure public support for privatization and create a dispersed class of private owners. The development of management and employee buyouts was a means of forming a coalition of interests between bureaucrats, workers collectives, managers and political leaders.<sup>172</sup> Moreover, in many cases foreign investors would be reluctant to invest given unstable political conditions, an underdeveloped legal framework, and weak law enforcement. Therefore, while wide-scale foreign ownership was not a feasible solution in Russia primarily for political reasons, this could work well in other transitional economies.

Employee buyouts in the process of privatization should, at best, lead to concentrated control by outside investors (preferably foreign). Employees should receive only minority stakes, which would improve incentives without adversely affecting the ability of a company to raise external financing and maintain effective mechanisms to control managers. If privatization needs wider public support, giving non-voting shares to workers seems to be the most effective solution. Non-voting stock will not scare away more effective outside investors who could purchase controlling blocks, which would be beneficial for controlling managers in an unstable environment. Moreover, non-voting shares would allow employees to receive a share of company profits without taking an active role in the decision-making process.<sup>173</sup> This would also help encourage market-oriented incentives for corporate managers, which outside investors are more likely to have. In the context of post-socialist paternalistic heritage, it is important to ensure effective communication of employee interests by strengthening the independence of trade unions and introducing forms of employees' participation in enterprise management, rather than giving employees controlling blocks of shares as gifts.

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<sup>171</sup> See Djankov, *supra* note 166 (demonstrating that foreign ownership of more than 30 percent of Russian companies was always positively associated with labor productivity growth).

<sup>172</sup> See generally Igor Filatotchev, Trevor Buck & Mike Wright, *Privatisation and Entrepreneurship in the Break-up of the USSR*, 15 *WORLD ECON.* 505 (1992) (showing that political compromises were necessary to reach any workable outcome).

<sup>173</sup> However, it would make sense to encourage "pure" employee buyouts in the sectors with homogeneous work force, such as service sector.



## CONCLUSION

This Article shows that while employee buyouts helped to reduce unemployment in Russia and prevent any major social conflict, privatization otherwise had a negative effect on corporate governance and economic productivity. An excessive labor force and management's tendency to preserve Soviet-style corporate governance hampered the long-term growth of privatized enterprises in Russia. In sum, it would have been more productive to give non-voting shares to workers and sell controlling blocks to foreign owners with superior capacity to invest and effectively manage privatized enterprises.