

# Carnegie Council Privatization Project

## The Politics of Russia's Privatization Program



**Dr. Andrei Shleifer**  
Advisor to the Chairman,  
State Committee on Property  
Management, Russia



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**I** think it probably is fair to say that Russian privatization has so far been a success story. I'm not sure it's been a success story as far as completed privatization and restructuring of the economy is concerned, but it certainly has been a success story relative to expectations. The privatization effort in Russia started in November of 1991, when the current team headed by Deputy Prime Minister Chubais came in, and I've been working with that team from around that time. Merely a year ago even the possibility of privatization in Russia was highly uncertain; it was not at all clear that anything would take place. The fact that the privatization ministry was called the State Committee on the Management of Property tells you precisely what the state of mind was at the time. A lot of people, including the bureaucrats who worked for that committee, believed that the committee's task was going to be the management of state property rather than privatization. Debates raged in Parliament about whether it was important to have privatization in Russia. A year later, Russia has a privatization program which has been accepted by Parliament and which is not really seriously debated any more except in details; approxi-

mately ten or fifteen percent of small-scale shops have been privatized; the lynch pins of the privatization program—vouchers—have been distributed to half the population, approximately 70–75 million people; and 6,000 of the largest enterprises have been corporatized and have submitted their applications for privatization. A thousand of these have been approved and so, in principle, are ready to be privatized. The first voucher auction—or sale of shares for vouchers—took place yesterday, in fact, at the cake factory called *Bolshevik*, which may well be the future Kellogg's of Russia.

The president of the country has been strongly endorsing privatization and has been telling all the journalists and all the visitors who see him that privatization is the most important item on the government's economic agenda. Mr. Chubais, who is the head of the privatization program, is probably one of the two or three most popular and well respected politicians in Russia. So, in that respect, even though no large en-

terprises have been sold, except from the point of view of building the consensus for privatization and building the machinery for privatization, I think the first year has been highly successful. Today, I would like to describe what has happened in Russia over the last year and perhaps suggest to you why, in fact, Russia has gone further in privatization than might have been expected. I should also point out, of course, that this relative success in privatization should be compared to the complete disaster in monetary policy, in balancing the budget, in social policy, and in politics, and to the general chaos and disintegration of the country.

The key aspect of the Russian privatization program is that it has been an overtly political program. It has realized from the beginning that there is no central government in

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Russia; there is no center that can enforce its desires on enterprises or on the population. Therefore the only privatization with any hope of succeeding would be privatization that provided the various participants of the process with the incentives to push for privatization themselves. This means trying to give incentives for enterprise managers to be involved, trying to give incentives

to local governments to be involved, trying to give incentives to workers' collectives to be involved, and so on. I think precisely by trying to be overtly political and precisely by trying to be very careful about making sure that the various participants in the process have an interest in privatization, the program has gotten as far as it has.

Let me now talk about what the political situation in Russia is, what the various lobbies and power centers are, and how the privatization program has tried to address the preferences or the interests of these lobbies. I also want to step back and describe the corporate governance system under socialism. Under socialism, enterprises were controlled from the center by means of the central ministries operating from Moscow. The main enforcement mechanisms to make sure that the enterprises did what the center wanted were the Communist Party and the administrative control of the ministries. So if a manager wanted to get promoted, he had a Communist Party

representative sitting next door to his office and he had to do basically what the ministry said and what the Communist Party said or else he was out. Managers did have some power under socialism, but not much; they didn't really have control over wages, over output, over the delivery of inputs or over many

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other production decisions. Very importantly, workers—contrary to Marx and Lenin—had absolutely no power in the socialist state, nor did the local governments. During the transition under Gorbachev, these control mechanisms crumbled. The Communist Party had been destroyed as an effective source of power, and the central ministries lost a great deal of influence as well. Where did this power go? It went to the managers of the enterprises who basically picked up where the ministries and the Communist Party left off and became more or less *de facto* in control of the enterprises. Some power also went to the local governments since they were now fearful of the electorate. For example, if enterprises tried to refuse to fulfill their social functions to the area, local governments could threaten to turn off water and electricity. In this way, the local governments got some control over the enterprises, but really not very much. However, the workers in Russia, unlike in Poland, did not gain very much power. In some sectors of the economy, such as coal, there were strikes and some evidence of worker mobilization for improving their conditions, but this was more an exception rather than the rule. In sum, when the government came in, it found itself with this overwhelming power of enterprise directors, some power of the local governments, much less power of the workers, and, of course, some residual efforts by the ministries to maintain their control. When the privatization program was designed, it tried explicitly to make sure that all of these major constituencies, to the greatest extent possible, would be capable of benefitting from privatization, at least in principle. That in some sense gave a foundation to the design of the program, so let me talk about the different strategies towards these various constituencies.

First of all, the Russian program was extremely generous toward the workers right from the start. Workers at each enterprise could choose between two variants of privatization. One variant would give them 25 percent of the stock of a large enterprise right away, for free, plus a host of other smaller benefits; another variant would let the

workers and the managers buy out 51 percent of the shares at a fairly low price. So, a big step was taken right away toward getting the workers' collectives interested in privatization. There is no question that something like that was essential; whether the program was too generous is hard to tell. Approximately half of the 6,000 largest enterprises that applied for corporatization in the last month or so picked the first variant, which is 25 percent of the shares for free, and about half picked the worker/management buyout at a low price.

In addition to the workers, the local governments were also accommodated to a very substantial extent. They have complete control over privatization of shops, movie theaters, bath houses, and various other small enterprises; and they also get virtually all the cash proceeds from privatization. The federal government gets virtually none. So there was a tremendous step taken toward accommodating the local governments by giving them a lot of control over privatization as well as cash revenues.

The strategy toward managers was also extremely generous from the start and in some sense I think it still is probably impossible to privatize an enterprise in Russia against the wishes of its managers. The managers get a large ownership stake in the enterprise and have virtually complete control over the privatization process. There will not be large shareholders of foreign investors brought into these enterprises against the wishes of the managers; the Czech variant, whereby there is some competitive process and somebody may become a large shareholder and control the managers of these enterprises, has not been accepted. Even though it would be very nice to accept, it was absolutely politically infeasible. As a result, the control over the enterprises would initially remain with the managers. One of the mistakes the govern-



Left to right: Alan Batkin, Kissinger Associates; George Anders, The Wall Street Journal; and Kevin Leitao, Le Boeuf, Lamb, Leiby & Mac Rae.



*Masahiko Imazato (left), Japan Development Bank, and Alessandro Roselli, Banca d'Italia.*

ment made is that it decided initially to be tough with the sectoral ministries because they bitterly opposed privatization. In the end, that probably was too costly in the sense that it made the design of the privatization program much more painful than it could have been. Some of the sectoral ministries were destroyed in the process, which is probably a good thing, but some of them have succeeded in keeping some enterprises or some sectors of the economy in state hands. The one bitter fight that has occurred in the last couple of months and that the privatization authorities have lost is over privatization of the energy sector. In August Mr. Yeltsin brought in as deputy prime minister a fellow named Chernomyrdin, who came from the gas industry, and the main item on his agenda has been to keep most of the energy sector in state hands. He won that battle. Even so, the vast majority of state assets will be put up for privatization and so the sectoral ministries will not be a terrible problem.

Finally, we've come to what is in some sense the linchpin of privatization, which is to get the most important constituency interested in the process, namely the public. This was done in Russia through a voucher program—in some ways very similar to that adopted in Czechoslovakia—whereby each citizen of Russia gets a piece of paper that says “10,000 rubles” on it which will be exchangeable for various assets, including, most importantly, shares in privatized enterprises. When vouchers were chosen in Russia, it was mostly a response to concern about the Polish scheme, in which shares of the largest enterprises were divided between a few state-blessed and foreign-run mutual funds with the idea that shares in these mutual funds would then be distributed to the population. The concern that the Russian government had about this scheme—quite properly, in my opinion—was that it would be very difficult to separate these mutual funds from the government. As a result, rather than being the top monitors of the managers, these mutual funds would become lobbying tools for further state subsidies to these enterprises. In this case, the main purpose of privatization would be defeated. It turned out that vouchers became the most potent political force for privatization. They are extremely popular. They have been promoted by the president very heavily, and the question that's asked most often of the privatization minister is how such a uniquely Russian mechanism for privatization was invented. It is very clear that the best hope for Russian privatization and

for its long-term survival, even despite possible opposition, will be the popularity of vouchers. Even the Communists cannot speak against vouchers, at least in public. What the Communists say is that using vouchers for privatization is dishonest and a trick on the public and that instead they should be used for major medical expenses, education, and various other things. They try to derail the use of vouchers for privatization, but they cannot effectively resist them.

In sum, the Russian program tries to interest as many constituencies as possible. It tries to interest the managers by giving them an opportunity to be wealthy and at the same time to maintain a lot of their control; it tries to interest the



*Left to right: Paul Sachs, Multinational Strategies; Michael Weinstein, The New York Times; and Martin Blumenthal, Techint, Inc.*

local governments by giving them cash; it tries to interest the workers by giving them tremendous stakes in their enterprises; and it tries to interest the public by giving them vouchers.

Of course this is not a perfect program by any means and in particular one very important thing was given up in designing this program, namely, the creation of large block holders or core investors who would have monitored the managers and enforced the restructuring. This has been an important point of privatization in France, Czechoslovakia, Poland, and Latin America, but was given up in Russia for the very simple and straightforward reason that it's politically infeasible to try to force control upon the managers. If that was tried, the managers would simply block privatization and that would be the end of it. There is, however, still hope that some control mechanisms will come to play a role. For example, there are absolutely no restrictions on the accumulation of vouchers by any investor, either domestic or foreign, so many investors will have an opportunity to accumulate large blocks of shares through the voucher auctions. More importantly, it's beginning to look more and more likely that many of the Russian enterprises will line up foreign investors with whom they would make deals subsequent to the allocations of the shares to the workers and the sale of large blocks of shares for vouchers to the public, thereby creating some governance mechanism. But it is certainly fair to say that as far as the creation of heavy-handed and intense governance mechanisms is concerned, Russian privatization has given up. So what is the current status of this program? As I said, firms have been prepared, vouchers have been distributed, and small-scale

privatization is moving along—although not nearly as successfully as it did in Poland and Czechoslovakia, mostly because I think public sentiment for small-scale privatization is not as strong and the local governments are much more communist and much less reformist in Russia than they are in eastern Europe. Corporatization has taken place quite successfully against all the predictions of the experts from the world's leading lending institutions; and many enterprises—I would say a thousand large enterprises—are ready for privatization. The privatization ministry is swamped with applications of enterprises that want to privatize and get out from under government control by going through a voucher auction. The first very enthusiastic auctions of shares of a large enterprise for vouchers have already begun and there will be a half dozen or so in the rest of December and more at the beginning of next year.

Let me now address two topics in conclusion. The first concerns what may go wrong, and the second asks if privatization makes any sense in a situation of utter economic chaos.

Three main dangers threaten the Russian privatization program. The first potential danger is logistical problems. Russia is a country of 150 million people with very poor communications, and with virtually no central control. The government has to exchange shares of thousands of enterprises for vouchers with the promise from the president that a person in any city in Russia can buy shares in any enterprise in Russia. I think that this promise will probably be fulfilled in the spirit more so than in the letter. But while the logistical problems are quite awesome, I am skeptical that they will stop privatization. The population is quite used to the fact that things don't go perfectly, and so far things have more or less worked. Corporatization has more or less worked even though 6,000 enterprises have been given only six weeks to convert

privatization in terms of logistics, but I don't think that is what's going to stop it.

A second risk, which is more difficult to assess, is that privatization will be boycotted from below. Specifically, in a lot of cases enterprise managers will simply refuse to cooperate with the privatization of their firms or else local authorities committed to maintaining some control over the en-

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terprises will similarly boycott privatization, which will slow it down considerably. For example, in the autonomous regions of Russia populated by ethnic minorities there has been absolutely no privatization at all or even preparation for it. These people are busy sorting out their ethnic problems and their ethnic differences with Russia and they are simply not, at the moment, very interested in economic reform. In various other regions in Russia privatization is also not going very well. In Moscow, for example, the city government seems to be much more interested in slow sales of property for cash and in the revenues that the city and the bureaucrats derive from such slow sales rather than in rapid privatization. At the same time, the more important point is that at the moment enough people want to privatize and enough property is ready to go on the market in smaller cities in Russia that slow local governments will not present a major problem at the beginning. There are enough cities where the local governments and the enterprises are in a close relationship—which is to say the city government does what the enterprise managers tell it to do—that these things move very smoothly. So

even though at some point this problem of reluctance to privatize at the local government and enterprise level will become serious, at the moment there are plenty of firms that are ready to be privatized.

The biggest danger, and the one that is probably on everybody's mind given the

events of yesterday's ouster of Deputy Prime Minister Gaidar, is the risk of privatization being stopped from above, by a government that will try to sabotage the process of privatization. In his official 13-point program, Mr. Volsky, the head of the Civic Union, advocated the end of mass privatization and a switch to something like a hundred demonstration cases over the next three years, rather than a mass privatization program. Even though such sabotage is a genu-

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themselves to joint stock companies, and the distribution of vouchers has more or less worked, and there haven't been any major scandals so far. There is an enormous, although backward, state machinery in place in Russia that is in some ways involved in the privatization process. Indeed, vouchers will be taken by hand, counted by hand, and the machines that will verify whether these vouchers are genuine will be moved by airplane or train between cities. This will not be an efficient

ine risk, there are reasons for being optimistic. The most important one is that vouchers are popular and people clearly expect to be sold something for their vouchers, and an attempt to stop that will create tremendous political upheaval. Secondly, the president has gone out of his way to support the voucher program and has talked about millions of owners being created in Russia rather than a few millionaires. And I think for the president it is virtually impossible to go back on that commitment to the public.

On the other hand, if a number of Communists come into the government, more enterprises would be pulled off the block and kept in the state sector. In the near future, that's not really the greatest risk because, as I mentioned, there are plenty of enterprises to privatize. So despite all these problems and potential dangers, I still think that the process is going to go ahead.

Now, does it make sense? Will privatization accomplish anything when there is complete monetary disorder and rapidly declining production? I think the answer to that question is yes. Privatization will succeed not because of an immediate incredible increase in output or in production resulting from privatization. The benefits of privatization will be less direct. I think two benefits should be stressed: number one, privatization will create some preconditions for growth after monetary reform takes place. It's hard to say when monetary reforms will take place in Russia; the Central Bank at the moment answers to Parliament and Parliament believes that a 25-percent budget deficit paid for by printing money is fine, so at this point monetary reform and price stabilization are not really on the books. On the other hand, the structure of monetary policy will have to change at some point, and at that point if a significant sector of the economy is private, one

could expect to see all the benefits, in terms of growth, that we have come to associate with privatization.

The second, and, I would say, potentially even more important, benefit of privatizing now is political. In a situation like the one Russia is in today, the political benefits might be much more important than the economic benefits. Privatization will create a political class or a political grouping that is supportive of reform. It will create a group of owners who would want to live in a normally functioning economy; who would believe that they can take care of themselves, that they can benefit from growth; and that they don't need to rely on the state as much as other people do, or as much as they have in the past. This will create a political sentiment for monetary reform, for reform in general, and for a government of reformers. And that is an absolutely essential first step.

If you think about the situation in Poland and in many other countries throughout the world, the impetus to reform comes not just from a small group of people at the top of the government who happen to believe in the market intellectually, but rather from a substantial public sentiment in favor of these changes. This sentiment is only beginning to emerge in Russia and it is beginning to emerge largely through the distribution of vouchers. If privatization does take place and if a substantial part of the population does begin to work in the private sector, and does feel itself to be owners of enterprises in whatever indirect way—that they begin to see that privatization means more and better goods in the stores, and better jobs for their neighbors—this would create a political sentiment, maybe even a political group, and maybe even a political party, that would be in the vanguard of economic reform. If this is accomplished over the next year or two, then privatization in Russia would be an even bigger success than we currently conceive.

## Questions and Answers

**Q** How long do you expect it to take for these benefits to accrue and become realizable in the context of the current Russian political system?

**A** The political benefits will probably accrue reasonably fast. We are already beginning to see some evidence that public sentiment is changing in favor of privatization. The remarkable example of that is Nizhny Novgorod, which was one of the leaders of small-scale privatization in Russia. They started with public demonstrations, red flag waving against privatization, but now public opinion polls suggest that the majority of the population supports privatization because they see goods in the stores. For the economic benefits of privatization, one has to distinguish between small-scale and large-scale. Small-scale benefits will probably be visible rather fast. But the restructuring of state enterprises will not be very fast, mostly because there are no mechanisms in place for rapid restructuring. This hard-core attitude of "Let's lay off half the labor force, bring

in a foreign investor, junk our capital stock and get some new capital stock" is not happening. It will not happen because it's just not politically sustainable. In that respect, the economic benefits of privatization in Russia will be much slower to come than they are in eastern Germany or even Czechoslovakia.

**Q** Do you have any sense of a time frame: one year, five years, ten years?

**A** I would say five years. I think it is completely feasible to privatize 1,000 large enterprises, or about a sixth of the corporatized enterprises, next year. There are about 100 privatization offices throughout Russia and a thousand enterprises basically means that each one of them has to run one voucher auction a month, which is totally feasible logistically and will not be done only if they don't want to do it, not because they cannot do it.

**Q** My first question is, is there a legal structure in place for privatization and are there laws protecting the right of property? Are there laws on the enforcement of contracts; does the judiciary have any role to play? And the second question is, could you say a few words about privatization of agriculture?

**A** Some beginnings of a legal structure are starting to emerge. When enterprises become joint stock companies they will get charters, boards of directors, and fairly explicit sets of rules concerning how the corporation is governed. The courts are another matter: at this point civil courts in Russia basically say, "We do divorces; we don't know anything about this economics stuff." At the same time you do see the spontaneous creation of a private system of arbitration. In the last two or three years Russia developed hundreds of commodity exchanges on which goods were traded without standard contracts. Interestingly, as many as 25 percent of the deals that went through these commodity exchanges went to arbitration. But the exchanges seemed to have been able to resolve most of the disputes through private arbitration within a few days. So you are going to see in Russia the use of a private arbitration mechanism instead of courts, while the legal system is going to be much slower in developing. The problem of the lack of laws and a legal system should not be exaggerated. It's a huge problem, I agree with you, but most countries in the world don't have legal systems as refined as Britain's and the United States'. If Russia does as well as many of these other countries it will be doing very well. One could make a lot of progress even with slow development of the legal system. I should also mention as an aside that Parliament just passed an utterly ridiculous bankruptcy law which basically says that nothing can go bankrupt. So in that respect, the restructuring is going to be quite difficult.

On the question of privatization of agriculture, it is going extremely badly. The task has been given to Vice President Rutskoi, who is very skeptical about privatization to begin with and is surrounded by people who are even more skeptical than he is. They had some fairly bizarre schemes proposed over the first year, none of which has made much headway. In the near future, privatization of agriculture will be spontaneous, whereby farmers get some claims to the output of land. Formal privatization of agriculture is still some time away.

**Q** The privatization scheme that you described essentially involves keeping today's managers in place in the same enterprises doing the same things without any effective governance structure. Given the powers that the managers are getting, and considering that Soviet enterprises are monopolistic and producing poor quality goods that nobody wants to buy, isn't it possible that giving vouchers will be seen as a kind of cruel hoax; that is, they are not really worth anything to the people who get them?

**A** I disagree with that for a variety of reasons. Even though Russian privatization is not as governance-intensive as privatizations in some other countries, there are still some mechanisms that are being put in place. Workers get substantial power and in some cases where the management isn't competent, they will play a role. There are also opportunities for accumulation of blocks of vouchers and shares by outsiders. In a large number of cases, you will see managers eager to restructure or improve the situation of the enterprise by finding either foreign partners or other Russian companies who will bring in capital and know-how, and in exchange for that the managers will surrender some of their control. Even more importantly, the managers will get very strong financial incentives to increase the value of their enterprise. Whether they will restructure, or sell their stake to someone who will run the firm better, remains to be seen. So I don't think it's fair to say that this is a governance-free situation.

**Q** My question is related to legal infrastructure. Growing up in the Soviet Union, I know that Russian government has this tendency to be very intrusive. It used to combine two functions, the role of the owner of all the enterprises and the role of the regulator. Now that the role of the owner is shed, how is the regulatory system going to proceed? Will it still be so intrusive?

**A** I agree with you that this is going to be a long and difficult fight. The sectoral ministries still exist and they're certainly very eager to regulate and even own and control whatever they can. One of the organizations that has been created to address this monopoly problem has been the Anti-Monopoly Committee which has the following ideological view of its role: The way you control monopolies is by regulating prices, but one of the problems is that when you have several enterprises in an industry, it's kind of hard to control all their prices, so maybe first we should combine them into one entity and then regulate the price of that entity.

Needless to say this is not a very healthy view of regulation; we are lucky that this committee has been dormant. These dangers are always there and I think that all one can say at the moment is that if Russia in fact gets itself into a more reformist mood and if the sentiment for reform is greater, these tendencies to regulate and interfere will be controlled better than if the sentiment for reform is weak.

**Q** You mentioned that the new bankruptcy law is not really effective and it strikes me that there has not yet been a rationalization of the need for privatization, especially in large-scale industry. If you look at what's happening in eastern Germany,

one would expect that there, sooner or later one will see truly massive change. If privatization in Russia takes place before that rationalization takes place, which is what you seem to be outlining, I wonder about the political implications after many people have cast their voucher into some large state dinosaur.

**A** Let me make a couple of comments. First of all, people tend to be smarter than we think they are. The surveys of voucher holders in Russia indicate that not so many of them are all that eager to put their vouchers into state dinosaurs. If you ask them where they want to put their vouchers, they say they want to put them into bakeries and ice cream and beer factories and not so much into steel and chemical factories. As far as the restructuring and particularly the layoffs are concerned, there is absolutely no question at this point that the process is going to be much slower in Russia than would be ideal from a pure efficiency point of view. Managers are not going to lay off people as fast as might be desirable simply because, first of all, the workers have a lot of shares, and second of all, the managers live in these communities and have to deal with the workers on a daily basis. At the same time, in thinking about privatization one has to keep in mind the fact that there are two processes going on. One is the process of the growth and the expansion of enterprises that are viable, and you see in Russia as well as in every other country in the world that private enterprises in consumer goods sectors, trade, and retail are expanding like crazy. The manager of *Uralmash*, the giant machine-tool conglomerate, says he has lost 4,000 employees during 1992, all of them young employees who went into retail—which he refers to as the “unproductive” sector of the economy. So even if layoffs in the state dinosaurs are not as fast as they should be, that doesn't mean that privatization is not working. In fact, it's quite possible—and I don't want to sound too soft—that from the point of view of the social sustainability of privatization, slow layoffs are not so terrible.

**Q** You have painted a picture which is extremely eloquent and one hopes things will go this way, but what happens if Rutskoi takes over from the present president? If that

happens, what happens to all these developments that you have been telling us about?

**A** If Rutskoi takes over from the president, the reform will be finished. It's not quite clear how that would take place, however. The president has been elected and has his position until 1996. It will take a fairly extraordinary move by Parliament to replace him, or a military coup, and I don't see this at the moment because the president remains fairly popular. The other thing to realize is that Parliament is absolutely universally hated in Russia. It is a bunch of communists who got there before the reforms, who are every day shown on television being either asleep or totally drunk in the sessions, and who got into a fist fight last Tuesday in Parliament. It is not a widely respected institution, to say the least, and I think that if Parliament tried to take this action against the president, it is not at all clear to me they would win. At this point, the president is vastly more popular than Parliament.

**Q** Would you care to comment on the role of entrepreneurship and grassroots initiatives in the privatization process?

**A** It is fair to say that Russia has been lagging far behind other countries in Eastern Europe in supporting grassroots entrepreneurship. Most of this comes from the fact that there has been virtually no turnover of regional administrations; they are still run by the same people who ran them many years ago. They view entrepreneurship as a threat to their control, and they particularly try to exercise their control through the control of real estate and through allocation of space to entrepreneurs. The streets of Moscow are literally covered by little kiosks through which most trade is taking place, at the time when the state stores which were turned over to the workers are staying open but are empty. I think that letting people use vouchers for privatization of shops will, in fact, put a lot of pressure on local administrations and then you will see more action.

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