New wave of Russian privatization

Sergei Guriev
Note from the French-Russian Observatory, n°2, January 2013
About the author

Sergei Guriev

Sergei Guriev is a professor of economics and rector, New Economic School. Sergei Guriev graduated summa cum laude from the Moscow Institute of Physics and Technology in 1993. In 1997–98, he held a postdoctoral position at MIT; in 2003–04, taught at Princeton University. Dr. Guriev has published in the leading international journals, incl. American Economic Review, American Political Science Review, and Journal of European Economic Association. In 2006, Dr. Guriev was selected a Young Global Leader by the World Economic Forum, in 2011 he joined WEF’s Global Agenda Council on Europe. In 2009 and 2010, he was included in the top 100 of the President of Russia’s Cadre Reserve. He is a board member of Sberbank, Russia Venture Company, Alfa Strakhovanie, Agency for Housing Mortgage Lending, and the Dynasty Foundation. He is a member of the President of Russia’s Council on Science, Technology and Education, of the Advisory Council of the Peterson Institute for International Economics (Washington, DC) and of the Scientific Council of BRUEGEL, a Brussels-based economic policy think tank.

Sergei Guriev is a member of French-Russian Observatory’s Scientific advisory board.

About the French-Russian Observatory

Created in March 2012 and linked to the Economic Council of the French-Russian Chamber of Commerce and Industry (CCIFR), the French-Russian Observatory aims to produce an in-depth expertise on Russia, and promote a greater awareness of French realities among Russian political and economic elites. It publishes policy papers and the yearbook on Russia. It also organizes events such as colloquiums, seminars, press conferences in Paris, Moscow and Russian regions. The following are members of the French-Russian Observatory’s scientific advisory board, both scholars and experts, who actively participate in its work: Alain Blum, Pascal Boniface, Isabelle Facon, Peter Kopp, Jean Radvanyi, Marie-Pierre Rey, Yevgeny Gavrilenkov, Sergei Guriev, Sergei Karaganov, Fyodor Lukyanov, Ruslan Pukhov, Konstantin Simonov.
New wave of Russian privatization

Contents

2 About the author / About the French-Russian Observatory
3 Contents
4 Introduction
5 What does the Russian state actually own
7 Why privatization
8 Arguments against privatization
12 Words and deeds
13 The risk of delaying privatization
14 Conclusion
15 References
Introduction

Russia is about to launch a massive sale of state property. For several years, Russian presidents Dmitry Medvedev and Vladimir Putin have declared privatization to be a top priority for their economic policy. In his keynote speech at the St. Petersburg International Economic Forum in June 2011, Dmitry Medvedev said that he thinks that a sale of controlling stakes (and in some cases even blockholdings) in state-owned companies is needed. The only exceptions would be the infrastructure monopolies and defense industry. A year later Vladimir Putin, Medvedev’s predecessor and successor, addressed the same audience confirming his commitment to private property and reiterating that «state capitalism is not our goal», and promised that «the state will steadily withdraw from a range of industries and assets». During the presidential election campaign, Putin published his economic program as the article in the newspaper Vedomosti («We need a new economy», Vedomosti, January 30, 2012). This is where he announced «diminishing the state’s role in the economy» as one of the priorities of his economic policy.

These promises were formalized in the Presidential Decree «On the government’s long-term economic policy», which Putin signed on May 7, 2012, right after his inauguration. In this decree, President Putin promised to «withdraw state capital from non-resource companies which are not natural monopolies or the defense enterprises by 2016». This promise was less ambitious than those given in previous speeches. In particular, the decree excludes the privatization of natural resource companies and natural monopolies (including Gazprom and Rosneft, the sale of which would probably have brought the Russian budget more funds than the rest of the privatization deals combined). But the decree did assign the clear deadline of 2016 for completing the sales. As we will see in the next section, the state will have to work extremely hard to sell all these assets by that date, even excluding the defense, natural resources and natural monopolies, as it currently owns such a big part of the economy.
What does the Russian state actually own

Measuring the government’s share of the Russian economy is not easy. However, there’s no doubt that it is too high, as both Putin and Medvedev acknowledge in the policy statements above. The Russian government keeps the «controlling heights» of the economy - the key sectors and enterprises. Even if we exclude the so-called «state corporations» such as VEB and Rosatom, and the 100% state-owned joint stock companies (for example, Russian Railways, the United Shipbuilding Company and the United Aircraft Company), the state owns most of the largest Russian companies. Consider the top ten listed Russian companies in terms of market capitalization. The proportion of those in which the state has a controlling stake (more than 50%) is 62% of the total market capitalization. Expanding that to the top 20 listed companies still leaves over half (54%) where the state controls over half the shares, with a further 4% of companies where the state owns a blocking stake.

Nor is state ownership limited to large enterprises. The website for the Federal Agency for State Property Management («Rosimushchestvo») shows that the state has stakes in 2933 companies. It also shows that the state owns a billion hectares of land (i.e. over half the land area of Russia!). The Unified State Register of Federal Property counts 1,379,446 state entities.

How much is all of this worth? In reality, no-one knows this yet, not even Rosimushchestvo itself. It is no coincidence that the Draft Concept Note on the Management of Federal Property, which covers the period up to 2018, provides for full accounting and evaluation of federal property only by 2015 (this Concept Note is essentially the strategic plan of the Federal Property Agency).

According to estimates from the Control Directorate of the Presidential Administration¹ the value of these assets can be in the order of magnitude of tens of trillions of rubles. This is certainly a very large amount for Russia. To put that in perspective, the 2012 Global Wealth Report calculated the combined personal wealth of all Russian households at about $1.3 trillion (40 trillion rubles).

The assets owned and operated by the Federal Property Management Agency are only the tip of the iceberg. First, there are the state companies’ vast empires of subsidiaries and affiliates. One example is Gazprom. Not only is it a gas

¹ Sergei Strelnikov (2012), Member of the Expert Council of the Russian Government, «Privatization is all up to you», Expert, December 3, 2012
manufacturer, it also produces electricity, operates media, bank, real estate used for various functions, and other unrelated enterprises. Secondly, in addition to the federal property, there is also property owned by subnational governments. Thirdly, there are special organizations with de facto state ownership, although they are not officially state-owned companies. This last type includes Sberbank (which is not owned by Rosimushchestvo, but by the Central Bank) and the state corporations, and also the so-called «development institutions». State corporations are nonprofit organizations whose boards are chaired by senior government officials. Some state corporations, including VEB, Russian Technologies and Rosatom, have huge assets, and in each case these have either not been assessed, or an assessment has not yet completed.

Development institutions are another type of nonprofit organization set up to address specific problems in a market or in a region. Some of these institutions, such as the Russian Venture Company or the Agency for Housing Mortgage Lending, are joint stock companies 100% owned by the government. Other development institutions, such as VEB and Russian Technologies, are state corporations. However there are certain development institutions which are neither state-owned companies nor state corporations - for example, the Skolkovo Foundation, which is a nonprofit foundation.

Not only does the state hold a substantial portfolio of assets, it also controls the key sectors of the economy. In particular most of the transportation is state controlled. Russian Railways is responsible for 85% of non-pipeline transportation (non-pipeline transportation accounts for half of the transport sector), and Gazprom and Transneft completely control all the pipeline transportation. Since the acquisition of TNK-BP by Rosneft, the state-owned companies control the majority of Russia’s oil production. Gazprom dominates the gas market. The six largest Russian banks are all state-owned, and these six banks control 54% of the banking system’s assets.

So, despite the difficulty in accurately estimating the state’s share of the Russian economy, it is clearly very high.
Why privatization

There are four clear arguments in favor of privatization. First, privatization will improve the quality of governance and efficiency of the companies that become privatized. In companies around the world, privatization improves efficiency and market capitalization of the privatized companies (Megginson, 2005, Guriev and Megginson, 2006).

Secondly, privatization will dramatically improve the Russian economy’s competitive environment. Today the commanding heights in the key sectors of the Russian economy are held by state companies. Even where these companies are competing with each other, this is still not a fair market competition. Not only this harms consumers - such environment also undermines the incentives of their suppliers to raise efficiency.

Thirdly, privatization will not only improve today’s competitive environment - it will also create demand for institutional reforms tomorrow. The 1990s reformers’ argument (Boycko et al, 1995) - that without private property there is no demand for market institutions - now seems obvious. State-owned companies and state corporations are much less sensitive to the poor quality of the judicial system, the lack of competition and the protection of property rights. Without improving these institutions, it would be very hard to modernize and diversify the economy, improve the investment climate, reverse capital flight, and accelerate the economic growth.

Fourth, privatization will raise substantial funds for the national budget. Today when there is no budget deficit it seems that these additional funds are not really needed. But they are certainly going to be needed. In particular, even though it will take a few years until the deficit in the pension system starts to bite, pumping in significant resources today will help to raise the funded pillar of the pension system, and will ensure a more balanced position of the pension system in a few years’ time.
Arguments against privatization

Despite the fact that Putin and Medvedev have both spoken on many occasions about the need for privatization, the majority of Russians think it would be harmful rather than helpful. The Russians are not unique in such attitude. As shown by Frye et al (2009, 2012), people in the most transition economies are uncomfortable with privatization, especially those who have not succeeded during the transition to market. On the other hand, the degree of this opposition to privatization is higher in Russia than elsewhere. The European Bank for Reconstruction and Development carried out the Life in Transition Survey in 2010. This was a survey of 39,000 people in 35 countries around the world (30 transition economies, as well as the UK, Germany, Turkey, France and Sweden). The survey found that only Azerbaijan had a lower degree of confidence in private ownership than Russia.

The main argument against privatization is the people’s experience of privatization during the 1990’s. Russian public opinion considers the 1990’s privatization as a failure. This is partly because Russian society considered it to be unjust as well as ineffective, both in terms of increasing revenue for the national budget, and from the point of view of increasing efficiency of the privatized enterprises.

However, there are many reasons to believe that the upcoming privatization can be designed much more efficiently than it was in the 1990’s. Firstly, Russia now has the basic institutions needed for a market economy, primarily legal and financial institutions (including banks, financial markets, and asset management companies). So there is no reason to doubt that Russia can hold a fair and competitive sale of state property today. Moreover, such precedents have already been set, for example the privatization of energy assets in 2007-08.

1Judging by the materials of the recent legal battle in London between Boris Berezovsky and Roman Abramovich, at least some loans for shares auctions did involve substantial fraud.
Table 1. The degree of confidence in private ownership.


<table>
<thead>
<tr>
<th>Country</th>
<th>Confidence in private property</th>
<th>Country</th>
<th>Confidence in private property</th>
</tr>
</thead>
<tbody>
<tr>
<td>Azerbaijan</td>
<td>0.35</td>
<td>Lithuania</td>
<td>0.52</td>
</tr>
<tr>
<td>Russia</td>
<td>0.38</td>
<td>Slovakia</td>
<td>0.52</td>
</tr>
<tr>
<td>Kazakhstan</td>
<td>0.41</td>
<td>France</td>
<td>0.52</td>
</tr>
<tr>
<td>Serbia</td>
<td>0.41</td>
<td>Kosovo</td>
<td>0.52</td>
</tr>
<tr>
<td>Hungary</td>
<td>0.41</td>
<td>Croatia</td>
<td>0.53</td>
</tr>
<tr>
<td>Latvia</td>
<td>0.42</td>
<td>Albania</td>
<td>0.55</td>
</tr>
<tr>
<td>Ukraine</td>
<td>0.44</td>
<td>Armenia</td>
<td>0.56</td>
</tr>
<tr>
<td>Montenegro</td>
<td>0.44</td>
<td>Romania</td>
<td>0.56</td>
</tr>
<tr>
<td>Estonia</td>
<td>0.45</td>
<td>Slovenia</td>
<td>0.59</td>
</tr>
<tr>
<td>Uzbekistan</td>
<td>0.45</td>
<td>Sweden</td>
<td>0.60</td>
</tr>
<tr>
<td>Bulgaria</td>
<td>0.46</td>
<td>Belarus</td>
<td>0.60</td>
</tr>
<tr>
<td>Moldova</td>
<td>0.47</td>
<td>Italy</td>
<td>0.61</td>
</tr>
<tr>
<td>Turkey</td>
<td>0.47</td>
<td>Mongolia</td>
<td>0.61</td>
</tr>
<tr>
<td>Kyrgyzstan</td>
<td>0.48</td>
<td>United Kingdom</td>
<td>0.62</td>
</tr>
<tr>
<td>Bosnia</td>
<td>0.48</td>
<td>Czech Republic</td>
<td>0.62</td>
</tr>
<tr>
<td>Macedonia</td>
<td>0.50</td>
<td>Georgia</td>
<td>0.64</td>
</tr>
<tr>
<td>Poland</td>
<td>0.51</td>
<td>Germany</td>
<td>0.67</td>
</tr>
<tr>
<td>Tajikistan</td>
<td>0.51</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

2 0 means that the respondents would prefer to increase state ownership in the economy, 1 is for the preference for increasing private ownership. For intermediate values, we use linear interpolation.
Secondly, Russia has trained a new generation of skilled managers, so there will be cadre to replace the existing managers of state companies. Thirdly, Russia now has macroeconomic stability, which is important for encouraging long-term investments by new private owners.

Another argument put forward by the opponents of privatization is that many countries have raised their share of state ownership in recent years. But this argument is also wrong. Many developed countries did use state intervention to save the banking system and restructure enterprises during the economic crisis, but the assets were re-privatized again as soon as the situation improved (Privatization Barometer, 2010).

Finally, there is the argument that it’s «not the right time» to sell state assets. Many opponents of privatization believe that Russian companies are too cheap right now, so we should wait for their prices to rise before selling them. Another variant of this argument says that we should not only wait but take the time for restructuring state companies before selling them, which will increase their value, hence raising more money through privatization. There is a simple answer to this: yes, it is true that Russian assets are cheap (investment banks’ analysts estimate the Russian companies trade at a 40% discount compared to assets in other emerging markets), but they are valued at their market’s worth. For example, oil prices (which affect most Russian assets) can rise or fall, depending on the state of the global economy. Of course, some pre-sale restructuring would be useful. But we must also remember that Russian state-owned companies are so cheap precisely because the market does not believe that they can become more efficient while remaining in the state’s hands. Indeed, in 2008 the Russian government promised to make state-owned companies the model of good corporate governance, but so far these promises have remained on paper (despite the fact that the government has total control over state-owned companies by definition). Yes, most likely, the value of these assets will grow after privatization. But this will be thanks to privatization, due to the takeover by new, more efficient private owners.

---

4 As is shown in Barberis et al. (1996) privatization improves efficiency of privatized enterprises when their managers are replaced with new ones, better suited to private enterprises.

5 This problem is not unique to the Russia. As shown in Megginson (2005), privatization leads to a 30% increase in market capitalization on average.
Some opponents of privatization argue that private property cannot operate efficiently in Russia, because, for instance, the culture of private property has been destroyed by decades of Soviet rule. This is also incorrect. While it’s true that privatized enterprises did not work effectively during the 1990’s, Russia did start to have economic growth once it gained macroeconomic stability and basic market institutions, and the vast majority of this growth took place in the private sector. The most careful econometric studies of the effects of privatization in transition economies (Brown et al. 2006, and Brown et al. 2011) have shown that at first privatization had a zero or negative effect on the performance of the privatized enterprises, which turned into a substantial positive effect in the first half of the 2000’s⁶.

⁶ These studies do not cover the second half of the 2000’s.
New wave of Russian privatization

Words and deeds

Despite the obvious arguments in favor of privatization, it has not really started yet. In fact, the state’s share in the Russian economy is actually growing. For example, the proceeds from privatization in 2008-10 were less than $1 billion (i.e. substantially smaller than 0.1% of the annual GDP). In 2011 this figure was higher - 121 billion rubles ($4 billion), but the vast majority of this total was the result of a single transaction - the sale of 96 billion rubles worth of VTB shares. The combined total of all the other transactions was less than $1 billion. Also, the big VTB transaction was the re-privatization of part of the shares that the state nationalized at the height of the financial crisis in 2009. So this was merely a (partial) post-crisis exit.

The results will look better in 2012, but again this is due to a single transaction. This time the big one is the privatization of 7.6% of Sberbank shares (worth 160 billion rubles, i.e. over $5 billion). But the state still remains the majority shareholder of Sberbank.

The plans for the future are much more ambitious. The plan called «The program for the management of federal property and the main directions for privatization of federal property in 2011-2013», approved in 2010, suggests that the Russian budget will raise a trillion rubles ($30 billion) due to privatization taking place during these three years. If this actually happens, the amount will still be less than the nationalization deal between Rosneft and TNK-BP, in which the private and foreign shareholders together received around $40 billion in cash (with the remainder arranged through an equity swap).

The acquisition of TNK-BP is not the only example of the state’s increasing role in the economy. Most of the assets that the state (or state-owned banks) acquired during the crisis are still on their balance sheets. There are also transactions unrelated to the crisis, such as acquiring «Troika Dialog» (the largest private investment bank) by Sberbank, and Gazprom’s purchase of energy assets.

So why is privatization not happening (or at least not yet happening)? It is possible that the state realizes how inefficient their companies are, and fear that privatization will lead to restructuring and a reduction in the inefficient employment, which would in turn increase the social discontent.
The risk of delaying privatization

What will happen if privatization is delayed? This largely depends on world oil prices. If oil prices fall, and remain low for an extended period of time, then the Russian government will initially respond by spending reserve funds and cutting certain fiscal expenditures, but sooner or later the government will have to start selling state property. The problem then will be the fall in value of Russian assets, since their value is very closely correlated with the global price of oil. In that situation it would be impossible to sell privatized assets at a high price. In turn, low proceeds from privatization would make privatization unpopular which can make privatization politically illegitimate. These political risks would make buyers pay even less than they would pay otherwise. But at that point Russia would have no option to defer privatization any further, because the state will need cash desperately.

What would happen if the price of oil goes up? In this scenario, there would be no incentives to privatize. This is mainly because the state would not need to raise any additional cash. Moreover, the growth of state-owned companies’ market capitalization (due to the increase in commodity prices) would mislead their management into believing they are outperforming their peers in the other countries. And - as we have recently seen - this may result in further acquisitions by state companies.

If the global oil prices remain high, this will eventually lead to privatization. In a few years, the Russia’s pension deficit will start to grow rapidly. Hence, Russia will need cash; at the same time the high price of oil will support high valuations for Russian assets. In this case, privatization can happen, and assets will be sold at relatively high prices.

Another risk of delaying privatization is a political one. Despite the fact that state companies’ employees are an important support base for the government, reneging on the clear-cut commitment to privatization could substantially damage the government’s reputation. After becoming the president again in 2012, Vladimir Putin clearly stated that the new government must stick to publicly announcing targets, deadlines and key performance indicators. In this sense, a blatant disregard for these privatization promises will undermine the middle class support for the president and the government.

Borrowing on the international market would be expensive and difficult with oil at a low price. Particularly as it’s such a large economy as Russia. To compensate for the losses caused by the fall in oil prices, say by a third, then Russia would need to take around $50 billion per year. It’s quite possible that the bond markets wouldn’t have that big an appetite for Russian assets.
New wave of Russian privatization

Conclusion

The Russian economy is at a crossroads. President Putin and Prime Minister Medvedev have announced that there will be a large-scale privatization over the next three years. This privatization will make the Russian economy more competitive and efficient, and create demand for further institutional change. But so far it is not clear whether these plans are going to be implemented. In recent years, the government has already announced ambitious privatization plans a few times, yet the state’s share in the economy has been growing. However, in 2012, Putin and Medvedev instructed the Federal Property Management Agency to develop a new concept for the management of state property, which would take the following simple principles into account. First, the Federal Property Management Agency should «sell or explain». If they cannot publicly justify why the asset should remain in state ownership, then it should be privatized. Secondly, the sale should be carried out in a competitive and open way. Implementing these principles will finally reduce the state’s control of the economy, and help to create legitimate private property in Russia.
New wave of Russian privatization

References


