

## SUCCESSFUL PRIVATIZATION REQUIRES DIVESTITURE

The current Government privatization program transforms state-owned monopolies operated by the *bolshaya shyshka* (old line directors and chief engineers) into privately or publicly-owned monopolies operated by the same *bolshaya shyshka*. A distinction without a difference.

Some state-owned monopolies have directors and chief engineers that can function as businessmen rather than "biscrats" (bureaucrats who are businessmen in name only). Many, however, lack initiative and lack the ability to make decisions, to motivate workers, to plan ahead and solve problems.

The continuation of an enterprise under the leadership of many of today's directors and chief engineers, even in a quasi market economy, will end in wide spread bankruptcies. Witness 1992, when enterprise directors exercised their political power to increase Central Bank credits and exploited their "good ol' boy" (former Communist comrade) network to obtain no interest loans from fellow enterprise bosses just to continue producing ever decreasing amounts of goods.

Enterprise directors and chief engineers, like American corporate executives, will probably not relinquish the power, status and wealth of their positions without a push and compensation (often called a "golden parachute"). The golden parachute can consist of an attractive retirement pension funded by the government and the privatized enterprise and ownership shares in the enterprise.

The push may come from the realization, already apparent, that the monopolies they lead need government subsidies in order to survive. But the Government does not have enough money, even in depreciated rubles, to provide what monopolies need to pay workers, suppliers and maintain production, let alone increase it. Workers and suppliers with less money buy less and demand decreases. Not even phantom credits (credits not backed by value) and an overactive printing press can replace the value lost when

production slumps. Approaching failure may convince incompetent directors and chief engineers or provide them with no choice but to turn over leadership to the younger (generally in their 30s and 40s) middle level managers who still have the drive and receptivity to learn a new way of doing business.

Waiting for the failure of incompetent directors and chief engineers will result in higher inflation and lower production. A situation called "stagflation" (a stagnant economy with high inflation). Unable to meet its peoples' needs, Russia's only alternative, other than a new dictatorship, will be to borrow even more heavily from Western nations. Use the funds to buy needed imports and sell its natural resources in order to earn hard currency with which to service its debt. A situation fully agreeable to Western businesses, since they will then have another source of cheap raw materials and another market for their manufactured products. Russia will serve the same economic purpose as Latin America, Africa and parts of Asia.

Russia can take a step towards avoiding stagflation if many of the old comrades running state enterprises accept a golden parachute to retire comfortably to their dachas or agree to compromise and run a spin-off of a privatized monopoly. Large American conglomerates, corporations running many different businesses, have often found it more profitable to sell, that is, spin-off some of their businesses and allow their middle level managers to become the directors of a newly spun-off independent business. This allows the new enterprise to concentrate on making one business profitable.

A Russian state-owned or privatized monopoly consists of many different businesses because of horizontal and vertical integration and the provision of ancillary (social, municipal, retail, etc.) goods and services to its workers and town's people. Horizontal integration means few, if any, other enterprises sell the same goods and services within a region. Vertical integration means the monopoly runs all or many of the operations from extracting raw materials to marketing the finished product to consumers. Ancillary goods and services often include construction and management of apartments and rest homes for workers, manufacturing of furniture and other consumer goods, selling consumer goods, construction of roadways and transportation systems, provision of utilities, etc.

Divesting Russia's monopolies into their constituent businesses will provide old line directors and chief engineers with a business to operate and will provide the younger,

middle level managers with businesses to operate that they are most familiar with and therefore most likely to operate successfully.

Divesting or spinning-off a monopoly's constituent businesses will also stimulate competition. Since many of Russia's monopolies engage in ancillary production and servicing, the spinning-off of these businesses by all the monopolies will create a marketplace with different independent organizations providing the same types of goods and services. Divesting the vertically integrated businesses will have the same effect by creating many independent extractors of raw materials, processors of raw materials, distributors and suppliers of raw materials and processed raw materials, distributors of finished goods and retailers of finished goods. The divestiture of monopolies, however, will still leave horizontally integrated enterprises producing a finished product such as cars. But after its divestiture of vertically integrated and ancillary businesses, the horizontally integrated enterprise producing the finished product will have significantly less market power to prevent entrepreneurs from successfully starting their own competing production of a particular finished good.

Besides accommodating old line directors and middle level managers with enterprises they can run, divestiture serves a more important function: the efficient allocation of resources through competition. Efficient allocation means resources, all of which are limited, are used to satisfy the wants of people at the least possible cost. Monopolies do not allocate resources efficiently. In a competitive market, competition will force the price of a good or service down to the point where it equals the cost of production plus a reasonable return. In a monopolized market, the price will stabilize at a point higher than this; there will be a monopoly profit. So a competitive market will provide goods and services desired by consumers at a lower cost than a monopolistic market; that is, a competitive market will allocate resources efficiently -- a monopoly market will not.

In a competitive market, every buyer who is willing to pay the competitive price of a product or service in order to obtain it will be able to do so because the product or service sells at their cost. In the monopolized market, the only buyers who obtain the same product or service are those ready to pay in excess of the competitive price. Those who would pay amounts equal to or higher than the competitive price, though not the full monopoly price, must substitute other products. Today, the wants of most Russians either go unsatisfied or partially satisfied because most Russians cannot afford to pay the monopoly price for many products and services.

Other reasons for a marketplace with many competing enterprises include: .  
decentralization of economic power (economic democracy), reduction of the range within  
• which private discretion may be exercised in matters that effect the welfare of others and  
increase opportunity for more people to exercise entrepreneurial talents.

A couple of examples of quasi-divestiture in Russia include the Kalinin factory in Yekaterinburg and the Leninetz plant in St. Petersburg. Kalinin, a former producer of launchers and fuel systems for SS missiles, split up into units producing timber-felling equipment, tractors, food-processing and industrial-refrigeration plants. The Leninetz plant, which produces avionics for Migs, divided into 117 business units. The problem with these two examples is they still maintain a central control over all the separated units. True divestiture necessary for competition to efficiently allocate resources requires independent enterprises free from the anti-competitive dictates of any central control.

A method for divesting Russia's large state-controlled monopolies easily flows from a privatizing scheme that uses worker-manager leveraged buyouts. Under this privatization procedure, workers and managers form a limited partnership that purchases a majority or more of the shares in a state-owned monopoly. The partnership pays for the shares with a debt instrument issued to the Government and collateralized with a mortgage or security interest granted the Government. Citizens and other investors purchase the shares of the enterprise not bought by the limited partnership or the shares above 51% that the partnership decides to sell. To assure divestiture, the Government can refuse to accept a mortgage or security interest or any other method of financing the privatization unless the enterprise agrees to divest once privatized.

Divesting or spinning-off one of the new privatized monopoly's units or businesses would entail issuing shares in the spun-off unit to all the shareholders of the privatized monopoly on a pro rata basis. That is, each shareholder of the privatized monopoly before the spin-off would receive a number of shares in the spun-off unit determined by the number of shares owned in the entire monopoly. This way none of the shareholders would lose any value through divestiture because they would now own a proportional share of the new, spun-off enterprise. The spun-off enterprise would agree to assume its proportional share of the debt issued to the Government and collateralize that debt with a mortgage or security interest in its own assets as a condition for becoming an independent enterprise.

Divesting privatized monopolies will provide old line enterprise bosses with a doable challenge of transforming a discrete part of their former enterprise from a profitless business to a profitable one. It will allow younger middle level managers the opportunity to use their knowledge of a unit of a monopoly to turn it into a profitable, independent enterprise. In addition, Russia's economy will have a betting chance to avoid stagflation and reap the benefits of competition, which means the growth in production of manufactured and agricultural products and services needed for a modern industrial economy.

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