A Property Theory Perspective on Russian Enterprise Reform

Michael Heller
University of Michigan, mhelle@law.columbia.edu

Available at: https://repository.law.umich.edu/book_chapters/15

Follow this and additional works at: https://repository.law.umich.edu/book_chapters

Part of the Business Organizations Law Commons, Comparative and Foreign Law Commons, and the Property Law and Real Estate Commons

Publication Information & Recommended Citation

This Book Chapter is brought to you for free and open access by the Faculty Scholarship at University of Michigan Law School Scholarship Repository. It has been accepted for inclusion in Book Chapters by an authorized administrator of University of Michigan Law School Scholarship Repository. For more information, please contact mlaw.repository@umich.edu.
CHAPTER 10

A Property Theory Perspective on Russian Enterprise Reform

Michael A. Heller

Why have Russian enterprises performed so poorly since privatization? This is a problem with many answers, each independently sufficient: the bleak mix includes vacillating macroeconomic policy, endemic corruption, a corrosive tax structure, poor human capital, and so forth. Even well-performing companies must hide good results because visible profits or dividends provoke confiscatory taxation and mafia visits. In such a difficult environment, the rule of law generally, and corporate governance in particular, may seem not to count. Macroeconomic implosions dwarf subtle distinctions in corporate dividend rules or minority voting rights.

Nevertheless, the rule of law matters in explaining the puzzle of Russian enterprise reform. This chapter suggests that corporate governance problems in Russia have important, though previously unnoticed effects. Even if Russia were to correct legal policy errors elsewhere in its economy, Russian corporations would likely continue to fail in impressive ways. More precisely, the initial structure of corporate ownership may play an independent explanatory role in current corporate performance, or in the jargon of the day, performance is path-dependent in interesting ways. This argument complements recent evidence demonstrating the link between well-designed corporate governance rules and well-performing equity markets (La Porta et al. 1996; see also Shleifer and Vishny 1997). Though it may be impossible to quantify the effects of initial conditions on current economic performance in Russia, the rule of law nevertheless matters in subtle ways.

A conventional story of corporate governance might predict that the initial distribution of shares during privatization would not matter much in Russia or elsewhere. According to this story, the initial pattern of corporate share ownership may affect who ends up with each slice of the pie, but will not stop owners from rearranging poorly deployed real assets to create bigger pies. In Russia, then, the initial distribution of shares to competing groups of insiders—managers, workers, and local governments—should not defeat the strong in-
centives these new owners have, in their capacity as majority shareholders, to reach Coasian bargains that would enrich them all. Perhaps new owners cook the books and mercilessly freeze out minority shareholders, but this is only a transitional concern on the way to more streamlined ownership and more competent management. So long as corporations begin to prepare standard accounts, develop open share registries, and hold regular shareholder meetings, any of a range of reasonable corporate governance regimes should do its job over time.

Yet, in Russia, the continuing dissipation of firm assets and the absurdly low valuation of Russian stock relative to these assets belie the conventional story. This chapter suggests that insights from property theory might help explain why the corporate governance regime has not had the positive effects that reformers predicted. Fragmented ownership of poorly performing corporations may be a stark example of what I call anticommons property, a wasteful corporate governance regime that results when initial share ownership is distributed to competing groups of insiders who then block each other from making value-maximizing moves with corporate assets (see Heller 1998).

Anticommons property is most readily understood as the inverse of commons property. In a commons, by definition, multiple owners may each use a given resource, and no one may exclude another (Michelman 1982). When too many owners have such rights of use, the resource is prone to overuse—a tragedy of the commons (Hardin 1968; Ostrom 1990). Familiar examples include depleted fisheries and overgrazed fields. In an anticommons, by my definition, multiple owners may each exclude others from a scarce resource, and no one has an effective right to use (Heller 1998). When there are too many owners holding rights to exclude, the resource is prone to underuse—a tragedy of the anticommons. Corporate governance in Russia may be an unfortunate example of a tragedy of the anticommons. Legal and economic scholars have mostly overlooked this tragedy, but it can appear whenever governments create new property rights. Conventional models of the rule of law focus on the clarity of property rights; the anticommons approach suggests that the content of rights may be as important. For example, Rebecca Eisenberg and I (Heller and Eisenberg 1998) offer an example in biomedical research, where sharply defined, nonoverlapping rights in gene fragments may have inadvertently blocked development of gene-based drugs.

The goals of this chapter are to introduce the idea of anticommons property as a tool for corporate governance theory and, more specifically, to aid understanding of Russian enterprise transition. The next section introduces the property theory framework for readers unfamiliar with the idea of a tragedy of the anticommons. Then I briefly describe how that framework operates across the gradient of socialist property in transition. The following section shows how an anticommons property perspective can help explain the path of Russian enterprise transition. Finally, I explore the consequences of initial patterns of
share ownership, particularly the migration to manager domination and the stifling of equity markets. Whether a corporate anticommons emerges in a developed or transition economy, and whether it lasts for a short or long period, societies can avoid its social costs by attending more to the patterns of initial share ownership. The difficulties of overcoming a tragedy of the anticommons suggest that corporate governance theorists and policymakers should pay more attention to rules for ameliorating the consequences of perverse share ownership during privatization and not just to the rules for subsequent share transactions.

A New Tool for Corporate Governance Theory

Private Property

Corporate governance is often discussed within a property theory framework because the modern corporation is, of course, a highly particularized species of private property (Milhaupt 1998). Corporate private property may be contrasted with categories such as commons property and state property (Kennedy and Michelman 1980; Waldron 1985). Anticommons property has not figured in this typology. This section makes the anticommons more accessible for corporate governance theorists.

Theorists usually note three elements to be essential in defining private property, each element with its corporate law counterpart: (1) Private property is understood as comprising a core bundle of rights chosen from the infinite relations that may exist among people with respect to a scarce resource (Hohfeld 1923; Honore 1961). The corporate form comprises one highly contingent form of private property, a bundle of rights and obligations established under the corporate laws of each jurisdiction (Hansmann 1996). (2) Ownership of private property includes the possibility that an individual can control the core bundle, such that the owner’s decision on use will be treated as relatively final by society (Michelman 1982). On this point, the most distinctive element of corporate law is the separation of ownership by shareholders and control by managers (Grossman and Hart 1986). (3) Owners may break up the core bundle subject to constraints on fragmentation that keep objects available for productive use, in an alienable form, and with a clear decision-making hierarchy among owners (Michelman 1982; Ellickson 1993). In corporate law, the key problem becomes how to structure the internal governance mechanism to align managers’ decisions with shareholder interests (Hart and Moore 1990; Cheung 1983).

Of course, even in settled market economies, the boundaries of the corporation may remain unclear despite the web of legal rules, institutions, and informal norms (Barzel 1989). For example, one current corporate law debate concerns whether managers might consider the interests of nonowner “stakeholders,” such as labor and local communities, commensurate with their regard.
A Property Theory Perspective

for stockholders (Oswald 1998). Ambiguity may arise because of a range of unresolved conflicts and changing values regarding ownership. Nevertheless, most workaday activities that require contact with corporations take place without negotiation over the corporate rights and obligations that are constitutive of the property bundle. If people thought deeply about corporate ownership, perhaps they would see that even its core meanings are historically contingent and indeterminate (Kelman 1987). However, our everyday experience of the corporation masks its somewhat mysterious character.

Anticommoms Property

Theorists have usually used the term *commons property* to describe a property regime that is not private property. For example, Michelman describes a commons as “a scheme of universally distributed, all-encompassing privilege . . . that is opposite to [private property]” (1982, 9). More generally, as Yoram Barzel notes, the standard economic analysis of property has “tended to classify ownership status into the categories all and none, the latter being termed ‘common property’—property that has no restrictions put on its use” (1989, 71). Thus, property theory traditionally dichotomizes commons (nonprivate) property and private property. This dichotomy is too limited to capture the diversity of real-world property relations. More generally, property relations are better characterized as a triumvirate of commons, private, and anticommons.

I define anticommons property as a property regime in which *multiple owners hold effective rights of exclusion in a scarce resource*. This definition departs from previous definitions along three dimensions: (1) Rights of exclusion—Because others define an anticommons to include only situations in which everyone has a right to exclude (Michelman 1982, Ellickson 1993), they have missed the existence of real-world anticommons property, in which a limited group of owners have rights of exclusion. Nonuse can occur even when a few actors have rights of exclusion in a resource that each wants to use. (2) Implication of nonuse—Although perpetual nonuse of property may be optimal in a few situations, there are more situations in which nonuse results but is not socially desirable. For most resources that people care about, some level of use is preferable to nonuse, and an anticommons regime is a threat to, rather than the epitome of, productive use. (3) Formality of rights—Multiple rights of exclusion need not be formally granted through the legal system for anticommons property to emerge.

The Tragedy of the Anticommons

Like the familiar tragedy of the commons, resources held in anticommons form are prone to waste. The tragedy of the commons is that rational individuals, act-
ing separately, may collectively overconsume scarce resources. Each individual finds that she benefits by consumption, even though her use imposes relatively larger costs on the community. Using my definition, an anticommons is prone to the inverse tragedy. A tragedy of the anticommons can occur when too many individuals may exclude each other from a scarce resource. The right to exclude is valuable precisely because others want to use the resource and will pay something to collect the right. The tragedy is that rational individuals, acting separately, may collectively waste resources by underconsuming them (even after accounting for effects on the environment, neighbors, and future generations).

By itself, the appearance of anticommons property—such as fragmented corporate ownership—is not necessarily a problem for the efficient use of resources. In a world without transaction costs, owners should rearrange initial endowments through ex-post bargaining in markets (Coase 1960). Such bargains would put resources to productive use, perhaps by bundling anticommons rights into private property. Of course, we do not live in a transaction-costless world, as Ronald Coase (1988) recognized. If many people can block each other from using a resource, they must incur at least the transaction costs of identifying and bargaining with each other to put the resource back to use. These transaction costs may result in ownership remaining fragmented and resources being wasted.

The reasons why individuals fail to reach Coasian bargains vary with the resource: sometimes the transaction costs of locating counterparts, bargaining, and enforcing deals prove to be prohibitive; other times agency costs, cognitive biases, or heterogeneous interests among owners preclude deals. The real-world effect of multiple rights to use an object or multiple rights to exclude others from use is not a theoretical absolute, but is instead an empirical matter. Expectations about overuse or underuse of property, and our policy responses, must be grounded in experience and observation.

**Anticommons Property in Transition**

**The Gradient of Property Reform**

Socialist legal systems organized property in a fundamentally different way from private property systems (Feldbrugge 1993; Gray, Hanson, and Heller 1992). For example, socialist law did not have the legal concept of limited liability corporations with privately held share ownership or of real estate defined as land and those things permanently affixed to it. Instead, the state owned all key economic assets—"the means of production"—indivisibly with no right of alienation. For administrative convenience, the government allocated complex use rights to state organizations. In resolving conflicts among users of state
property, dispute-settlement mechanisms accorded primacy to state socialist expediency, rather than to abstract legal principles. Legal tools such as share registries for corporations or land registries for real estate did not have any place in socialist law.6

The absence of corporations or real estate as legal categories suggests three elements that distinguished socialist law from market legal systems and set the stage for the emergence of an anticommons during postsocialist transition: (1) Hierarchy—While market legal systems tend to dichotomize among types of property (for example, real and personal, or tangible and intangible) and to focus on the scope of individual rights, socialist law categorized property according to the type or identity of the owner (Gray et al. 1993). State socialist property was at the top, followed by cooperative and personal property in decreasing order of protection (Mozolin 1993). (2) Objects—The category of socialist property included the objects of greatest economic value in socialist society. Because all productive assets were in principle “unitary” and belonged to “the people as a whole,” socialist law did not delineate corporate, physical, or legal boundaries in a way that would be familiar or functional in a private property regime (Butler 1983). (3) Ownership—Instead of assigning a single owner to each object, socialist law created a complex hierarchy of divided, coordinated rights loosely comparable to familiar Western forms of trust ownership (Feldbrugge 1993). Central-planning mechanisms coordinated uses; state arbitration courts, formally, and the Communist Party, informally, resolved conflicts. Thus, most valuable assets in socialist countries began the transition to markets with indistinct boundaries and overlapping ownership.

When property is organized along the hierarchy of socialist legal protection, a notable trend emerges: the starting point for ownership matters. Within a given national regime, the more protection property received under socialist law, the less successful its performance has been in a new market economy; conversely, property with less socialist law protection has performed more vibrantly.7 It is difficult for existing transition literature to explain this inverse correlation between protection and performance. For example, the level of administrative corruption, judicial incapacity, and clarity of rights is reasonably consistent across types of property within any given postsocialist market. Yet residential property, which received relatively less protection under socialist law, appears to be performing better than corporate property, which received relatively more—even if the two forms of property occupy identical physical spaces (compare Struyk 1996 with World Bank 1996).

Poorly performing anticommons property is most likely to appear and persist in resources that begin transition with the most fragmented ownership (Heller 1998). In contrast, private property emerges more successfully in resources that begin transition with a single owner holding a near-standard bundle of market legal rights. In such resources, the transition from a socialist to a
market economy occurs more smoothly. Each point along the gradient of property in transition suggests lessons about the nature of anticommons property and possible routes to rebundling it as private property. The following section notes just one point on the gradient, a point useful for understanding puzzles in postsocialist corporate governance.

Case Study of Empty Stores in Moscow

Stores in socialist regimes were notoriously bare because of an economic policy that disfavored production of consumer goods. Although the transition to markets took root in the early 1990s and storefronts were privatized, many storefronts in Moscow unfortunately remained empty during subsequent years. On the streets in front of these empty stores, however, new entrepreneurs set up thousands of metal kiosks that they rapidly filled with goods. Kiosk merchants negotiated around the anticommons regime through corruption agreements with local government rights-holders and protection arrangements with mafia. By routinizing corruption, kiosk entrepreneurs quickly reduced the transaction costs of assembling quasi-private bundles of rights:

Regular payments must be made to local officials and a powerful mafia. "You have to pay bribes to get financing," [Karlamov, a kiosk owner,] said. "You have to pay bribes to get permission to put your kiosk up on a promising site. And even after things are all set up, you have to pay bribes to make sure they don't close you down. The mafia is the easiest of all to deal with. They don't charge too much, they tell you exactly what they want up front, and when an agreement is made, they live up to it. They don't come back asking for more. . . . The hardest part was finding out who was the right person to bribe," he explained. "At first, we had no idea who could do what, so we began visiting the local prefect's office almost every day. We gave candy and other presents to people we met there, and eventually they directed us to people who could help." (Gallagher 1993, 1)

Creation of commercial space through corruption and mafia protection can be reasonably stable over time when procedures become routinized and entrepreneurs come to rely on formal forbearance and informal ex-post assembly of anticommons rights into private property rights. The presence of kiosks can be seen as a visual and analytic indicator for measuring a transition country’s progress from anticommons to private property in the real estate sector. In Poland, for example, anticommons property in commercial real estate lasted less than a year before kiosks disappeared. Why were Moscow merchants slower in moving from kiosks into stores? The answer lies partly in the legal regime surrounding commercial real estate.
Within the legal and institutional context of the Moscow storefront, the main actors were a wide variety of state and quasi-state organizations. In a monograph on commercial real estate markets in Russia, April Harding (1995) notes that the initial assignments of state property to different levels of government were opaque and varied. Local and regional government agencies emerged as the key players, with nearly monopolistic control over property such as commercial real estate. Privatization ratified some existing socialist and informal use rights while it superimposed a new set of market ownership rights. As a result, in postsocialist Russia, a heterogeneous set of owners have been thrown together in any given store. No owner in the new market economy held a bundle of rights that resembled any of the wide range of workable bundles that appear in well-functioning market economies.

There are some further complexities for transition in Moscow storefronts. First, multiple parties may share most rights. In this example, multiple owners must agree among themselves to exercise their "ownership stick" in the property bundle. Second, local government agencies may be distinguished from the bureaucrats who occupy decision-making roles and control use of the property. Officials may exchange leases at below-market rents for bribes. Even if only one party opposes use, that party may be able to block others from exercising their rights. The Moscow storefront thus meets my definition of anticommons property. The tragedy of the storefront anticommons is that owners waste the resource when they fail to agree on any economic use. Empty stores result in forgone economic opportunity and lost jobs. As of 1995, about 95 percent of commercial real estate in Russia remained in divided local ownership, and much was unused (Rapaczynski 1996).

Over time, store by store, entrepreneurial property bundlers may convert an anticommons by negotiating with all the holders of rights of exclusion. Indeed, evidence suggests that this process is happening already in Russia. However, the market route to bundling rights might fail altogether if the transaction costs of bundling exceed the gains from conversion, or if holdouts block bundling. The alternative route to bundling is for government to intervene by redefining and reallocating property rights. Local governments could exert more control over their subordinate agencies and transfer rights to or consolidate rights in the equivalent of a "sole owner," a single public decision maker able to act as an owner on behalf of the local government. However, existing rights-holders, including local government agencies and the private actors who have invested in reliance on the current property regime, may cling tenaciously to their rights. At an extreme, transition governments might defend badly designed property rights and then wait for the market to sort out the problems, or they might intervene radically in the market and undermine investor confidence.

Why do ground-floor stores often remain empty while physically identical apartments above are actively traded and kiosks flourish out on the streets in front? The different outcomes may be summarized in part by three factors...
relating to the transaction costs of bundling and strategic behaviors of owners locked in bilateral monopolies: (1) Public or private owner—The transaction costs of negotiating with private mafia may be lower than those of negotiating among state and corporate parties. (2) Number and homogeneity of owners—There are fewer owners with more homogeneous interests in kiosks than in stores and enterprises, with the result that transaction costs are lower. (3) Property boundaries—Even without formal title registries, people generally seem to agree on the limits of kiosk ownership, which constitutes the core object of value. By contrast, enterprise and store boundaries are not as transparent. A single bakery, a chain of bakeries, or all local retail stores may constitute the relevant object of property over which parties can negotiate.

The lessons of the Moscow storefront are strikingly parallel to the problems emerging with corporate ownership. For each point along the property gradient, governments are tempted to create anticommons property, perhaps to respond to pressure by existing stakeholders or to address short-term distributional concerns. Rather than assigning a usable bundle in a scarce resource to a sole owner, governments may assign rights in an object to multiple owners, so that many people can get a piece of each pie. After initial entitlements are set, institutions and interests coalesce around them, with the result that the path to well-functioning private property may be blocked and scarce resources may be wasted.16

The Path of Russian Corporate Governance

A Transition Puzzle

Enterprise reform has been the most discussed, and most puzzling, point in the literature on the transition from socialism.17 After the fall of the Soviet system, state enterprises were rapidly privatized, stock markets created, and corporate legal institutions adopted. Yet in 1994, the total stock market capitalization of all of Russian industry, based on voucher auctions, was under $12 billion—about equal to that of Kellogg Corp., a single U.S. cereal firm (Boycko, Shleifer, and Vishny 1995, 117). Oil stocks were twenty to thirty times cheaper per barrel relative to their proven reserves than the stocks of their Western counterparts. Even at their peak in the fall of 1997, the prices of Russian shares still left total capitalization at a trivial fraction of the apparent value of the underlying corporate assets controlled by these Russian corporations. By the summer of 1998, “the Moscow Times index of 50 leading shares hit an all-time bottom, lower than its starting level four years ago” (Daigle 1998).

While comparisons among transition economies are risky, the differences in corporate performance are so striking as to merit notice. For example, China has experienced tremendous economic growth, particularly among “township
A Property Theory Perspective

and village enterprises” (TVEs), apparently without “clearly defined” property rights (Li 1996). By 1995, these TVEs employed perhaps 300 million people, about 50 percent of total employment in rural nonprivate enterprises (Jin and Qian 1998). While analysts such as Andrei Shleifer (1994) suggest that clarifying rights will prove essential to continued growth, the anticommons perspective suggests that clarifying property rights may be only part of the story. Political and fiscal decentralization in China may have kept the core bundle of property rights relatively intact at the local level, so that the current process of TVE privatization may not lead to anticommons tragedy (see Pan and Park 1998). Even though rights are not clearly defined, perhaps a sole decision maker can exercise effective control over assets of each TVE. If further research confirms this hypothesis about Chinese enterprise reform, the content of control rights may be even more important than the clarity of those rights during transition.

The anticommons prism might usefully reflect on this divergence in corporate performance. If so, then the image of empty storefronts may not be an idiosyncratic artifact of early postsocialist transition, but rather a window into a more widespread phenomenon. Transition policy might focus more on the particulars of property bundling during political decentralization and enterprise privatization, the paths by which anticommons property is either formed or avoided. In particular, perhaps the fragmentation of ownership of the Russian firm helps to explain the slow pace of change. Privatization broke up the socialistic bundle of corporate governance rights among a heterogeneous set of managers, workers, and local governments (Boycko, Shleifer, and Vishny 1995). As discussed below, these new owners were given excessive rights of exclusion, such that no one could decide affirmatively to restructure the firm, and each could prevent the others from redeploying corporate assets in a value-enhancing direction. To gain support for rapid privatization from socialist-era stakeholders, Russia may have transferred socialist ownership at the state level to anticommons ownership at the corporate level.

Enterprise Privatization as Insider Buy-Out

Russian enterprises have a long history of insider management control. During the Soviet era, the decisions reached by “general director” were disciplined to an extent by central planning and ministry supervision. Beginning with late Gorbachev reforms and early Yeltsin reforms, central ministries loosened their control but they failed to select any outside monitor as a replacement. General directors recognized that to run their enterprises they needed a single decision-making owner, and many decided that they indeed were that owner.¹⁸

Before firms were privatized, they went through an intermediate step called corporatization, in which the enterprise was formally created as an in-
corporated business unit with a separate legal identity, a board of directors, senior management, share ownership, and a notional economic value ascribed to its assets (Blasi et al. 1997). When a firm was corporatized, 100 percent of its stock was still owned by the state, but central ministries lost control, and the firm was poised for privatization. During this preprivatization stage, the board of directors of the firm explicitly divided control among the general director, rank-and-file workers, and the local and federal governments. While employees elected the senior management, they rarely exercised this power in anything but the most nominal sense. By cooperating with the workers, managers positioned themselves to keep control of the firm at privatization.

Russia's mass privatization program of 1992–94 transferred more than 15,000 medium and large state firms to private ownership with "a speed that is quite unprecedented in the postcommunist world" (Frydman, Pistor, and Rapaczynski 1996). These firms employed over 17 million workers and managers and included the bulk of the Russian industrial core, except for a few categories of firms, such as energy, defense, and infrastructure. By 1996, when the big wave of privatization was over, 77 percent of medium and large state enterprises were privatized, accounting for 88 percent of industrial output (Blasi et al. 1997, 25).

Although the mass privatization used vouchers and formally created open stock ownership, the program "was basically a management-employee buyout program because of its preferential treatment of managers and workers" (WDR 1996, 5). Insiders had several privatization options. About one-quarter of enterprises chose the option that gave minority employee ownership for free. Nearly all the rest chose the option that allowed managers and workers to acquire 51 percent of the firm for extremely low prices. After insiders bought shares, each citizen could bid for some of the remaining shares at auctions using vouchers they were given. Immediately after privatization, insiders typically owned about two-thirds of the shares of firms privatized under the second option, noted above. On average, managers owned 9 percent and workers about 56 percent (WDR 1996, 55; Frydman, Pistor, and Rapaczynski 1996, 189). Outsiders obtained about 20 to 30 percent, split between investment funds and individual investors. Various government agencies retained the remainder of shares.

For example, the city of Moscow now runs 1,500 businesses, and "in another 300 firms, the city is a partner with outside investors. The businesses include bakeries, hotels, construction, publishing, banking, aviation, and communications firms, beauty salons, an oil refinery, and a pair of giant, troubled automobile factories" (Hoffman 1997, A1). Local governments also retain control of the land on which enterprises are located, an even more important problem for corporate transition, given the anticommons perspective introduced ear-
lier in this chapter. As one reporter notes, “Many companies seeking to get a clearer title to their land still face stiff resistance from regional authorities who see land ownership as a source of power in dealing with local enterprises” (Larsen 1996).

Postprivatization, senior managers invoked numerous mechanisms to thwart employee and outsider control. These mechanisms included, for example, keeping share registries locked up in their offices and refusing to acknowledge ownership by people they disfavored, threatening to fire workers who sold shares to outsiders, and stock dilutions aimed at outsider shareholders. As Andrei Shleifer and Dmitri Vasiliev said, “Old guard managers, who supported privatization in exchange for assurances that they would keep their jobs and full array of perks, are desperately fighting back. Some managers physically threaten challengers at shareholder meetings, rig shareholder votes or illegally change corporate charters” (Landry 1994). Even voucher investment funds, which are the most aggressive and informed outside shareholders, often cannot get even rudimentary information about the firms they own and instead “resort to spying on their own companies” (Frydman and Rapaczynski 1994, 204). Although managers did not acquire a majority of shares during the initial privatization, they have often been able to lock up control that cannot be dislodged.

Workers who did acquire majority share ownership did not achieve anything like a “workers’ democracy.” Instead, they remained locked in an uneasy arrangement with management, able to block restructuring but not able to seize control. While insider ownership has begun to decline, from 65 percent in 1993 to about 56 percent in 1995, the problems of majority insider ownership remain endemic. By 1996, the typical board contained four managers, one state representative, and two outside shareholders (WDR 1996; Blasi et al. 1997, 99). Because only five directors were required to make decisions, the insiders and the state representative could always prevail if they cooperated. According to the EBRD Transition Report (1997):

In over 65% of Russia’s 18,000 privatized medium-sized and large firms, management and employees have majority ownership, whereas non-state outsiders control only 20% of these companies. While in the top 100 largest companies outsiders have an ownership stake well above the average, the wide dispersion of these shareholdings often ensures a controlling position for the management. Insiders typically focus more on maintaining control over their firms than on restructuring. Maintenance of “pocket” share registrars (i.e. registrars controlled by the firm), manipulation of voting procedures and obstacles to board representation of outside shareholders have been widely used as defense mechanisms to preserve insider control.
Assessing the Value of Law in Transition Economies

The Consequences of Initial Conditions

The prices of publicly traded Russian corporations are so absurdly low that they evidence more than just poor performance in a difficult economic environment. These low prices suggest that corporate governance problems are an important contributory factor to poor performance. The share price of a listed corporation represents a market estimate of the value of holding its shares as a noncontrol outsider. In the case of the typical Russian corporation, share prices are only a small fraction of a pro rata claim on what appears to be the future potential cash flow of the firm. This is because of the high probability that the firm’s underlying assets will be grossly mismanaged and that whatever cash flow is produced will be diverted to benefit insiders or reinvested in unproductive projects. Such concentrated insider ownership is unique to Russia among all the important economies of the world. This initial condition may prove decisive in understanding whether the corporate governance system converges to either the American stock market or European bank-centered approach (Milhaupt 1998; Bebchuk and Roe 1998).

The anticommons perspective suggests two failures associated with the Russian pattern of initial share ownership. The first failure is that the three groups of insiders are unable to work together to operate their firms in a way that would lead to even their own joint benefit. They tend to view their shares more as control rights than as financial instruments. Each group has, despite privatization, continued to focus primarily on how each firm could be run in a way that would most benefit it directly. For management, this has meant extensive perquisites and diversionary business deals involving themselves and their associates. For labor, this has been continued employment of redundant workers with attendant (minimal) social protection. For regional government entities, this has been continued provision by the firm of public services to the community. Again, the relationship between privatized enterprises and the Moscow government provides a stark example, with the insiders using enterprise land as the basis for a “cozy relationship [that] is multiplied a thousand times. . . . The property was leased for a nominal sum, but the city also made unwritten demands not in the lease: to plant trees, rebuild a hospital, pave a highway” (Hoffman 1997, A1).

Each group, in agreeing to the policies desired by the other groups as the price of getting the policy it desires for itself, has acted in a way that ignores the effect of such an arrangement on the financial value of their shares. Or, in terms of anticommons theory, each group blocks restructuring by exercising low-cost vetoes, and in exchange extracts a minimal level of benefits from firm assets. From a social perspective, corporate assets are wasted in low-value uses, producing returns far below the performance that might be expected by comparison with Poland, China, or any other peer group of transition economies. In
terms of the above example, the particular enterprises in Moscow that planted the trees, rebuilt the hospital, or paved the highway are unlikely to be effective providers of such services; indeed, provision of such services may be incompatible with the firm's economic viability.

The second failure is that the three groups run the firm in a way that is particularly disadvantageous to outsider shareholders. The primitive state of the Russian legal system and the general lack of corporate transparency means that outside shareholders gain no real protection from the fiduciary duties nominally placed on managers and only weak protection from procedural rules designed to police against interested transactions. Thus the fact that the insiders are in the majority crushes what would otherwise be the only meaningful constraints on their behavior: the ability of outsiders to vote out the board and the hostile takeover threat. From the anticommons perspective, outside property bundlers cannot unify ownership in corporate assets and then redeploy those assets in value-increasing uses.

A Comment on Black and Kraakman

The main, recent corporate law reform—passed in 1996 and inspired partly by American law professors Bernard Black and Reinier Kraakman (1996)—was intended to respond precisely to the problem of insider domination that emerged from the initial privatization scheme and immediate postprivatization enterprise behavior. For example, the new corporate law attempted to improve the position of minority outside shareholders by mandating cumulative voting. Also, significant transactions in which insiders are interested are supposed to be approved by separate votes of the outside shareholders. Nevertheless, the new corporate law does not really get at the problem of multiple groups of insiders unable to cooperate even to maximize their own joint wealth. The law's procedural approach, which does not rely heavily on court enforcement, goes a long way toward creating a viable corporate governance regime. However, these reforms alone are unlikely to protect outsiders sufficiently to make public equity finance possible even when firms have made the transition to management control. Instead, the problems associated with insider blocks may require a more substantive approach.

For example, Black and Kraakman (1996) sensibly suggested neutralizing the voting rights of local governments, which make up one of the competing blocks of insiders and which are unlikely to use their rights to maximize shareholder wealth. But the suggestion to sterilize shares of local government owners applies with equal force to management and labor blocks—perhaps an economically sensible reform, but certainly a politically impossible one. Rules on disinterested ownership could also be used to take control of the board away from the initial group of insiders and increase the value of being an outside
shareholder. Insiders could profit more from increased share value than from diverting opportunities from the firm. While changing management and labor shares into nonvoting form may be infeasible and imprudent after privatization has been completed, the consequences of bad initial decisions may become more salient as the losses associated with the current system mount.

Later amendments to the 1996 corporate law attempted to address some of these concerns, but these revisions have not been effective: “Critics said the legislation fails to attack the real problem—insider dealing—and doubt anything but better information disclosure requirements and an understanding of basic ethics will help the situation. In Russia, company directors and managers are routinely accused of insider dealing, which includes everything from accepting bribes to acting against their company’s interests to selling assets or shares to relatives or friends” (Daigle 1998). In a system that starts with competing blocks of insiders, the anticommons perspective suggests that tinkering with voting rules will not put corporations on the path to equity-driven restructuring. Even Black and Kraakman have recently disowned many of their initial optimistic predictions for the role that corporate law could play in improving Russian enterprise performance (Black, Kraakman, and Tarassova 2000).

**The Consequences of Insider Domination**

Russian enterprise privatization closely parallels storefront privatization. For both, the path taken represents not only political expediency, but also the primacy of neoclassical economists over experts sensitive to the particularities of law and economics and to the bargaining implications of packaging rights. In each, the pure economists wanted to privatize as quickly as possible. They hoped that simply by getting interests into private hands, markets would establish mechanisms by which assets would migrate to the control of persons who would put them to best use. But reformers failed to consider the dynamics of anticommons ownership. The anticommons perspective suggests two main consequences that result from initial insider domination during corporate privatization: a path to insider domination and the stifling of equity market development (see Fox and Heller 2000).

This section discusses these consequences by drawing on anecdotal evidence—a second-best solution in a data-constrained environment. The next step will be rigorous empirical testing of the arguments advanced here, but study design for such a project is daunting. As noted at the beginning of this chapter, current macroeconomic and other factors may swamp the subtle effects of corporate governance rules on enterprise performance. Also, managers have strong incentives to hide precisely the crucial information that surveys or case studies would seek to capture: actual levels of share ownership and indirect con-
trol by insiders, rates and mechanisms of skimming of corporate opportunities, deal-making among insiders that cuts out shareholders, and real accounting information on firm performance. There is quite a substantial and growing body of empirical data on enterprises in Russia's transition, but none that is yet on point for pinning down the arguments advanced below.

The Path to Manager Control

The first expected consequence of the initial pattern of share ownership is that the dispersed allocation will not be sustainable over time. More specifically, as seems to have been the case with Moscow storefronts, the direction of ownership patterns will likely be that increasing numbers of firms will be taken over by one group of insiders, particularly the managers who can squeeze out other insiders and minority outside owners. This result can be predicted when substantial value remains within privatized enterprises, but the multiple groups of insiders are unable to make joint wealth-maximizing agreements regarding corporate assets. Where the insiders completely block one another, the assets may be wasted in a tragedy of the anticommons, but if one party can effectively exclude the others, then they may be able to unlock some of the value hidden within privatized firms, though at a suboptimal level because of the need for secrecy when transactions are formally illegal.

1. The Insider Game. The old managers have proven to be best positioned to wrest control from all other comers. Indeed, as one commentator notes, "Most Russian enterprises are still run by red directors—former communists who stack their boards with old-regime subordinates or cronies, bully workers into selling their shares back to management, and deny outside shareholders access to their books, boardrooms, and shop floors. Many consolidate control of their companies by issuing large blocks of new shares to company insiders, often at bargain basement prices" (Kranz 1997, 60). With weak formal corporate legal systems, insider managers devise ever more effective measures to entrench control by excluding labor and local government insiders and by diluting or eliminating ownership by outside shareholders: "New tricks... range from diluting the ownership stake of investors to such simple ploys as erasing the names of outside investors from computerized shareholder lists" (Galuszka and Kranz 1995).

From a narrow economic standpoint, the likelihood that managers—even bad managers—will take more control may not seem so troubling: by seizing control, these managers can overcome the tragedy of the anticommons and begin to operate the corporate assets in more value-maximizing ways, as if the assets were their sole private property. In this sense, concentrated manager control is a more stable ownership pattern and represents a social gain because the managers are more motivated to put assets and cash flow to productive uses—
leaving aside the unsettling distributive and social implications that manager domination expresses. Even from an efficiency perspective, however, the management control equilibrium is still far from ideal, and its shortcomings represent large continued failings in the Russian system of corporate governance, especially because managers have continued to divert rather than restructure assets. For example, the EBRD Transition Report (1997) notes:

Enterprise restructuring has hitherto been achieved mainly through changes in the product mix, shedding of labour through attrition, expanded use of unpaid leave or reduced hours. Deeper restructuring in the form of factory shutdowns, changes in management, major reorganisations and modernisation is a very early stage and is constrained by, among other factors, limited access to investment resources. Recent evidence suggests that roughly 25% of the medium-sized and large companies are engaged in serious restructuring, many of them being members of Financial and Industrial Groups (FIGs). About half of the medium-sized and large companies have not as yet undertaken any meaningful restructuring.

Often the managers’ aims have been achieved by extralegal means that are difficult to legitimate and have the collateral consequence of demoralizing labor and antagonizing local governments. Indeed, it may be premature to conclude that managers will ultimately prevail in the dynamic game of insider consolidation. By diverting the spoils of the enterprise away from local governments, managers can go too far, spurring local governments to shift the venue of competition. Every firm that fails to keep current with crushing local and regional tax obligations—a ubiquitous problem—opens itself to formal sanction by squeezed out local bureaucrats. In a surprising recent twist, with perhaps wide-ranging implications, local and regional governments have begun forcing resident companies into bankruptcy as part of a program to collect back taxes—when informal revenue dries up, then these governments appear to be turning to formal mechanisms. But the bankruptcy seems not to lead to a sale of the enterprise and its assets to produce cash that satisfies the firm’s debts. Rather, it appears that local and regional governments may be deploying these legal actions as an indirect route to an effective renationalization of privatized enterprises. Although data are sketchy, sub rosa renationalizations appear concentrated in firms that produce substantial cash flows, such as oil companies. For example, Kranz notes, “In regions across Russia, both local governments and creditors have filed bankruptcy suits against subsidiaries of Potanin’s Sidanko Oil. The suits ostensibly seek payment of back taxes and delinquent energy bills. But the real prize could be Sidanko’s oil assets” (1998, 44).

Local and regional governments, when cut out from the insider game, seem willing to strike back, and they have relatively effective legal tools to do
so; similarly, it is possible that employees could enter the game, though the tools available to them—such as strikes—require substantial efforts at collective action with less certain payoffs. In this struggle among insiders, the new equilibrium will take considerable time to reach and often will not put assets in the hands of those most capable of using them.

2. Deterring Outsider Investment. Early trends suggest that the best improvement in corporate performance in Russia comes when firms have substantial outside ownership and those owners place outside directors on the board (for example, see the Baltika Brewing case study in Fox and Heller 2000). This observation may be causally backward, however, in that outsiders tend to invest in the best firms, particularly those that are generating sufficient positive cash flow that payment of dividends becomes possible. One collateral consequence of the insider game is that outside owners, who may play a crucial role in disciplining corporate managers, will not appear, either through public equity offerings or through private purchases. One much-discussed example has been the huge, ailing Zil truck plant in Moscow. Rather than bring in outside investors and benefit from their access to capital and technical expertise, inside management has allied itself with the local Moscow government, particularly the current mayor, and both together have continued to run the firm into the ground, producing trucks that are hopelessly uncompetitive. Outside shareholders found they had little recourse as their investment was progressively squandered. According to one of many such reports, share owners "realized that, despite the municipal and federal authorities' special treatment of this flagship of the automotive industry, the enterprise was a hopeless failure, and they tried to exert some direct influence on the situation [but this] proved to be not such an easy thing" (Berger and Dokuchayev 1996).

Even faced with the most aggressive outside investors, insiders have been successful at undercutting their control. Examples abound. Recently, in a transaction allowed by Russian regulators, "the Moscow City Telephone Network, or MGTS, [announced that it] is planning to increase its authorized capital by 50 percent, handing the shares over to a single shareholder linked to the Moscow city government for next to nothing" (Baker-Said 1998). At Lebedinsky Mining and Processing Plant, a company on top of one of Europe's largest iron ore deposits, outsiders were about to buy 30 percent of the company's shares during privatization. But then, "after a series of quarrels, Lebedinsky managers barred [the outside owners] from the annual shareholder's meeting . . . While the [outsiders] cooled their heels . . . , the company's board approved a share issue that cut the [outsiders'] stake from 30% to 5%. Since then Lebedinsky managers have ignored an arbitration-court ruling that the issue was illegal" (Kranz 1997, 60).

Similarly, in an ongoing saga, insider owners of Sidanko Oil have repeatedly mistreated outsider shareholders and investors. According to one account,
"Sidanko outraged 10 percent owner British Petroleum Co. and foreign investment funds that own 4 percent of Sidanko stock by restricting the sale of a convertible bond issue to affiliates of [insider owners]. (The sale was reportedly at a tenth of the bonds’ estimated market price.)" (Fairlamb and Ivanov 1998; Whalen 1998). In early 1998, the Russian Securities and Exchange Commission blocked one attempted dilution, virtually the only time during the transition that minority shareholders were so protected by a public regulatory body—and only then because the minority shareowners were foreign investment funds with access to Western media. Since 1998, Sidanko’s insider owners have taken even more drastic action and are now completing a move to push out BP Amoco, the strategic investor that had invested over $500 million for its stake (Higgins 1999, A15). Whether insider dealing favors management or local governments, outside minority shareholders and strategic investors are equally driven out. In response, and over time, outsiders may become relatively less willing to make investments, even in natural resources and telecommunications companies with strong cash flows, despite the possibilities for substantial synergies and the firms’ need for new technology and investment capital.

When multiple insiders block each other, there is little commitment by insiders to the financial aspects of share ownership. Similarly, when manager insiders take control and divert assets illegally, outside investors have little incentive to purchase minority interests. The question for Russian corporate transition is whether privatized enterprises can systematically move in the direction of increasing outsider ownership and control, but the anticommons perspective would suggest migration in the wrong direction.

Constraints on Equity Market Development

The second consequence of initial ownership patterns is that there will continue to be severe limits on the emergence and development of equity financing markets. The ability of insiders to divert wealth from any existing or potential outside shareholders makes raising capital through public sales of equity virtually impossible. Instead firms must rely solely on internally generated cash flows, which are not particularly likely to match value-enhancing investment needs. From industry to industry, managers appear to be taking the same shortsighted approach: looting companies rather than ensuring continued access to capital markets for new investment. As one commentator notes:

All the infrastructure in the world can’t bring an ounce of liquidity to the market if directors do not want to have their shares bought and sold freely. More often than not, directors do little more than give lip-service to the ideal of a liquid secondary market for their shares. They smile and shake
hands when analysts and potential investors come knocking, but when the tough questions concern financial transparency and corporate governance—such as accountability—they start grumbling. The reluctance of many directors to use the stock market for their benefit is a paradox: After all, an overwhelming majority of directors managed to grab sizeable portions of equity in their companies during the wild privatization years of 1993 and 1994.... Were directors to understand the virtue of shareholder value, they could help make themselves even richer. (Peach 1998)

Because managers waste corporate assets by diverting corporate opportunities, firms have a low value on equity markets. In turn, managers are unwilling to trade control for the small amounts of financing that outsiders will offer. Also, the absence of outside investor voice in firm management reduces the likelihood that corporate assets will be used even in the best interests of the management insiders. Outside owners, either shareholders or banks, cannot play a role as monitors of management performance, particularly over managers who are incompetent holdovers from the socialist era. In one striking and odd report, "one company director... owned over 51 percent of a company, ... yet took personal bribes of about $10,000 to push through decisions that robbed the company of millions. Obviously, this man doesn't understand what he's doing" (Daigle 1998).

One particularly disastrous consequence of constraints on equity market development is that funds are not available for investment in new firms. First, because existing firms do not actively use equity markets, they do not generate positive externalities by creating the depth and liquidity necessary to support new firms coming to market. Also, the failure of existing equity markets means that there are no efficient mechanisms by which existing companies can release and recycle excess cash flow to new firms. In a well-functioning equity market, firms would pay out funds as dividends funds that they could not profitably reinvest, and such funds would then be available for reinvestment in new firms with higher rates of return. Instead, as the EBRD Transition Report (1997) notes, "The main source of the expansion of the private sector remains the privatisation process and the contraction of the state sector.... The creation of de novo businesses continues to lag far behind the pace typical for the central European countries and many newly established businesses continue to operate in the informal economy."

The final consequence of initial ownership allocations is that they continue to help drive capital flight. Privatization is intended to create wealth that is available for reinvestment in Russia, but the insider structure of corporate ownership instead stimulates capital flight. Diversifying risk through portfolio investment is impossible, so investments must be in controlling equity stakes un-
nder the current system. A system that starts with fragmented insider ownership has led to one where floating share equity is impossible and capital leaves Russia because of inadequate viable investment opportunities.

Concluding Remarks

The existing scholarly literature on comparative corporate governance reflects the range of dominant share ownership patterns in the United States, Western Europe, and Japan. It has not yet focused on the role of initial ownership structures at the time of privatization and the bargaining failures that may follow. We pay a high price when we overlook the effects of ownership structure on economic performance.

This chapter seeks to begin filling this gap by highlighting the tragedy of the anticommons in Russian enterprise reform. Governments must take care to avoid creating anticommons property accidentally when they define new property rights. With enterprises, as with storefronts, when there are too many competing owners, and weak or nonexistent institutional structures to mediate their conflicting interests, then an anticommons tragedy may emerge, and the resource may be squandered. Neither markets nor subsequent regulation will reliably convert an anticommons into useful private property, even if rights are "clearly defined" and subject to the "rule of law." The experience of anticommons property in Russian transition—from storefronts to enterprises—suggests that the content of property ownership, and not just the clarity of rights, matters more than we have realized.

NOTES

Generous support for this chapter was provided by the IRIS Center at the University of Maryland and by the U.S. Agency for International Development (USAID). The sections "The Path of Russian Corporate Governance" and "The Consequences of Insider Domination" are adapted from Merritt B. Fox and Michael A. Heller, Corporate Governance Lessons from Russian Enterprise Fiascoes (New York University Law Review, forthcoming 2000), a research project supported by the William Davidson Institute (WDI) at the University of Michigan Business School and the Cook Endowment at the University of Michigan Law School. The views expressed are the responsibility of the author and do not necessarily reflect those of the IRIS Center, WDI, USAID, or the University of Michigan.

1. This argument draws from and is substantially elaborated in Fox and Heller 2000.
2. In a recent article, Rebecca Eisenberg and I extend the theory of anticommons property to explain puzzles in biomedical research in the United States. We identify an unintended consequence of the trend in biomedical patent policy to grant more rights to premarket research. Paradoxically, more fragmented premarket rights may stifle dis-
covery of the commercial innovations that actually save lives (Heller and Eisenberg 1998).

3. Frank Michelman appears to be the first to use the term *anticommons*, though the source has been hard to pin down. A thorough search of the literature revealed few other uses (e.g., Dukeminier and Krier 1998; Ellickson 1993).


5. There are many other reasons why anticommons property may not be tragic: some resources are most efficiently managed in anticommons form, just as some are often held in commons form (Ostrom 1990; Rose 1986). Also, property theorists have shown that the efficiency of a property regime cannot be derived ex ante from a limited set of axioms, such as the assumption of rational, self-interested individuals (Kennedy and Michelman 1980; see also Krier 1992; Rose 1990).

6. While working for the World Bank in the early 1990s, I was often asked by Russian officials to help identify reform priorities in the housing sector and responded that property registries were among the highest priorities as they help clarify ownership, secure finance, and enable taxation.

7. The measure of performance is difficult to quantify given the available data. A comparison of Russian assets with similar assets in developed market economies, however, provides a useful proxy for the concept of performance. While this chapter focuses more on efficiency-related measures, comparing distributive outcomes is equally possible.

8. For elaboration on the Moscow storefront case study, see Heller 1998, 633–47.

9. Several reporters at the *Moscow Times*, including Ellen Barry and Adam Tanner, traced the rise and fall of Moscow kiosks in the transition years. These articles are available in Lexis-Nexis.

10. Newspaper accounts of kiosk enterprises often provide colorful confirmation of the anticommons arguments in this chapter. For example, Shapiro (1993, A15) notes that:

    [Andrei, a kiosk owner,] has had to bribe tax inspectors, pay protection money to mafia toughs and fork over "gifts" to officials whose approval is needed for a business license. . . . To start his business Andrei needed to get a host of city officials—firefighters, electricians, architects—to sign his permit request. . . . When a date was set for delivery of the kiosk, Andrei and his partner took care of a key business matter: making peace with the "protection" racketeers who have carved Moscow up into fiefdoms and who punish those who resist.

11. The kiosk system does not, however, generate the levels of economic activity that could be achieved by a well-functioning retail sector. Hernando de Soto (1989) argues that the vibrant informal economy should be viewed as an important contribution to the overall economic performance, rather than a drain. Second, and just as important, he contends that commentators should not mistake vibrancy for optimality, either along efficiency or distributive dimensions. The informal economy represents the triumph of ingenuity in the face of bad law. De Soto argues that a better solution would be to create the "good law" that characterizes successful economies, such as property registries and inexpensive enforcement of long-term contracts.
12. One article reports: “All this buying and selling takes place on the street because the title to most stores is unclear or because stores are occupied by moribund state enterprises. The sidewalks were free and empty, so the new entrepreneurs moved in” (Lally 1992).

13. A stroll down Tverskaya, one of Moscow’s central shopping streets, today shows relatively few empty storefronts compared with just a few years ago.

14. Communal apartments (komunalkas) form a particularly poignant example of a tragedy of the anticommons, with property bundlers murdering elderly tenants who hold out against assembling their rooms into a marketable single-family apartment. Komunalkas were a despised feature of Russian socialist life, one noted often in Soviet-era fiction (Bulgakov 1967; Zoshchenko 1963).

15. Frank Michelman (1967) suggests a calculus of settlement and demoralization costs for use in deciding whether a government should compensate for a regulatory change.

16. For recent explorations of the problem of path dependence and its relation to law and economics, see Roe 1998 and Milhaupt 1998.

17. This section draws substantially from Fox and Heller 2000, discussing lessons for corporate governance theory from Russian enterprise fiascoes.

18. As Blasi et al. (1997) recount:

The Russian general director is similar in authority to the chief executive officer (CEO) of a capitalist company. . . . In the past, a Soviet ministry could hire and fire him. Once Gorbachev removed cabinet supervision from the top managers of [the general director’s] plant, the only formal authority over his enterprise was a distant state bureaucracy that was spinning out of control, and the now independent, authoritarian [general director] could do what he pleased. [The general director] was probably tempted to treat the company as his personal property. This process has been called spontaneous privatization. (33)

19. In 1988, medium (more than 200 employees) and large enterprises (more than 1,000) accounted for about 95 percent of employees and production in Russia (Blasi et al. 1997, 25). In 1995 a few large, rich firms such as oil and gas companies were privatized through a controversial “loan for shares” program that handed shares over to a number of financial-industrial groups controlled by new private tycoons.

20. A third option attracted only 2 percent. This option allowed a management buyout on the promise of reaching particular restructuring targets (Blasi et al. 1997, 41).

REFERENCES


Gray, C. W., and Associates. 1993. Evolving Legal Frameworks for Private Sector De-
Assessing the Value of Law in Transition Economies


