ENTERPRISE RESTRUCTURING

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I. INTRODUCTION: CHALLENGES AND OBJECTIVES

Despite impressive progress in mass privatization, Russian enterprises have not made significant progress in cutting ties to the state, resolving financial difficulties, attracting investment, developing new products, and finding new export markets. Moreover, in Russia there has not been a large scale entry of new firms which, in Western market economies, are a traditional engine of job creation and a source of employment opportunities for workers laid off from older, non-viable enterprises. As a result, the initial economic reforms -- price liberalization, mass privatization, etc. -- have not created the foundations for renewed growth and the Russian enterprise sector remains in a low-investment, low-restructuring trap.

Mr. Putin's January 4 statement, "Russia at the Turn of the Millennium," provides a compelling summary of the resulting industrial ills in Russia: (i) GDP that declined by nearly 50% in the 1990s, (ii) productivity that is extremely low -- only 24% of the US average; (iii) an antiquated industrial capital base -- only 4.5% of Russia's industrial capital stock is less than five years old and 70% is more than 10 years old; (iv) minimal FDI flows; (v) minimal spending by Russian industry on R&D; (vi) a dramatic fall in the production of internationally competitive manufactured goods; and (vii) a decline in Russia's ability to produce world class science-intensive products.

Enterprise Reform Challenges/Goals

The Government should address these problems as a part of a comprehensive enterprise reform strategy that would focus on the following objectives.

Financial Discipline

Any enterprise reform operation should aim to strengthen the financial discipline of the corporate sector. The failure to establish or enforce hard budget have clearly contributed to a worsening investment climate and a declining competitive position of many enterprises. These distortions -- many of which provide considerable benefits to loss-making industrial enterprises at the expense of more productive new entrants -- have prevented the appropriate enterprise response to liberalizing macroeconomic reforms.

Contrary to expectations a few years ago, hard budget constraints have been very difficult to enforce. Tax arrears have replaced subsidies and directed credits while the problems of non-

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payments and barter have grown dramatically.[1] The proliferation of barter and non-payments have weakened the investment climate and competitive position of these enterprises.

Exit

Bankruptcy is still a nascent institution. It is hard to imagine a company in Russia today petitioning for the bankruptcy of its supplier or client in a production chain where monopsony and monopoly are the rule, both upstream and downstream. The weak capacity of courts and enforcement of judgements, makes bankruptcy the exception rather than the rule. The lack of exit of non-viable companies crowds out both the entry of new firms and the expansion of existing viable ones. The perpetuation of loss-making enterprises subsequently obstructs the transfer of resources to more viable enterprises. Therefore, administrative liquidation by owners and state creditors must be considered as a critical complement to the imposition of hard budget constraints.

Improved Corporate Governance

Ultimately, one must ask *why* the construction of the institutional apparatus required to ensure payments discipline and protect investors has proven so intractable for so long. An answer to this question must address the distorted incentives of two key stakeholders -- insider-managers and governments – along with the system of corporate governance that has preserved firms as, above all, a source of rents. In many cases, the divestiture of these firms was accomplished by granting special concessions or privileges to enterprise insiders -- salaried employees and former enterprise directors -- with residual shares held by central or regional government authorities.[2] These private and public shareholders have benefited substantially from an ill-enforced property rights regime, from opportunities for rent-seeking, and in the extreme, from cash-flow diversion and asset theft.

Thus, in addition to the protection of minority shareholders or other financiers, a central problem of corporate governance involves the weak incentives for manager-owners to restructure the firm and maximize its value over the long run. This short time horizon is the result of several factors. The first, of course is the threat of persistent macro-instability. Second, manager-owners perceive title as uncertain, temporary, and subject to expropriation. With short time horizons, their expected gain from increasing firm value is less than the replacement value of stripped assets. Second, maximizing value is a reasonable long-term objective only if value can be realized through the sale of the ownership rights in enterprise.

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[1] "Nonpayments Cycle in Russia Suffocates Economic Growth – Proposal of World Bank Economists, Transition, December 1999.

[2] This leads to a misalignment of ownership and control since managers often hold only a minority stake in the enterprise but wield extensive operational control without effective checks by other shareholders or creditors.

Given the illiquidity of secondary markets, managers have little incentive to increase value and might instead sell the *actual assets themselves* as a way of alienating their control rights.[3]

Competition

Price controls have been lifted on wholesale and retail goods, and most state owned enterprises (SOEs) have been privatized through the mass privatization program (MPP). However, Russia did not undertake significant restructuring of dominant firms or eliminate non-economic barriers to entry. As a result, horizontal and vertical dominance among incumbent firms and barriers to entry by new businesses are considerably more pronounced in the Russia's industrial sector compared with transition economies in Central Europe and the Baltics.[4]

Entry

The relative absence of new businesses is particularly striking in Russia. The continued presence of non-viable firms, made possible by soft budget constraints and discriminatory policies, is a significant barrier to entry and expansion of new start-up enterprises as well as to private enterprise in general. According to a recent enterprise survey, an uneven "playing field" between SOEs vis-à-vis private firms created barriers to entry in (i) financing and collateral; (ii) business licensing and regulations; and (iii) taxation.

II. TOOLS AND POLICIES FOR ENTERPRISE REFORM

Without exception, the large variety of enterprises in Russia defies any comprehensive solution to the challenges outlined above. Any well-designed enterprise restructuring strategy, therefore, must consider how various tools and policies can be employed to deal with different types of firms.

Classes of Firms

For purposes of designing an overall enterprise reform strategy, it is useful to consider the following three categories of firms[5]:

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[3] Desai and Goldberg: "The Vicious Circles of Control: Regional Governments and Insiders in Privatized Russian Enterprises", Policy Research Working Paper 2287, The World Bank, February 2000, available at www.worldbank.org/research/workingpapers

[4] This description is partly based on Broadman (1999).

[5] Two additional groups of enterprises that are not discussed in this paper are (i) small, private firms that with tax and/or other arrears. Restructuring this group of firms is best handled by establishing a hard budget constraint and establishing a credible exit threat for recalcitrant non-payers. (ii) private enterprises that do not have significant tax or other arrears. The future success of these firms can be best assured by improving the general business environment – i.e., reforming the tax system and promulgating clear, transparent regulations and licensing procedures that are consistently applied and enforced.

A: SOEs (and residual shares in partially privatized companies) that have the potential to receive significant offers from external, including foreign, investors and are immediately sellable;

B: SOEs (and residual shares in partially privatized companies) that are not immediately sellable because they require certain financial or organizational issues to be settled prior to sale, without which they will not attract outside investment; and

C: Wholly privatized firms that are receiving no investment, are being decapitalized, or are running up significant arrears to workers, tax authorities, non-budgetary social funds, or suppliers.

Type A Firms: Enterprise Level Restructuring (ELR)

Completing the privatization of remaining SOEs and residual state shares via open, transparent, and irreversible transactions is needed to sustain the transformation of these firms. For these sales, the best tool currently available is the "case-by-case" (CBC) method, traditionally used to prepare SOEs for divestiture in industrialized countries via trade sales or share issues (IPOs). The benefits of CBC are well known and are highlighted in the Government's Letter of Development Policy issued in conjunction with SAL III. These benefits include transparency of contractual arrangements, greater flexibility, and greater control over investment.

A program of CBC privatization is needed for the remaining large SOEs because they require a *strategic buyer* selected via a transparent, international tender organized by internationally reputed investment banks with particular experience in this line of work. As a result, CBC entails significant transactions costs in terms of both the due diligence and institutional apparatus needed to settle and monitor transactions. IFIs can finance these costs by helping the Government establish a sustainable *program* of CBC sales (as opposed to a series of isolated, independent transactions).[6]

Type B Firms: Work-Outs and Liquidation

The second class of firms contains those that simply cannot be sold without some financial or organizational restructuring. In reality, this category comprises two sub-classes of firms: those firms that, following workout or reorganization, will become type A firms, and those firms that should be liquidated. Whether a type-B firm belongs in the first or second sub-class, of course, cannot be estimated *a priori* without great difficulty. There is no simple

6 If the enterprise is illiquid or loss making, the government may need to assume some of the old obligations (social, financial, environmental) or ringfence the company by selling core assets rather than shares. Another alternative would be to convert implicit subsidies (tax arrears and offsets, energy arrears and offsets) into explicit financial support tied to downsizing, worker retraining and severance payments, environmental cleanup, etc. This might be especially relevant for Type B firms slated for privatization following a workout or restructuring.

way to tell which assets are viable and which are value-subtracting; this is the inherent ambiguity of restructuring in Russia.

In order to facilitate this asset sorting and separation, sufficient funds must be available to pay for the requisite advisory services as well as other ongoing costs. More importantly, a legal framework is necessary but insufficient to enable the voluntary liquidation of SOEs. Often, adjustments need to be made to bankruptcy laws to enable administrative liquidations, restructuring and workouts.

Type C Firms: Markets for Corporate Control

The last class of firms are those that have been fully or partially privatized, yet now require improvements in corporate governance and significant new investment to refurbish and modernize their capital stock. In many ways, this is the most troubling group of firms -- often consisting of privatized firms that once held great promise but have recently lost value.

Voucher-based mass privatization programs were used extensively in the first transition decade to privatize rapidly thousands of SOE's. However, concessions or excessively dispersed shareholding transferred *de facto* or *de jure* control to enterprise insiders who have failed to attract further investment, who have been unable to restructure their firms and put them on a sound financial footing, and in the worst cases, who have stripped the firm of its most valuable assets. Where insider control is entrenched, outside investors have little confidence that they will be able to take control of the firm even if they purchase a large percentage of the outstanding shares. The net effect, therefore, is a vicious circle of no restructuring and decapitalization which, in turn, limits prospects for new investment.

In Russia, as a result, we have to account for the puzzling behavior of insider-managers who, in stripping assets from the very firms they own, appear to be stealing from one pocket to fill the other. It is likely that asset-stripping and the absence of restructuring are the consequences of interactions between insiders (manager-owners), and governments in a particular property rights regime. In this regime, since the ability to realize value is limited by uncertainty and illiquidity, managers have little incentive to increase value. National and subnational governments alike have imposed a variety of distortions on enterprises in order to protect local employment. Prospective outsider-investors, finally, have neither the confidence in acquiring effective control rights to allow restructuring of these firms, nor the ability to avoid distortions imposed by regional governments upon the firms in which they will invest. Consequently, no restructuring is accomplished, and little new investment is achieved.

Governments typically have two options to combat this vicious circle of insider control: (i) they can devise policies and rules to promote bank-led restructuring via general bankruptcy provisions; or (ii) they can establish the institutions that will enable investor-led restructuring.

Creditor-led Restructuring

In Russia, most outstanding enterprise liabilities are not to banks, but rather to governments, workers, suppliers, and non-budgetary funds. As a result, bank-led restructuring via bankruptcy is not a feasible method of resolving enterprise sector distress. Moreover, there are four critical problems in relying upon bankruptcy procedures to initiate ownership transformation:

(i) *Many creditors may be unwilling to initiate bankruptcy*. Much of this unwillingness has to do with the tight industrial and financial links between suppliers and customers in monopolistic or monopsonistic settings. Suppliers, therefore, may be hesitant to bankrupt their main customers.

(ii) *Creditor coordination may be difficult to sustain.* Bankruptcy is collective in nature, therefore all creditors must share costs of the bankruptcy proceedings, and all must agree on external management and other matters.

(iii) *The capacity of the judicial system may be limited*. Ownership transformation based on bankruptcies will ultimately rely on courts—significant burdens to entrust to an already over-loaded system.

(iv) *Bankruptcy is disruptive*. If an amicable agreement is not forthcoming, it may encourage the antipathy of regional authorities opposed to liquidating a company in order to change ownership.

Given the entrenchment of insiders, and given the small likelihood that bankruptcy rules will encourage changes in ownership in the short term, alternative ways of facilitating enterprise restructuring should be seriously considered.

Investor-Led Restructuring

Beyond improving the general investment climate and pursuing liberalizing reforms, what can governments do to attract investors to initiate and lead enterprise restructuring?

In several other ECA countries, governments have played significant roles in attracting foreign investors. In one of the first examples of investor-led restructuring, Volkswagen acquired Skoda Auto in the Czech Republic through a series of concessions, rewards, third-party monitoring agreements, and other incentives. In a Hungarian example, a "mix" of Greenfield and Brownfield strategies allowed an investor to acquire selected assets and establish new production facilities without the liabilities. Investors in this case, simply set up adjacent facilities next to existing ones, hiring workers from the old company and avoiding its debts.

Experience from a wide range of countries also suggests that investors are more willing to contribute capital when the web of enterprise liabilities is untangled and somehow settled. Therefore, to facilitate investor-led restructuring, government-supported mechanisms should be established to resolve certain outstanding liabilities while, at the same time, offering residual stakes and debt-to-equity conversion opportunities to new investors.

However, the McKinsey Report elaborates one case after another of how Russian regional governments behave as residual claimants to firms; how firms succumb over and over again to pressures from regional governments to avoid restructuring and to maintain employment levels, through a combination of formal limitations on layoffs, restrictions on business activity, the threat of fines, or other implicit forms of control. Incumbent owner-managers of privatized firms are, in some sense, part of a coalition that derives its benefit from ensuring that these firms remain a source of rents (which provide them broader benefits) rather than profits or value. If this is true, then it indeed matters *who* the managers are and what incentives are in place to motivate their behavior. Changing these parameters is a salient part of any enterprise reform program.

In the current climate, policy or regulatory measures alone will be necessary but not sufficient to restore the growth of the real sector. Institution building at the enterprise level through appropriate privatization and enterprise restructuring will also be necessary. These enterprise reforms will help create and empower *constituencies* to support further policy, regulatory, and institutional changes. Non-payments, as a prominent example, have proven so persistent despite of the efforts of various governments to reform the tax system, due to the power of coalitions of incumbent insiders-managers and regional governments, and their efforts to maintain firms as a source of rents for both groups.[7]

Under such circumstances, it is unlikely that top-down, policy-based lending can be solely relied upon to create a receptive environment for investment. Rather, it is imperative that some role be fashioned for regionally-based, grass-roots interventions. Preliminary evidence indicates that enterprise level restructuring (ELR) involving well-designed, ground-level interventions can yield positive results, train cadres of local managers, consultants, and advisors in the concepts of restructuring and management, and most importantly, alter the incentives of politicians to encourage private sector growth.

III. REGIONALLY-BASED, ENTERPRISE REFORM

In many instances, regional government now actively obstruct enterprise restructuring via the perpetuation of soft budget constraints and, in some cases, through formal limitations on enterprise activities. Subsidies can take the form of preferential tax treatment, discounts on utility bills, and favored status in public procurement, all of which are intended to prevent companies from shutting down and laying off employees. This puts potentially productive companies at a cost disadvantage, blocking investment and growth. In other cases, regional governments have de facto re-nationalized previously privatized property or set up regional investment vehicles to consolidate regional government holdings in important local industries. However, while the ostensible purpose of these strategies is to preserve jobs and

[7] Several Russian academics have argued that "non-payments" are intrinsic to the political economy of power relations in Russia and suggest that non-payments is a form of asset stripping and capital flight. They focus on the micro roots of the non-payments problem and speak about micro solutions. ex-Minister Yasin pointed out that "a struggle against non-payments is a struggle against loss-making companies" and in this respect, he commended the attention to safety nets to mitigate layoffs from restructuring in the Bank's Coal Project. Comments as a seminar in the Working Center for Economic Reform, January 2000, Moscow.

improve social welfare, the long term impact is just the opposite. By inhibiting real enterprise reform, long term job creation is stifled and tax revenues decline. Without a vibrant private sector, the demand for public services increases at precisely the time when there is no fiscal base to support the growing demand for social services.

In Russia, therefore, the wide ranging powers of regional and local authorities over the fledgling private sector is significant enough to warrant the adoption of a regionally-based enterprise reform strategy.[8] The objective of this strategy would be (i) to demonstrate by example to regional governments that a more sustainable way of protecting employment lies in providing managers with incentives to increase the value of their enterprises by transferring effective control to investors and (ii) to work on a pilot basis with those Governors who are truly committed to developing a vibrant enterprise sector within their oblast.

A comprehensive enterprise development strategy would include (i) investment in technical assistance for enterprise *restructuring*, (ii) investment in *safety nets*; (iii) investment in physical *infrastructure* and (iv) *regional guarantee facilities* whereby coverage against "non-commercial risks" would be utilized to attract private financing for eligible enterprises in a particular region.[9]

Investment financing for a safety net would set up a mechanism of severance pay and worker retraining – similar to what the Government has done for coal sector employees. It could finance and support the divestiture of social assets and relocation for laborers who are laid off or newly recruited. Investment financing for infrastructure would support the provision of complementary public infrastructure that is deemed necessary for restructuring -- e.g., the extension of railway lines, the rehabilitation of a town's heating system, or improvements in the reliability of power supply.

However, the two key components of this strategy would be the provision of TA for enterprise restructuring and the provision of a regional guarantee facility to help private enterprises in each region attract the commercial finance which they need to refurbish and modernize their capital base.

Technical Assistance for Enterprise Restructuring

Regional officials generally have little knowledge of how to undertake case-by-case privatization, workouts and liquidation, or investor-led restructuring. Nor do they have much prior experience in managing these transactions. Therefore, to ensure that regional officials

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8 For an impressionistic picture of regional powers over private sector development and enterprise restructuring, see the various issues of the Russia Regional Report, published simultaneously in English and Russian by the East-West Institute.

9 This strategy suggests an important strategic role for the state in sorting out claims, fostering management and ownership changes, attracting a strategic investor, and assuming certain social obligations that were previously borne by the enterprise. However, at the same time, it is also important to emphasize that the state should not try to restructure the enterprise or make other investment decisions that require a deep understanding of the firm's long term business rationale, investment priorities, or strategic direction.

get the best deal possible, financial advisors with international experience should be retained to assist with the enterprise restructuring process. One possible procedure would be as follows:

- The regional government, using the transparent, competitive procurement rules required by IFIs, conducts an open tender to select an investment advisor to find strategic investors for a selected pool of companies in the region. The formula for compensation of the investment brokerage is based on a fixed fee that covers expenses of valuing the whole pool, in addition to a success fee for each company successfully resold.[10]

- The selected investment brokerage conducts a tender for the sale of selected companies.

- Among the enterprises that could benefit from this program are current SOEs (either Type A or Type B) that are expected to have a future as commercially viable, privatized going concerns and which, therefore, are viewed as high priority candidates for CBC and (ii) private enterprises that have tax arrears and recalcitrant managers who are using the firm to strip assets rather than to build wealth, pay wages, and preserve jobs. This latter group would be high priority candidates for Investor Based Ownership Transformation (IBOT). (See Box 1 for a summary description of the IBOT mechanism[11].)

Regional Guarantee Facilities

Irrespective of whether they are already privatized or have recently been privatized via CBC or IBOT, owners of viable private enterprises in a region must find a way to finance the fixed and working capital assets they need to restore production, exports, and employment. Ongoing work by the Government in the Russian coal and forestry sectors suggests that a Non-Commercial Risk Guarantee Facility could be one important element in helping to attract private loans to finance commercially viable transactions with Russian coal and forestry sector enterprises.

The concept of a Regional Guarantee Facility is based on the coal and forestry precedent as well as on the guarantee that the Government issued to support the Sea Launch commercial space launch project. The underlying principle of these guarantees is that the Government – federal and regional -- should take direct financial responsibility for the consequences of its actions. The Government achieves this objective by issuing Guarantee Contracts in which it promises (i) not to interfere with private transactions by, for example, canceling licenses, confiscating input goods or output goods, imposing retroactive and/or discriminatory taxes on the transaction, etc. (ii) to resolve problems that arise from unwarranted government interference and (iii) to pay compensation with budget funds if government interference does occur. By giving the Government an incentive and a mechanism to resolve problems rather than pay claims, the guarantee facility reduces the probability that a covered risk will occur.

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[10] A program like the one described above is under way in Romania.
[11] For a more complete description of the IBOT mechanism see, Desai and Goldberg, op.cit.

This, in turn, could encourage both guaranteed and non-guaranteed lenders (EBRD, IFC, and export credit agencies) to finance transactions with newly private Russian enterprises.

The Guarantee Contracts would cover the following non-commercial risks: (i) Inability to convert and transfer currency; (ii) Expropriation; (iii) Seizure of goods or restrictions on import, sale or export; (iv) War or civil disturbance; (v) Issuance or cancellation of licenses; (vi) Imposition discriminatory taxes; and (vii) Interference in the carriage of goods. Any risk that is not explicitly listed and defined in the Guarantee Contract is not covered. Equally important, the Guarantee Contract does not carve out any special commercial privileges, legal benefits, or tax advantages for the Guarantee Holder or any of its local partners and suppliers. All foreign and local enterprises associated with a guaranteed transaction would be subject to the same laws and tax, regulatory, and environmental compliance regime as any other foreign or domestic enterprise doing business in Russia.

Investors could be offered a choice of accepting coverage against (i) actions of the federal authorities only or (ii) actions of both federal and regional officials. The list of covered risks would be identical in either case. In fact, some investors may be interested only in federal coverage and others might be interested in the facility only if coverage extends to actions of regional officials. However, coverage against actions of regional officials would be offered only in those regions that agree to sign a Cooperation Agreement specifying the risk mitigation, management and control mechanisms that would be established at the regional level, in cooperation with the federal authorities.

In order to give federal and regional officials an opportunity to correct any policy related actions that could trigger a claim payment, a short but reasonable cure period would commence when Government officials are notified of a potential claim. To insure the effectiveness of this corrective mechanism, Government officials (at the federal or regional level, as the case may be), would be vested with responsibility for meeting with the Guarantee Holder and correcting problems during the cure period. A Guarantee Holder would have the right to file a claim only if the issue has not been resolved satisfactorily. To sustain his claim for payment under the Guarantee Contract, the Guarantee Holder must prove that (i) a covered risk occurred, (ii) the scheduled debt service on the guaranteed loans was not paid, and (iii) "but for" the occurrence of a covered risk, the guaranteed commercial loan could have been serviced. The Government's liability would be limited to the regularly scheduled debt service (principal and interest) on the guaranteed commercial loans that could not be paid as a direct result of the occurrence of a covered risk.

The World Bank could enhance the credibility of this mechanism by backstopping the (federal or regional) Government's claim payment obligations. For example, in the case of both the Coal and Forestry Guarantee Facility and the Sea Launch project, it was agreed that the Guarantee Holder would first present a valid claim directly to the Government for payment. However, if the Government fails to pay within the time specified in the Guarantee Contract, the World Bank would make the requisite payment to the Guarantee Holder pursuant to the terms and conditions of an IBRD Guarantee Agreement. Finally, pursuant to the terms and conditions of the Counter-Guarantee (Indemnity) Agreement between the IBRD and the Russian Federation, the Federation would indemnify the Bank "on demand or as the Bank otherwise directs" for all claim payments and expenses incurred by the IBRD pursuant to its the Guarantee Agreement.

IV. CONCLUSION

With the lure of jobs, tax revenues, and investment in local enterprises, several regions might be interested in participating in a regionally based enterprise reform program.[12] The benefits of participation would be palpable, including:

- It would help viable Russian enterprises attract the private loans they need to increase their working capital and modernize and refurbish their capital stock, thereby enabling these enterprises to increase their employment, production, and exports. In effect, participating enterprises would be converted from value subtracting to value adding institutions.

- Participating regions would receive a comprehensive package of assistance, including TA, safety net assistance, and help attracting private finance for all commercially viable enterprises in the region. In effect, the region would advertise itself as "open for business."

- The Government would bear responsibility only for those non-commercial risks under its direct control and would not have responsibility for any of the commercial risks inherent in individual transactions.

- The real problem with the Russian enterprise sector is the strong misalignment of property and control rights which provides strong incentives for self-dealing and asset-stripping by managers. Majority takeovers of companies and the replacement of management, therefore, will be a critical element in any pro-growth, enterprise reform strategy. The strategy outlined above provides a mechanism to address these economic problems as well as issues of corporate governance and control.

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[12] A number of regionally based development programs are currently in operation in Russia. The US Government's Regional Initiative "is a US Government-funded program aimed at promoting democratic and market reform in Russia by helping to create successful models of economic and political development at the regional level…Over time, it is hoped that these regions will prove successful at achieving broad-based economic growth and reform, attracting outside investment, and building a strong civil society, and that they will participate in efforts to disseminate their experience to other regions of Russia." The Regional Initiative is currently centered on four oblasts -- Novgorod, Khaboravsk, Sakhalin, and Samara. Similarly, the Nuclear Cities Initiative -- a joint program of the US Government and the Government of the Russian Federation – operates a small business development job creating component, a community development component and a training component in ten Russian cities.

BOX 1
Investment-Based Ownership Transformation (IBOT)

Given the entrenchment of insiders in Russian enterprises, and given the small likelihood that bankruptcy rules will encourage changes in ownership, IBOT of Russian enterprises should be seriously considered as an alternative. The objective behind such a move would be to create new majority owners by converting tax debt into equity *that would be sold immediately to external investors in competitive auctions*. These converted shares, along with residual shares owned by governmental authorities, would constitute significant percentages of share capital in several cases. For reasons of manageability, it may be more feasible, in the short term, to concentrate on the IBOT of enterprises with significant tax debts to regional governments. The pitfalls of such an approach, including the problems of obtaining credible commitments by regional authorities to re-sell converted shares, are both complex and variable.

There are two major pitfalls, which need to be addressed if this scheme is to be further contemplated: one is what may be termed "investor capture," and the second, "governmental capture." The risk of *investor capture* is simply that IBOT will, once again, open the door to rent-seeking by current enterprise insiders eager to expand their control over productive assets in the Russian economy. As with the loans-for-shares program, IBOT will encourage investors with well-hidden connections to the enterprise to submit inflated bids, restricting competition for corporate control. On the other hand, *governmental capture* will occur if IBOT results in the renationalization of private enterprises. Piecemeal IBOT—by which a governmental body converts tax debts into shares, then awaits an acceptable investor—can also encourage governmental administrators to restrict bidding to favored parties, or to otherwise bias the auction in the interim.