

**PRIVATIZATION AND EQUITY**  
**IN BRAZIL AND RUSSIA<sup>1</sup>**

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Brazil and Russia underwent a profound process of privatization in the 1990s. The institutional starting point of this process seemed to be quite different. Brazil was a market economy, with full respect of property rights, but one in which the state had a prominent role as a producer of various types of goods, as owner of most of the country's public utilities, and as the owner of a large proportion of the country's financial institutions.<sup>2</sup> Russia was coming out of seven decades of communism, where all large industries were the property of the state, where private property rights were limited, and where market institutions did not exist.

What were the motives for the privatization process in each country? In the case of Brazil, it was due to the fiscal crisis, which necessitated the state to decrease its debt through the sale of its enterprises, and also due to the lack of resources to finance investments in its heavy industries and public utilities. In the case of Russia, the failure of the reforms of the 1980s within the Soviet framework and the resulting economic collapse and political coup, left the country's leaders almost no options but to transform the country's economy into a market system.

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<sup>2</sup> Baer (2001)

Our main concern in this comparative analysis is the impact of privatization on equity in each country – i.e., the distribution of assets and income. In the case of Brazil, with a long tradition of asset and income concentration, concern with privatization's equity impact was not taken into account. In the case of Russia, which emerged from 70 years of communism, concern about asset and income distribution played a more significant role in the design of its privatization program. It is the major purpose of this article to analyze the actual distributional results of privatization in each country.

Section one begins with a brief historical summary of state involvement in the economies of each country as they industrialized and establish the asset and income distribution which prevailed at that time. This is followed by establishing an analytical framework linking privatization with equity. Section three then summarizes each country's motives and methods of privatization. We also attempt to explain how and why income **concentration** failed to improve, or worsened, by analyzing how the control of state assets ultimately concentrated in the hands of the few, using the analytical framework presented in section two. We conclude with a discussion about the possible explanations for similar distributional outcomes of the privatization programs which took place in societies with dissimilar historical and institutional background.

## I. The Pre-Privatization Role of the State in the Brazilian and Russian Economies

### a) Brazil

#### *Growth of State Participation during Industrialization*

The large participation of the state in Brazil's economy should be viewed in the context of import-substitution-industrialization (ISI), which began in the 1930s as a reaction to the Great Depression of the 1930s and became the major development

strategy after World War II. When it became clear that neither the domestic sector nor foreign groups had an interest in building an integrated steel plant, which was deemed necessary as a requirement for a vertically integrated industrialization process, Brazil's government became involved in that sector.<sup>3</sup>

State firms were started in the 1940s and 1950s with the intention of guaranteeing Brazilian control over the country's non-replaceable resources, such as oil, iron ore, etc.<sup>4</sup>

Over the three decades following World War II the Brazilian government (both federal and local governments) founded and/or took over firms in the public utilities sector.<sup>5</sup>

The motivation was the need for public utility services to expand along with the rapidly growing urban centers and industry, while private domestic and foreign firms were not interested in the modernization and expansion of these sectors, whose regulated tariffs resulted in low rates of return which discouraged further investments.

State involvement in the financial sector, which dated back to the late 19<sup>th</sup> century, grew rapidly during the ISI and post-ISI periods. The federal and state governments established commercial banks to provide credit to sectors (such as agriculture) or regions which were neglected by private banks. As ISI proceeded in the post-World War II period there was increasing necessity for long-term financing while the country's capital

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<sup>3</sup> Brazil's government founded a state steel firm (Companhia Siderurgica Nacional) to do the job (with technical and financial help from the U.S. In the 1950s the state expanded its role in the steel sector by taking over locally-started projects. This expansion would ultimately result in state enterprises being responsible for about 65% of the country's steel output. See: Baer (1969) and Baer (2001).

<sup>4</sup> In the case of petroleum, Petrobras was given the monopoly over petroleum exploration. Petrobras became an industrial giant over the years, as it integrated forward, founding many subsidiaries in the petrochemical industry. The Companhia Vale do Rio Doce became the country's largest iron ore mining firm, also gradually diversifying into related fields, such as cellulose, steel, and thus become a large state conglomerate.

<sup>5</sup> State firms in railroads, telephone and electricity had already made their appearance much earlier, but a dramatic expansion, resulting in the almost total takeover of these sectors only occurred after World War II.

market was still very weak, the government founded a development bank (BNDE)<sup>6</sup>, which would make long term loans and/or buy stocks in newly established or expanding industrial enterprises.

Various quantitative measures show the importance the Brazilian state had acquired in the economy by the 1970s and 1980s. In the early 1970s almost 50 percent of total gross investment was accounted for by government and state enterprises; this rose to 65 percent by the early 1980s. In 1985 the federal and state commercial banks accounted for 40 percent of bank deposits and 44 percent of commercial loans of the fifty largest banks; in the same year the development bank (BNDES) and other government development banks (like the development bank for Brazil's Northeast) provided 70 percent of all loans destined for investment purposes. In the same year, a survey of the 8,094 largest incorporated firms revealed that state enterprises controlled 48 percent of the combined assets, 26.1 percent of sales, and 18.9 percent of employment. Finally, examining in 1990 the twenty largest firms by sectors, it was found that state enterprises had the following percentages of total sales:<sup>7</sup>

|                              |      |
|------------------------------|------|
| Public utilities             | 100% |
| Steel                        | 67%  |
| Chemicals and petrochemicals | 67%  |
| Mining                       | 60%  |
| Transport services           | 35%  |
| Fertilizers                  | 26%  |
| Transportation Equipment     | 21%  |

By the 1970s and 1980s the state's presence in the economy had an increasingly negative impact on Brazil's economy. The decadence of state firms was due to a number of factors: having monopoly positions in many markets, state firms became inefficient

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<sup>6</sup> Banco Nacional de Desenvolvimento Econômico, which was established in 1953. It was later

and many abused their monopoly positions in dealing with their private sector clients; the government used state firms as instruments of macroeconomic policies (e.g., forcing firms to charge low prices in order to fight inflation, or in obtaining unnecessary foreign loans), causing large deficits in their operations and forcing the government to provide large subsidies; many state firms succumbed to political pressures to over-employ; and as the state sector contributed towards increasing the government's budget deficit, it became a "crowding-out" phenomenon in relation to the private sector.<sup>8</sup>

*Income and Asset Distribution in Brazil before Privatization.*

Wealth and income concentration has been a characteristic of Brazil since colonial times, and lasted after independence when the country continued to be a primary export economy. Coffee production, although open to small holders, was more profitable for those with access to adequate transportation and an organized labor supply. The government provided for these needs by arranging for low cost immigrant labor and by granting concessions and subsidies for the building of railroads and other infrastructure that served the coffee sector. The influence of the planters in the first half of the 20<sup>th</sup> century was such that economic policy gave priority to sustaining the market for coffee exports.

With the collapse of this market in the Great Depression, state policy maintained the wealth of these groups through price supports<sup>9</sup> and opened the way to new concentrations of wealth and income in the post-World War II period through deliberate import substitution industrialization (ISI). These policies, which relied heavily on trade

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remained Banco Nacional de Desenvolvimento Econômico e Social. (BNDES).

<sup>7</sup> Baer (2001), ch. 12.

<sup>8</sup> For details, see Baer (2001) ch. 12.

<sup>9</sup> Furtado (1959), chs. 30 and 31; Baer (2001), ch. 3.

protection, subsidized credit, and other forms of government intervention in markets produced whole new sectors which were characterized by marked concentrations of ownership.

The large presence of the state did not act as a counterweight to Brazil's wealth and income concentration. Although formally owned in the name of all Brazilians, in reality many of the state enterprises operated as providers of subsidized inputs for large domestic and multinational enterprises. Few asked what these enterprises were worth and to whom they belonged. This large concentration of assets in the hands of the state was in principle the property of all. However, most of state enterprises were controlled by a small group of politicians and state managers, with little accountability to the population.

On the eve of Brazil's privatization drive in the late 1980s, the country's Gini coefficient amounted to .6; the gap between the 20% richest and the 20% poorest was 32.1; the top quintile of the population received 65% of the national income and the bottom quintile 2.6%. In many of the country's industrial sectors the top 4 to 8 firms accounted for between 65 to 90% of sales.<sup>10</sup>

Unlike Russia (in Soviet times), Brazil for a long time neglected the development of its human capital. The country's illiteracy rate stood at 51% in 1950 and dipped below 20% only by the 1990s (although functional illiteracy was probably still higher). Average school years completed amounted to 2.1 in 1960 and in the 1990s was about 5. About 84% of the age group 7 to 14 attended school in the early 1990s, but first grade repeaters was about 24% and fourth grade repeaters about 13%. Brazil's public expenditure on

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<sup>10</sup> For details see Baer (2001), ch. 12.

education amounted to about 4% of GDP in the 1990s, which was below what was being spent in advanced industrial countries. About 68% of government expenditures on education go to elementary schooling, 23% to higher education, and only 9% to secondary education (in South Korea 37% went to secondary education and only 11% to higher education). One observer stated that “...the regressive character, in distributive terms, of benefits provided by the government to university students becomes clearer if one realizes that some 50% of students ...in federal and state...universities are from families with monthly incomes higher than 10 minimum wages...”<sup>11</sup>. This also contributed to the continued concentration of income over time, as the proportion of the population with advanced training was scarce.

#### b) Russia in Soviet Times

##### *The Rise and Fall of State-Led Industrialization*

State-led industrialization in Russia differed from Brazil not only in the ideological motives and objectives, but also in its extent and achievements. From an ideological standpoint, state involvement in the Soviet economy was intentionally widespread, permanent and subject to central control, whereas state involvement in Brazil, even at its peak in the 1980's was more focused, intended as a means to rapid industrialization and was an integral part of a predominantly market-based economy. Soviet industrialization accomplished three main objectives. The main achievement of centrally-planned industrialization in the Soviet Union was more rapid accumulation of industrial capital than had been accomplished previously under capitalism. Also, the soviet system created an environment for upward social mobility and relative equality for the working class

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<sup>11</sup> Da Fonseca (1997), p. 204. See also: Barros et al (1995), pp. 258-260.

when compared to other systems. Finally, the state created an environment that fostered mass education at the primary, secondary, technical training and university levels. State control of industry escalated in 1925-6 and continued through the first-five year plan, which included much of the collectivization of agriculture (1928-32).<sup>12</sup> The second five-year plan (1932-1937) completed the state's takeover of the economy and nearly every other aspect of life, while expanding the size and scope of the economy.<sup>13</sup>

Considering the massive task facing planners, the first and second five-year plans achieved a substantial shift in the size and composition of the economy. For example, between 1927 and 1937 national income rose from 24.4 billion 1926-7 rubles to 96.3 billion and industrial output rose from 18.0 billion to 95.5 billion.<sup>14</sup> Industrialization halted during World War II, but restarted after the war and through the 1950s. Loosening and retightening of control by Gosplan and the industrial ministries oscillated under Krushchev and Brezhnev, with periods of decentralization to the managers usually followed quickly by recentralization back to Gosplan and the ministries.

<sup>12</sup> The first five year plan was actually "completed" in four years, shortened for political purposes.

<sup>13</sup> *Narodnoe Khozyaistvo SSSR, 1932*, pp. xlvii-xlviii (for 1925-6 and 1926-7), E Kviring, *Problemy ekonomiki* nos. 10-12. p. 5 (for 1928-32). Cited from Nove, Alec, *An Economic History of the U.S.S.R.* (London, Penguin Press: 1969), p. 137.

| Sector          | 1929 | 1930 | 1931 | 1932 | 1933 | 1934 | 1935 |
|-----------------|------|------|------|------|------|------|------|
| National Income | 56.0 | 74.3 | 90.0 | 93.0 | 94.6 | 96.0 | 97.8 |
| Industry        | 89.5 | 94.4 | (NA) | 99.5 | 99.6 | 99.7 | 99.7 |
| Agriculture     | 7.0  | 28.9 | 62.8 | 74.7 | 79.5 | 86.4 | 93.6 |

<sup>14</sup> *Sotsialisticheskoe stroitel'stvo, Fulfillment Report of the First Five-Year Plan, and Five-Year Plan Documents*. Cited from Nove, Alec, *An Economic History of the U.S.S.R.*, (London, Penguin Press: 1969), pp. 191, 225. Industrialization was largely carried out by increases in pressure on workers in the form of higher work strains and a decline in the standard of living. Labor shortages arose in industrialization-related sectors such as industry (where labor increased by 92 percent between 1928 and 1932), construction (293 percent increase) and transport (65 percent increase). Labor exchange lists, kept by the People's Commissariat of Labor, indicated 100 available workers to fill 125 available positions in industry. See Filtzer, Donald, *Soviet Workers and Stalinist Industrialization: The Formation of Modern Soviet Production Relations 1928-1941*, (London: Pluto Press, 1986), p. 45 for details

In 1985, Mikhail Gorbachev attempted permanent reforms of central planning. Reform laws passed between 1985 and 1989 drastically reduced the power of the industrial ministries, decentralized considerable authority over production to enterprise managers, and created a legal opportunity for the establishment of new private small enterprises. This reform strategy resulted in the unintended consequence of making it easier for managers to divert production in larger factories through their private “small” enterprises. As a consequence, goods became increasingly scarce to state-run distributors, and obtaining goods became increasingly difficult at centrally-planned prices and the prevalence of corruption exploded.<sup>15</sup> By 1991 the political system was eroding, the economy was declining, and the Soviet empire was disintegrating.<sup>16</sup> The combination of the 1991 coup, the breakup of the Politburo and ministries, and the economic strain left two choices: 1) leaders could rebuild the central planning apparatuses, or 2) divest its involvement in the economy, introduce markets and form a democratic government.

#### *Income and Asset Distribution in the Soviet Union*

Income distribution in the U.S.S.R. officially strove to be considerably more equal than in the Western capitalist countries. Though compensation schemes varied (based on experience, rank and education), and policies on wage differentials fluctuated over time, the official line was that workers in the Soviet Union were more fairly compensated than their counterparts in the West. Individual wealth was limited to a small number of private housing units, cooperatives, agricultural plots, consumer durables, savings

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<sup>15</sup> Clark, William A., “Crime and Punishment in Soviet Officialdom, 1965-1990,” *Europe-Asia Studies*, vol. 45, n. 2 (March 1993), pp. 259-280.

<sup>16</sup> The U.S.S.R.’s attempts to keep up in the arms race and its military presence in Afghanistan contributed to the economic and political failure of the Soviet system. Also, between 1989 and 1991, several East European states were rejecting soviet communism such as East Germany, Hungary, Czechoslovakia, and Poland.

accounts, and cash, whereas private enterprises were illegal until the 1985 enterprise law.<sup>17</sup>

Through the 1960s and 1970s, western scholars began to doubt the egalitarian nature of the Soviet system when compared with the West. Recent verdicts indicate that income in the U.S.S.R. was notably less dispersed than in the U.S., Britain, or France.<sup>18</sup> Similar studies of wealth concentration indicate that wealth and assets were highly concentrated in the Soviet Union.<sup>19</sup> However, since the total value of assets that were privately owned was quite low, the overall impact of wealth on equity was also small. The relative insignificance of wealth and income derived from wealth further sharpens the contrast between the Soviet Union and the West.

To compare with pre-privatization statistics for Brazil, the Soviet Union's Gini coefficient for 1979 was just 0.30 (about 0.27 for public sector income only); the ratio of income between the 80<sup>th</sup> and 20<sup>th</sup> quintiles was just 4.54; the top quintile received 39.5 percent of income and the bottom quintile 9.0 percent.<sup>20</sup> The Soviet Gini measure in 1989, shortly before the collapse, was just 0.27.<sup>21</sup>

Education was an early initiative of the Bolsheviks, because they viewed literacy as an important characteristic of the proletariat. From 1917-1927, education emphasized

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<sup>17</sup> Vinokur and Ofer (1987), pp. 194-7.

<sup>18</sup> Vinokur and Ofer (1987) pp. 182-195 use survey data from Soviet émigrés to estimate income inequality for 1973 and 1979. After adjusting for sample biases, they find, unlike previous authors such as Rabkina and Rimashevskaja (1972 and 1978), that income distribution was more equal in the Soviet Union than most advanced capitalist countries, with the exception of Sweden.

<sup>19</sup> Vinokur and Ofer (1987), pp. 195-97 cite Gini coefficients for wealth in the Soviet Union at 0.77 and 0.61 in 1973 and 1979, contrasted with 0.76 in the U.S. in 1972 and 0.74 in the UK in 1979. Much of the difference can be attributed to the vast number of Soviet citizens who held no wealth. The top 1, 5, and 10 percent of the population held a lower percentage of wealth in the Soviet Union in 1973 and 1979 than the U.S. in 1972 and the UK in 1979. Considering that wealth Ginis are typically higher than income Ginis, less weight on wealth would indicate a more equitable distribution.

<sup>20</sup> Vinokur and Ofer (1987), p. 193.

<sup>21</sup> Transmonee Project, UNICEF (1998).

arts and humanities, but beginning with the first five-year plan, educational priorities shifted to building scientifically- and technologically-trained cadres. The 16<sup>th</sup> party congress required compulsory primary education for children aged 8-10, which extended to age 11 in 1931-2. Krushchev introduced adult post-secondary education in the form of evening, correspondence and summer school outside of the traditional universities, institutes and academies, and the ninth five-year plan (under Brezhnev, 1971-5) made secondary education universal. Educational programs not only heightened the overall educational status of Soviet citizens, but also extended the reach of education geographically and ethnically.<sup>22</sup> Today Russian adult literacy and secondary enrollment rates rival their Western counterparts.<sup>23</sup>

#### Privatization Strategies and Income Distribution: Some General Considerations.

To what extent does privatization affect the distribution of assets and income? Are there ways to privatize in such a manner as to prevent a deterioration in a country's asset and income distribution or even to improve it? We have found it useful to address this question within an analytical framework provided by Ramanadham (1999). He proposed a number of policies for the divestiture of state assets that could minimize the concentration of assets and income. The strategies he recommended are: 1) the free distribution of asset ownership in place of sales; 2) allotment in favor of small investors; 3) breaking up enterprises into non-monopolistic units; 4) restricting resale for a given period; 5) including "claw-back" provisions (i.e., provisions allowing the state to reclaim the privatized enterprise) to prevent high short term capital gains from asset stripping; and 6) restrictions on retrenchment (such as laying off workers or closing down a

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<sup>22</sup> See Murray (1992) for details.

substantial proportion of productive capacity) for a given period.<sup>24</sup> To these six, we add a seventh: 7) fair and equal access to information and auctions. This includes allowing bidding and purchasing of shares without the agent being present at the auction, as well as the free and universal distribution of information on companies up for privatization.

Each of these seven provisions aims to achieve one or more of the following: 1) allowing a large number of individuals to participate in the ownership of former state-owned enterprises (SOEs); 2) decrease the advantages in the privatization process of wealthy or well-positioned individuals; 3) reduce short-term rent-seeking after privatization; and 4) limit worker displacement immediately after privatization. Also, some, but not all, of these tactics pose a conflict with the goals of efficient allocation of property rights (since transaction costs are not negligible) and productivity.

Free distribution of public assets, allotment to benefit small investors, and restrictions on resale tend to reduce the effectiveness of privatization in efficiently allocating property rights to privatized state-owned enterprises. This is because sales and auctions tend to signal information about each buyer's valuation of ownership in the SOE for sale, especially when credit markets are well-functioning. Privatization through the free distribution of public assets will not communicate this information as well. The same is true if the government favors small investors (or any specific group of investors). Restrictions on resale would inhibit the ability of the market to correct any inefficiencies in the initial allocation. Resale restrictions, however, may improve long-term

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<sup>23</sup> According to World Bank Development indicators, adult illiteracy in the Soviet Union was just 0.8 percent in 1989 and 1990.

<sup>24</sup> Ramanadham, V.V. "The impacts of privatization on distributional equity" in *Privatization and Equity*, edited by V.V. Ramanadham (London: Routledge, 1995), pp. XX-X.

productivity by attracting buyers who are interested in investing rather than speculating. It will help stabilize ownership and encourage long-term investment.

Claw-back provisions also tend to have a mixed effects in terms of property rights and productivity. On the one hand, such provisions would tend to discourage investors interested solely in short-term capital gains through asset stripping, as noted by Ramanadham. However, in terms of productivity, these provisions would decrease incentives for well-intended investors by creating uncertainty about the longevity of private ownership and fear of re-nationalization.

Restrictions on retrenchment would tend to have a negative impact on productivity. This is because government priorities differ from the priorities that influence decision-making in the market, including over-employment of labor in state sectors. By limiting retrenchment after privatization (and assuming that little restructuring occurred before privatization) the government limits the new owners' ability make optimal employment and investment decisions at the margin. Even when some restructuring occurs before privatization, limiting owners' ability to adjust to new information after privatization would lead to a second-best outcome in terms of productivity.

Breaking up monopolistic enterprises into non-monopolistic units should have a positive impact on both allocation of property rights and productivity. Increased competition tends to ensure that stronger enterprises will eliminate unprofitable ones, and foreclosure on unprofitable plants will usually lead to resale. We also expect that fairer and universal access to information and auctions to be complementary to efficient allocation of enterprise ownership, productivity and income equality. This is achieved by

reducing the advantage of “insiders” in government and management who might seize and strip assets without investing or restructuring.

Both Brazil and Russia incorporated some of the strategies advocated by Ramanadham, but in neither case did the distribution of income improve. This is an important point to consider because, as shown below, privatization in Brazil was primarily motivated by the revenue needs of the state, and the necessity to increase productivity, whereas in Russia, the ideological sentiment prevailed that the state’s enterprises belonged equally to all Russians.

### III. Privatization

#### a) Brazil.

Brazilian privatization was less the result of a change in ideology or political fashion than it was of fiscal necessity. Privatization began timidly in the 1980s, when the Special Secretariat for the Control of State Enterprises (SEST) conducted a census of federal public institutions, identifying 268 of them as “federal state enterprises.” The secretariat classified 140 of them as enterprises that could be privatized in the short-run, and listed 50 of them for sale. Some of the latter were sold during the 1980s. The primary motivation was to limit the expansion of state-owned enterprises, and the accompanying fiscal pressures which they generated. This policy was reinforced by multilateral organizations, such as the IMF and the World Bank, with whom Brazil was in continuing negotiations following the external debt crisis of the early 1980s.

Privatization was increasingly seen as contributing to fiscal adjustment in two ways. First, the proceeds of the sale of state enterprises could in principle make an immediate contribution to the reduction of Brazil’s large public debt, whose servicing costs had

dramatically risen in the 1980s. Second, by removing deficit-ridden enterprises from the public sector, the prospects for attaining future fiscal balance were enhanced.

Some privatization occurred in the 1980s, but its pace was slow and only 18 companies were sold in the second half of that decade. Total revenues from these sales were only US\$ 533, a tiny fraction of the state's total assets. Macroeconomic deterioration in the 1980s, however, set the stage for subsequent privatizations, as the fiscal situation continued to worsen and inflation reached four-digit levels by the end of the 1980s.<sup>25</sup>

The 1990s saw a substantial increase in the privatization process. The first significant privatization occurred in late 1991, with the sale of USIMINAS, a largely federally owned steel enterprise, for US\$ 1.9 billion, a price 14.4 percent above the government's asking price. Until the mid-1990s the major privatization efforts were concentrated in the steel and petrochemical sectors. Twenty firms were sold in the 1991-4 period, netting a total of US\$ 7.8 billion. Buyers of these firms were overwhelmingly domestic private groups, with foreign participation amounting only to about 6 percent of total receipts.

In the mid-1990s a number of institutional changes were made which permitted a widening and deepening of privatization by the inclusion of public utilities. In 1995 constitutional amendments ended public monopolies in telecommunications, gas distribution and the oil sector. At the same time, other amendments ended the distinction between Brazilian companies owned by domestic residents and those controlled by foreign capital, paving the way for privatization in the mining and electricity generation sectors. In addition, privatization was extended to state and municipal governments.

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<sup>25</sup> For details, see Baer (2001), ch. 12.

This was important from the fiscal point of view, since non-federal public enterprises had been significant contributors to the public sector deficit.<sup>26</sup>

Foreign participation in Brazil's privatization program increased substantially in the second half of the 1990s. This was, in part, the result of legislation that permitted foreign groups to participate in the operation of public utilities and in natural resource exploitation. For example, one finds that privatization through concessions in the telecommunications sector were won by foreign groups in the firms of Telesp (70.6% Spain, 23% Portugal); Embratel (100% U.S.); Tele Norte Leste (50.6% US, 34.4% Canada, 12.5% Argentina), and many others, while in the electricity distribution sector the concession consortium that won the Light Company bid in Rio de Janeiro consisted of 40.6% of a U.S. firm, 10.3% a French firm, and the rest was in the hands of Brazilian groups.<sup>27</sup> It has been estimated that of the US\$ 96.6 billion privatizations which occurred between 1991 and October 2000, the share of foreign firms amounted to 45%.

By the end of the 1990s privatization had extended to all of the sectors of the economy in which the state had previously been active. The largest sector for privatization was the telecommunications industry, most of which was auctioned in July 1998. Table 3 below shows the breakdown of Brazilian privatizations in the 1990s by sector. It may be noted that the telecommunication proceeds accounted for more than half the federal revenues or over a third of all privatization revenues. State government privatization, which became significant in the second half of the 1990s, were dominated by sales of state-owned electric power companies, which accounted for over two-thirds of

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<sup>26</sup> Many Brazilian non-federal public enterprises had borrowed from state banks and, as they defaulted, forced state banks to borrow from the central government. This contributed to federal expenditures and hence to the central government's deficit.

<sup>27</sup> BNDES/Finame-BNDESPAR (2000).

the value of state level privatizations. In the period 1991 – 2001 106 federal and state enterprises were sold.

b) Russia

Privatization of the Russian economy occurred in two major phases: voucher privatization (1992 to 1994) and a second phase, which shifted its emphasis to sales and revenue-generation (1995 to 1998). Although insider privatization was not the goal of privatization in Russia in 1991, political opposition to foreign buyouts of SOEs inhibited the nature of the privatization process and eventually, as shown below, biased it towards domestic insiders. Three main goals dominated the agenda: promotion of shareholder coalitions, speed, and simplicity. Promotion of shareholder coalitions was meant to diminish the influence of politicians and bureaucrats in the productive process, especially the ministries, and obtain the cooperation of the managers in the privatization process. Reformers saw speed as the second element of successful reform so that political opposition, which had built momentum in response to late soviet reforms of 1985 to 1991, could not block or reverse the process. Simplicity was essential because of the large number of enterprises to be privatized and the lack of experience of the Russian government and public in exchanging assets. Table 1 below shows the number of state owned enterprises and those privatized over the first five years.<sup>28</sup> If Russia had taken a slower approach, privatizing 1,000 per year (still 100 times more per year than Brazil) the process would span over 200 years.

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<sup>28</sup> *Public Enterprise Reform and Privatization Database*, ECSPF and DECRG, World Bank Group, 1998.

Table 1

Number of Russian State and Privatized Enterprises by Type

|                                        | 1992    | 1993    | 1994    | 1995    | 1996    |
|----------------------------------------|---------|---------|---------|---------|---------|
| State-Owned Enterprises                |         |         |         |         |         |
| Self-Financing                         | 204,998 | 156,635 | 126,846 | 90,778  | 88,347  |
| Leased                                 | 22,216  | 20,886  | 16,826  | 14,663  | 13,920  |
| with option to purchase                | 13,868  | 14,978  | 12,806  | 12,198  | 11,837  |
| SOEs turned into joint-stock companies | 2,376   | 14,073  | 24,048  | 27,040  | 29,728  |
| Privatization                          |         |         |         |         |         |
| Applications filed                     | 102,330 | 125,492 | 143,968 | 147,795 | 152,077 |
| Rejected                               | 5,390   | 9,985   | 12,317  | 13,295  | 14,557  |
| In process                             | 46,628  | 24,992  | 17,491  | 13,214  | 11,163  |
| Implemented                            | 46,815  | 88,577  | 112,625 | 118,797 | 123,432 |

Source: Russian Economic Trends, v. 10, n. 2 (1997).

Before privatization was opened to the public at large, a number of shares were reserved for workers and managers. In this part of the process 25 % of the ownership of each enterprise was given to workers in the form of nonvoting shares. An additional 10% of the shares could be purchased by workers at a 30% discount off the 1992 net book values, along with adjustments depending on workers' choice of benefit plans and up to a total of 51% of the authorized capital at 1.7 times the 1992 book price. This was a favorable price because (1) the book value was too low since it omitted important attributes (such as mineral resource rights) from the calculation and (2) share prices did not reflect inflation between 1992 when they were assessed and 1993 when they were sold. (3) the price often included *de facto* monopoly rights without the bidding process and restrictions that emerged in Brazil.<sup>29</sup> In addition, managers were given the option to

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<sup>29</sup> Soviet industrialization created large localized industries. When these industries were privatized they were often the only (or one of very few) Russian producer of the good. Also, there were large differences in Soviet components and Western components for many goods, putting Russian firms at a disadvantage abroad and Western firms at a disadvantage on Russian markets.

buy first 5 percent at the book price, then an additional 20% if two-thirds of the employees agreed, then an additional 20% at a 30% discount. It was possible for workers and managers to own 95% of their own enterprise's assets, of which managers could themselves control up to 45%. Vouchers could be used for up to 80% of the stock purchased under the worker-manager arrangements.<sup>30</sup> Following these worker-manager auctions, voucher auctions were opened to the general public.

Voucher privatization can be characterized by three attributes: mass giveaway of state assets, priority given to privatization over restructuring, and state-retention or control in key sectors, including mineral resources. In 1992, the government assessed the book value of state-owned enterprises approved for privatization and distributed vouchers worth 10,000 rubles to each Russian; these could be exchanged for stock in the SOEs up for privatization. Vouchers could be acquired through local branches of Sberbank for 25 rubles.<sup>31</sup>

Voucher privatization pertained to large (over 1,000 employees) and medium (200-1,000 employees) sized enterprises. The privatization of small (less than 200 employees) enterprises was delegated to regional and local authorities. By the end of 1993 about 70 percent of all small enterprises (about 75,000 enterprises) were privatized, mostly for cash, and usually quite quickly.

In 1995, policymakers, burdened by mounting debt and inability to collect taxes, departed from voucher privatization and began privatizing the remaining SOEs for cash and debt financing. To do this First Deputy Prime Minister Vladimir Potanin began

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<sup>30</sup> Gustafson (1999).

<sup>31</sup> Gustafson (1999), Goldman (2000), Schleifer (2000). Dollar estimates are not given due to the price and exchange rate volatility experiences of the 1990s in Russia.

arranging “Loans for Shares” agreements with large banks.<sup>32</sup> Banks offered the government loans, while the government provided shares as collateral, which would be returned when the debts were repaid. Expecting that the government would be unable to repay the loans, bankers stipulated that if the loans went unpaid, the banks could auction the stocks and yield a net return to the government. These auctions, which were meant to be competitive, were essentially closed to loans for shares insiders, who obtained the shares for only a small amount more than the original loans.<sup>33</sup> These arrangements favored those who established themselves in large banks, in particular Menatep and Sberbank.

In 1997 and 1998 the government attempted to make the process fairer and competitive. Competition and structural regulations raised the price of shares, but in doing so closed the bidding to many domestic investors, leaving only the winners from the first round and loans for shares—the oligarchs and managers, who headed “financial-industrial groups” which owned controlling shares in energy, primary inputs, telecommunications and the press, as well as protected sectors such as automobile and airplane manufacturing.<sup>34</sup>

### The Distributional Impact of Privatization

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<sup>32</sup> Potanin, incidentally, is now one of the most successful oligarchs, and owner of one of the major financial industrial groups that benefited from “Loans for Shares” (Interros Trading Co./Oneximbank), according to The Development Economics Research Group *Transition Newsletter* and RFE/RL “Russia’s Financial Empires,” His net worth in 1998 was \$1.6 billion according to Forbes Magazine.

<sup>33</sup> When outsiders tried to enter the auction, they often found that the airport where the auction was to be held was closed, or that they did not meet the qualifications to participate in the auction. See Goldman (2000).

<sup>34</sup> Development Economics Research Group, “The Twelve Oligarchs,” *Transition Newsletter* (July/Aug

In the analysis of distribution issues, it is useful to distinguish between policy effects on wealth (stocks) and on income (flows). Although often closely related, these effects may sometimes diverge significantly.<sup>35</sup> In the context of privatization, wealth effects are alternations in the ownership of the country's economic assets. This is a once-and-for-all change, occurring at the time of privatization. Income distribution effects, on the other hand, are the continuing consequences of privatization on the real earnings and income of various groups in the society, among them the new owners, workers, and consumers of the product of privatized firms. Let us first consider the wealth distribution effects of privatization.

a) Brazil

As already mentioned, Brazil's high income and asset concentration has been a constant through time. It was inherited from colonial times, and it persisted as the country passed through its phase of a primary export economy; the import substitution industrialization period only served to reinforce the concentration; and the neo-liberal era, with its emphasis on privatization, provided further continuity to a concentrated ownership system.

*Privatization and Brazil's Wealth Distribution*

The distribution of corporate wealth in Brazil has been divided traditionally into the *tripod* of state-owned, private domestic and foreign enterprises. Well before the major privatizations of the 1990s, many sectors of Brazilian industry were dominated by a small number of either private domestic firms or foreign firms. This was the case, for

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1999).

<sup>35</sup> In theory, a complete set of perfectly functioning capital markets would permit all income flows to be translated into equivalent stocks of wealth. For all its theoretical appeal, such an assumption is totally at odds with the realities of an actual economy like Brazil.

example, of the automobile industry, where the top four firms accounted for 94% of net receipts of that sector in 1998. In the same year, the top seven firms in the cement industry accounted for 60% of net receipts. In heavy construction, motors and components, electric appliances, and steel, the top eight, four, four, and seven firms accounted for 67%, 64%, 75%, and 82% of net receipts in their respective industries.<sup>36</sup>

Since the privatization program of the 1990s was largely driven by the government's need to maximize its revenues from the sale of state-owned enterprises to the highest bidders, it is not surprising that most of these bidders were either foreign enterprises or the largest domestic private firms. This suggests that the Brazilian privatization approach of selling to the highest bidder to relieve the fiscal stress on the public sector may have had either a negligible or even negative impact upon the distribution of wealth in Brazil. Had the privatization policy attempted to divide the value of the formerly state-owned firms among Brazilian citizens or taxpayers, it is possible that the effects of privatization on the distribution of wealth might have had a more positive effect. Even though some provision was made for workers and their pensions to share in the privatization process, this share was relatively modest. Through December 1997, only 7.5% of the shares of privatized firms were held by employees or their pension funds.<sup>37</sup>

This trend may have been reinforced, moreover, by the parallel trend in major mergers and acquisitions throughout the 1990s, which rose from 58 in 1992 to 212 in 1995 and 351 in 1998.<sup>38</sup> Some of these mergers were motivated in part by the need for

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<sup>36</sup> Calculated from data in *Gazeta Mercantil, Balanço Anual 1999*.

<sup>37</sup> De Mello Jr. (2000), p. 85.

<sup>38</sup> Siffert Filho and Souza e Silva (1999), p. 383.

private domestic firms to form strategic alliances large enough to make successful bids for enterprises that were being privatized.<sup>39</sup>

Some insight into the possible effects of privatization on the distribution of corporate holdings and organization during the 1990s is provided by Table 2, which shows changes in the ownership of Brazil's one hundred largest non-financial firms between 1990 and 1998. It classifies private domestic Brazilian firms into three sub-categories, corresponding to the degree of concentration of ownership. It should be noted that even the "lower concentration" firms shown in Table 2 included many which would not be considered "widely held" in the North American sense. Even though no one individual or family had more than 20% of the voting shares of the firms in this sub-category, a small number of owners could easily dominate the firm.

Table 2  
Distribution of 100 Largest Firms and their  
Revenues by Property Characteristics

|  | 1990 | 1998 |
|--|------|------|
|--|------|------|

<sup>39</sup> An example was the association among the Grupo Votorantim, Brazil's major cement producer, the large construction firm Camargo Correa, and Brazil's largest private domestic bank, Bradesco, to participate in the privatizations in the energy sector. See: Siffert Filho and Souza e Silva (1999), p. 385.

|                                | Number of Firms | Share of Total Revenues (percent) | Number of Firms | Share of Total Revenues (percent) |
|--------------------------------|-----------------|-----------------------------------|-----------------|-----------------------------------|
| Private – Lower concentration  | 1               | 1                                 | 4               | 3                                 |
| Private – Medium concentration | 5               | 4                                 | 23              | 19                                |
| Private – High concentration   | 27              | 23                                | 26              | 17                                |
| Public                         | 38              | 44                                | 12              | 21                                |
| Foreign                        | 27              | 26                                | 34              | 40                                |
| Cooperatives                   | 2               | 2                                 | 1               | 0                                 |
| <b>TOTAL</b>                   | <b>100</b>      | <b>100</b>                        | <b>100</b>      | <b>100</b>                        |

Source: Siffert Filho and Souza e Silva, 1999, p. 402.

Several trends are evident in Table 2. Privatization had little or no impact on either cooperatives or on the least concentrated of Brazil's top hundred private firms, whose combined share of revenues (3% of the total) remained unchanged. The major beneficiaries of the decline in the relative importance of public enterprises over the 1990-98 period were either foreign owners or those domestic private Brazil firms in which one individual or family owned at least 20% of the voting shares.<sup>40</sup>

Some specific cases illustrate well the dominance of large domestic firms and foreign buyers in the privatization process. In the case of the steel firms CONSINOR and Piratini, 99.8 and 89.8% of the shares respectively were acquired by the private Gerdau

<sup>40</sup> Once interesting example is provided by the privatization of the Companhia Siderurgica Nacional (CSN) in 1993, in which the successful bid was put together by the medium-sized Grupo Vicunha, which had previously been active primarily in the textile sector. It forged an alliance with a number of domestic banks, pension funds, and several foreign investors.

group.<sup>41</sup> In the sale of the large Companhia Siderurgica de Tubarão steel company, 45.4% of the shares were acquired by the private financial groups Bozano Simonsen and Unibanco. In other sectors, such as telecommunications, alliances between private Brazilian groups (Construtora Andrade Gutierrez, Bradesco, Globopar, Banco Opportunity) and foreign purchasers (Telecom de Portugal, Banco Bilbao Vizcaya, Stet International, Iberdrola) were important. In the electric power sector, Brazilian firms allied themselves with foreign enterprises from the U.S., Chile, France, Spain and Portugal.<sup>42</sup>

#### *Privatization and Brazil's Income Distribution*

Whatever the initial motivations for the establishment of Brazil's network of state enterprises, they gradually became a significant source of employment, both in terms of numbers and salaries. The social and political pressures generated by rapid labor force growth and a high level of rural-urban migration contributed to the willingness of successive governments to absorb labor in the public sector in excess of real needs.

Privatization reversed this trend in public sector employment. In a number of cases, even before firms selected for privatization were put on the auction block, they were "fattened up" to make them more attractive to potential buyers by eliminating excess employment. In the Federal Railroad System (RFFSA), about half of the 40,000 person labor force was let go even before privatization; and once in charge, private operators further reduced the labor force to about 11,500, while actually increasing the level of service. In the major public ports, the number of workers employed was reduced from 26,400 in 1995 to about 5,000 in 1997, with further reductions planned to bring the

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<sup>41</sup> Biondi (1999), pp. 42-47, provides an extensive list of the ownership structure of firms before and

number down to 2,500 workers. Substantial reductions in the work force also took place in the steel sector after privatization. The number of employees in the Companhia Siderurgica Nacional fell from 24,463 in 1989 to 9,829 in 1998; the COSIPA plant from 14,445 to 6,983; and in USIMINAS from 14,600 to 8,338.<sup>43</sup>

It has been shown that Brazil's public sector wages exceed those for similar employees in the private sector, and hence privatization may have produced declines in the incomes of former employees of the privatized firms.<sup>44</sup>

Analysis of the income distribution effects of the reduction in employment that resulted from privatization is complex, even when the economic efficiency arguments for eliminating overstaffing are straightforward. Had the income gains resulting from greater economic efficiency been distributed to Brazil's poorest, then privatization would have made an unambiguously positive contribution to equity as well as efficiency. There is little credible evidence, however, that efficiency gains were in fact distributed in this manner. What scanty evidence exists, notably the substantial increase in the profits of recently privatized firms, suggests that much of the income gain from increased efficiency was captured by the new owners. Thus in both 1997 and 1998 the magazine *Exame* listed four privatized firms among the 20 top profit-making firms of the country.<sup>45</sup> A significant share of these profits, moreover, accrued to foreign purchasers of the privatized firms. Some of the sharp increase in profit remittances in Brazil's balance of payments, which rose from US\$ 1.6 billion in 1990 to US\$ 2.5 billion in 1994 and to

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after privatization, based on BNDES data.

<sup>42</sup> Leal Ferreira (1999), p. 154.

<sup>43</sup> These numbers come from the magazine EXAME, which has a yearly edition dedicated "Melhores e Maiores" ("The Best and the Largest").

<sup>44</sup> Foguel, Till, Mendonça, and Paes de Barros (2000).

US\$ 7.2 billion in 1998, may reflect in part of the profits realized by foreign firms that participated in the privatization process.

The other major link between privatization and income distribution runs through the regulatory system and its resulting impact on prices. A large part of the privatization process centered on public utilities, and an essential element was the restructuring of the regulatory system so as to attract private operators who would adequately maintain and expand public utility services. Privatization forced a drastic revision of public utility rates. In telecommunications, for example, tariffs were raised dramatically in 1995, well before the actual auctioning of the system. Residential subscriptions were raised by a factor of 5, with the cost of local calls rising by 80%. In the electric power sector tariffs moved up considerably faster than most other prices.

The evidence available to date suggests that the regulatory climate in Brazil moved substantially in favor of the new private owners of public utilities. From an income distribution point of view, one must conclude that these regulatory changes shifted income to the new private concession holders from a much large group of consumers. In the city of Rio de Janeiro, for example, while the Consumer Price Index rose 189.7% between August 1994 and February 2000, the price index for public services rose by 264.7%.<sup>46</sup>

On the aggregate, however, Brazil's income distribution did not worsen in the 1990s, according to the Gini and Theil coefficients in Table 3. However, the percentage of poor increased slightly in the second half of the 1990s, when privatization picked up speed.

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<sup>45</sup> The firms were: Cia. Vale do Rio Doce, USIMINAS, CSN and the Rio LIGHT company. A

Table 3

Selected Indicators of Brazilian Income Distribution and Poverty, 1977-1999  
(billions of US\$)

| Year | Gini Coefficient | Theil Index | Gap between the 20% richest and 20% poorest | Gap between the 40% richest and 40% poorest | Poor as a percentage of the population | Absolute numbers of poor (in millions) |
|------|------------------|-------------|---------------------------------------------|---------------------------------------------|----------------------------------------|----------------------------------------|
| 1977 | 0.62             | 0.91        | 27.5                                        | 26.8                                        | 39.6                                   | 40.7                                   |
| 1981 | 0.59             | 0.69        | 24.0                                        | 21.8                                        | 43.2                                   | 50.7                                   |
| 1985 | 0.60             | 0.76        | 25.5                                        | 23.6                                        | 43.6                                   | 56.9                                   |
| 1990 | 0.62             | 0.78        | 31.2                                        | 26.9                                        | 43.8                                   | 63.2                                   |
| 1995 | 0.60             | 0.73        | 28.0                                        | 24.1                                        | 33.9                                   | 50.2                                   |
| 1999 | 0.60             | 0.72        | 27.2                                        | 23.3                                        | 34.1                                   | 53.1                                   |

Source: Paes de Barros, Enriques, Mendonça (2000)

a) Russia

*Wealth and asset distribution*

The dominant shareholder in the largest Russian enterprises continues to be the government. In 1998, it still owned an average of a one third interest in the 50 largest Russian enterprises and between one third and one half in the next 250.<sup>47</sup> After the ownership is concentrated in the hands of managers and large banks.

The main reasons that the various measures taken by Russia during privatization failed to result in a more equitable distribution of assets are: (1) vouchers only accounted for about 20 percent (on average) of enterprises privatized during the initial stage (about 14,000 enterprises)<sup>48</sup>; (2) the public by and large did not or could not take full advantage of their vouchers in purchasing equity in enterprises; (3) workers and managers had first

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decade earlier some of these firms had been on the list of the biggest loss makers.

<sup>46</sup> *Conjuntura Econômica*, January 2000, p. xxxiv.

<sup>47</sup> Gustafson, p. 40.

<sup>48</sup> Aslund (1995) p. 254-7.

shot at enterprise shares. While the first point is fairly straightforward, the second and third require some elaboration.

Although over 97 percent of Russians received their vouchers, only about 83 percent of these were used.<sup>49</sup> Many citizens were unable to decide whether or not to exchange vouchers for ownership due to a lack of information. First, information about which enterprises were being sold for vouchers, as well as when and where, was not readily available to the public. Additionally, auctions were held near the site of operations, so most people were only able to directly buy into enterprises in their own town.<sup>50</sup> Frustrated, many holders sold vouchers for below market value or simply threw them away. Funds bought vouchers through secondary markets, and the vouchers were concentrated in financial institutions, mainly in Moscow. From there bankers were able to utilize their contacts through the former *nomenklatura* to bid on the most profitable enterprises.<sup>51</sup> Table 4 below shows how citizens used their vouchers.<sup>52</sup>

Table 4

Russian Privatization Vouchers: Use Distribution

| Used or intended to use vouchers to: | Intent as of December 1993<br>(% of surveyed) | Outcome as of June 30,<br>1994 (% of surveyed) |
|--------------------------------------|-----------------------------------------------|------------------------------------------------|
| Buy shares in a fund                 | 26                                            | 30                                             |
| Sell for cash                        | 25                                            | 26                                             |
| Give away                            | 7                                             | 13                                             |
| Buy shares in workplace              | 15                                            | 8                                              |

<sup>49</sup> Aslund (1995), Shleifer (2000)

<sup>50</sup> Aslund (1995) p. 254.

<sup>51</sup> Gustafson, pp. 42-3. In 1992, when asked in whose interests had privatization taken place, 28.7 percent responded with “the shadow economy” and 15.4 percent said the former *nomenklatura*. By 1994 these categories were perceived as the intended beneficiaries by 49.2 percent and 26.4 percent respectively. Opinion that privatization had taken place on the workers’ behalf dwindled from 7.3 percent in 1992 to 1.4 percent in 1994.

<sup>52</sup> Gustafson, p. 41.

Buy shares elsewhere 8 6  
 Sources: VTsIOM and Mnenie polling organizations cited in Aslund, Anders, *How Russia Became a Market Economy*, (Washington, D.C.: Brookings Institution, 1995), p. 256

The results of the polls are worth comment. One, the number of people who ended up giving away vouchers was much higher than the number who intended to do so as of 1993. Second, the number of Russians who ended up buying shares in their workplace with vouchers fell substantially. These numbers can be interpreted as success or failure. On the one hand, 44 percent of the population became owners. On the other hand, 39 percent sold or gave away the opportunity to do so. Those who sold their vouchers frequently did so at a discount. In 1992, when asked in whose interests had privatization taken place, 28.7 percent responded with “the shadow economy” and 15.4 percent said the former *nomenklatura*. By 1994 these categories were perceived as the intended beneficiaries by 49.2 percent and 26.4 percent respectively. Opinion that privatization had taken place on the workers’ behalf dwindled from 7.3 percent in 1992 to 1.4 percent in 1994.<sup>53</sup>

As mentioned above, other methods of privatization made less of an effort to appear to be fair. Worker manager auctions essentially allowed insiders to dominate the control of assets before sales were opened to the general public. Later, during “loans for shares” privatization occurred behind closed doors and clearly benefited large bankers, who tended to be former *nomenklatura* or those otherwise connected under the old system. After 1996 few Russians had the means to participate in the market for private assets.

#### *Income distribution*

At first, it would seem that Russia’s privatization converted a fairly egalitarian system into one which increasingly resembled Brazil. On closer inspection, however,

there was not that much of a drastic change. Latent inequality hid beneath a thin veneer of equality in the Soviet Union. Although most assets belonged to the state, and thus to the Soviet people, the actual control of these assets was in the hands of a small group of people who controlled the political system. These not only had many personal privileges in the old soviet system (such as access to scarce foreign goods and foreign exchange), but had authority over the allocation of resources.

With privatization, there were two types of winners in Russia. According to Goldman (2000), the winners consisted of former *nomenklatura* and former high ranking Soviet bureaucrats, and of former (and current) black marketers, some of whom had been imprisoned for “economic crimes” under Communism.<sup>54</sup> These small groups were in a strategic position to appropriate the control of a large proportion of state assets to themselves. For the former officials who benefited, what had originated as wealth in the form of a property right to political capital became largely transferable into a property right to physical capital and financial wealth after privatization. For former black marketers the story is similar, since their underground connections had generated substantial resources that enabled them to maneuver in the new economy. In effect, privatization made the previous advantages of former *nomenklatura* and black marketers into tangible and accountable income and wealth.

This inequality manifested itself quickly, and Gini measures rose dramatically.

#### Table 5

#### Russian Income Distribution: 1989-1998

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<sup>53</sup> Gustafson, pp. 42-3.

<sup>54</sup> Goldman, 2000.

| Year | Gini Coefficient | Gap between<br>Richest and poorest 20% |            | Gap between<br>Richest and Poorest 40% |            |
|------|------------------|----------------------------------------|------------|----------------------------------------|------------|
|      |                  | Transmonee                             | Goskomstat | Transmonee                             | Goskomstat |
| 1989 | 26.50            |                                        |            |                                        |            |
| 1990 | 26.28            |                                        |            |                                        |            |
| 1991 | 30.91            |                                        |            |                                        |            |
| 1992 | 38.05            |                                        |            |                                        |            |
| 1993 | (NA)             |                                        |            |                                        |            |
| 1994 | 44.92            |                                        |            |                                        |            |
| 1995 | 45.89            |                                        | 8.72       |                                        | 4.48       |
| 1996 | 42.44            | 5.16                                   | 7.16       | 3.12                                   | 4.00       |
| 1997 | 40.84            |                                        | 7.35       |                                        | 3.99       |
| 1998 | (NA)             | 12.20                                  | 7.46       | 5.68                                   | 4.00       |

Source: World Bank.

reasons: 1) data publication in the Soviet Union often served the political goals of the party, rather than the public interest; 2) monetary accounting of incomes and expenditures provided a poor proxy for real consumption. Also, there are still considerable discrepancies between the official *Goskomstat* data for 1995-1998 and the independently-gathered *Transmonee* project data. While *Goskomstat* shows a decline in the gap between the highest and lowest quintiles, *Transmonee* shows a considerable increase from 1996-1998. Finally, it is impossible to tell how much of the increase came from the realization to new long-term realizations of new income for the rich, how much is from temporary increases in income for the rich derived from new wealth and asset stripping, and how much is simply from the bottom falling out for poorer Russians.

The most visible difference in income equality in Russia has been the increase in the occurrence of poverty. In 1994 poverty in the Russian Federation had reached 30.9 percent of the population in terms of the government-defined poverty line. In 1998, 7.1 percent of the population lived at less than \$1 a day and 25.1 percent lived at less than \$2 a day. Five years prior, in 1993, just 10.9% of Russians lived on less than \$2 a day. To compare this with Brazil, in 1997 just 5.1 percent lived on less than \$1 a day, and 17.4

percent lived on less than \$2 a day.<sup>55</sup> These figures become even more staggering when one compares the climates of the two countries and factors in energy costs required to survive the harsh Russian winters.

### **Evaluation**

The best way to explain the phenomenon of privatization leading to income and asset concentration in two societies with apparently different historical and socio-economic background is to refer back to Ramanadham's above reviewed general framework:

1. free distribution of asset ownership in place of sales: this did not occur in Brazil, and although it began intended as such in Russia, the voucher system culminated in a concentration of coupons and insider favoritism. After vouchers expired in July 1993, deals became increasingly insider-biased.
2. allotment in favor of small investors: this only took place in marginal way in Brazil, while in Russia most workers in large enterprises received non-voting shares.
3. breaking up enterprises into non-monopolistic units: did not occur in either country;
4. restricting resale for a given period: did not occur in Brazil, while some restrictions were instituted in Russia, but without an expiration on restrictions;
5. "claw-back" provisions: were not instituted in these two countries;
6. restrictions on retrenchment: there were none in Brazil, though there existed quite a few in Russia, especially with regard to eliminating excess

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<sup>55</sup> World Bank Development indicators.

labor;

7. fair and equal access to information and auctions: this seems to have been available in Brazil, but was quite restricted in Russia. However, one should keep in mind the initial conditions in Brazil, i.e. a pronounced concentration of income and wealth. This resulted in the fact that the average Brazilian had little access to information and credit. Had more Brazilians been able to obtain the latter, a larger proportion of the population might have been able to participate in privatization.

The basic problem with regard to equity (i.e., an increased equitable distribution of income and assets) is that in both countries it did not receive high priority during the intensive privatization period.

In the case of Brazil, from the very beginning, the motivation for privatization was first to raise government revenues and reduce its debt, and also to promote increased investments in both the industrial and infrastructure sectors. Given the initial income and asset concentration, there was little hope to achieve these goals through an equitably distributed privatization of government assets. This explains Brazil's not following most of the Ramanadham rules.

In the case of Russia, speed and simplicity were more important than real institutional development. Although vouchers were introduced, the motive for their use was to expedite the process rather than to achieve distributional equity. Later arrangements were far more biased towards insiders and voucher-phase winners. It would be fair to say that privatization could have been much better from both the efficiency and equity standpoints had leaders focused on decomposing monopolies and assuring fairness with

respect to access and information.

Reviewing the evidence presented above, one comes to the conclusion that privatization with equitable results has been mainly feasible in advanced industrial countries, where the average standard of living was fairly high. In other words, privatizing through sale of millions of shares to a broad mass of the population, where no individual or group would control more than a single digit share of a firm, was feasible in such countries as the U.K., Germany, or France.

Privatization with equity was not a feasible option for Brazil and Russia for two reasons. First, a large proportion of the Brazilian population was living at or near subsistence and thus could not possibly afford to participate in the privatization process. In the case of Russia, although the basic needs of the population were met, the majority had little income to spend beyond these needs. Although in Russia vouchers were distributed with equal access, over half of the population sold them to individuals or funds. One might suspect that a similar result would have occurred in Brazil had the voucher system been used. Second, there was a high concentration of “access.” In the case of Brazil, only a small domestic elite had access to wealth, credit and information, which made it possible to bid for state assets. In the case of Russia, only a small elite had the connections (both political and in the underground economy), which made it feasible to get control of most of the state’s most profitable former assets.

While for Brazil the extent of the results from privatization on inequity are limited to the absence of improvement of distributional equity, Russian privatization seems to have created a deepening divide between the rich and poor. What is difficult to discern is how much of the divide is attributable to the privatization process itself and how much of it

was hidden by the now defunct soviet regime. We maintain that, while the latter explains part of the divergence, it fails to explain all of it, especially with respect to poverty and displaced workers.

What is clear on the streets of Russia's cities is that there has been a segment of society that is decidedly worse off over the course of the transition, in particular pensioners and those since unemployed. Unemployment rose fairly quickly to levels comparable to many western European countries,<sup>56</sup> but without the generous welfare and unemployment compensation programs that exist in richer countries. Recent growth has created some new jobs, but lagging infrastructure in the provinces, regionalism and soviet era restrictions on worker mobility (such as registration and work permits, especially to live in relatively prosperous Moscow) have concentrated the benefits of growth geographically<sup>57</sup>

The most encouraging long-term characteristic of Russia in comparison to Brazil is the extent of mass and higher education infrastructure that was developed under communism and continues to be a priority. (introduce evidence either here or earlier, and/or in footnote here). This will allow younger displaced workers to update their skills to the changing work environment, and new workers to acquire skills that are in demand.

Re-nationalization is not going to achieve greater equity in either Brazil or Russia. In both countries institutional changes may help to achieve it, i.e. how credit is disbursed, how regulations are applied to the private sector, etc. In the case of Russia, one of the

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<sup>56</sup> Unemployment, Russia, 1995-2001.

|              | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 |
|--------------|------|------|------|------|------|------|------|
| Unemployment | 8.5  | 9.6  | 10.8 | 11.9 | 12.6 | 10.5 | 8.7  |

<sup>57</sup> For details and evidence on geographic disparities see Berkowitz (2001) or Friebel (2000). Friebel's paper is still in working phases, but uses Russian Longitudinal Monitoring Survey data to track regional

major challenges will be to more effectively use the human capital which was built during the Soviet period – that is, to preserve it domestically and to diminish its flow to the West. In the case of Brazil, the challenge is to create more human capital to attend to the needs of a post-industrial service economy and by raising the earnings of people with education, gradually attain a more equitable distribution of income and assets.

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