

Joint ARABOSAI – EUROSAI Conference

“Privatization and its Impact on the Management of Public Services”

THEME 3:

“Best Methodologies and Standards Used to Evaluate the Impacts of Privatization”

*Presentation of Dr. Sergey V. Stepashin
Chairman of the Accounts Chamber of
the Russian Federation*

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Dear Colleagues!

The Russian privatization is a **complex subject of research** on the basis of the generally recognized international standards or comparisons between nations. The denationalization of the Russian economy in the 90-es was unprecedented in its scale. Of this, in particular, the data on Slide No. 1, where the dynamics of the number of privatized enterprises is shown, give evidence.

As is seen, the privatization was of a mass and rapid nature. Its peak fell at the first two years after the corresponding legislative acts were passed in 1993 and 1994 (**the first so called “voucher phase”**), when privatized enterprises were registered in tens of thousands. During this period the privatization was not based on an objective approach to the choice of the subjects of privatization with the purpose of the enhancement of their performance. The efficiency of the state bodies of privatization was determined by the fulfillment of tasks assigned from above in terms of the number of privatized objects.

Virtually, the territorial bodies of privatization determined the choice of objects and order of their privatization, which very often resulted in an uncontrolled process. For example, during this period a number of strategically important enterprises of the defense industry were privatized without the corresponding permission of the federal authorities.

At the **second stage of privatization** (1995-1999) the aims of the improved recovery of the privatization, replenishment of the state budget which was highly deficit at that time were declared. And as the data on Slide No. 2 show, already 1997 saw the sudden growth of the privatization returns and not only in roubles, but in terms of the US dollar. Nevertheless, in reality the State still continued to sell its assets for a mere song, at the price which often differed in several orders from real value.

By results of ten specialized auctions selectively audited by the Accounts Chamber in 1996-1997 through the unfounded reduction of stock prices the lost profits of the federal budget constituted over 115 bln roubles (or almost \$20 bln). Exactly during this period the notorious “**shares-for-loans auctions**” took place when under a doubtful and non-transparent financial scheme the large shareholdings of the most profitable enterprises of the Russian economy (mainly in the oil industry) were privatized. The following data tell about a flagrant discrepancy between a property real value and its privatization price. During 1993-2003 the State received **some \$10 bln** from the privatization of **145 thousand of enterprises**. (For comparison I will tell that according to the data as of 1st September, 2006 the capitalization value of the biggest Russian joint stock company Gasprom was \$275 bln).

Thus the Russian privatization is unprecedented not only in its scale, but in its content as well. If the function of privatization under the developed market economy is the increase of the efficiency of separate enterprises, the task of the Russian privatization was the radical change of the economic basis of the whole society, assurance of the irreversibility of the reforms or as they said in those times “exclusion of communist restoration”. So, the socio-political tasks were being solved first of all, but not the socio-economic ones.

In substance, the process of privatization in Russia began to solve the generally accepted from the viewpoint of international practice tasks only after 1999. During this period as it was foreseen by international standards the emphasis was laid on a differentiated approach during the privatization of enterprises and the achievement of concrete economic and social indicators. The adopted at the end of 2001 framework law gave the privatization a planned format, made it transparent and expanded its instrumentation, described in details the preparation for the privatization of state and municipal enterprises.

In connection with this **the INTOSAI international privatization audit standards** approved in 1998 cannot be applied in full to assess and analyze the privatization processes in Russia in the 90-es. At the same time we would like to note

the high degree of actuality of directives No. No. 24, 25 and 26, specially worked out to provide the transparency of mass privatization in the post-socialist countries (Slide No. 3). As shows the Russian experience, the progress of business in many ways is determined by how actively and ably men in the street are ready to participate in the process of privatization as investors.

In many ways on this the acknowledgement by the society itself of the legitimacy of privatization results depends. That is why the efficiency of the relative educational campaign of the State, control over the fair practices of financial intermediaries (investment funds) and provision of external control over all the stages of public property disposal – from dissemination of information on sale to listing the shares of an enterprise on the stock exchange are of such a great importance. The Russian experience indicates that it is necessary to put all the stages of the privatization process under strict and efficient control on the part of the society, parliament and independent bodies of the public financial control.

The Accounts Chamber was set up in Russia only in 1995, when the phase of mass privatization was practically completed. Moreover, contrary to the INTOSAI standards the Accounts Chamber has not been yet vested with the right to directly control the whole process of privatization including such its initial phases as the presales restructuring of an enterprise, determination of the aim, time and initial price of its sale. We have gained a certain experience of participation in **determining an asking price of privatized enterprises**. And in those cases when the executive authorities deferred to our recommendations, fiscal revenues grew substantially. Thus, for example, the audit of the presale preparation for selling the stocks of OAO Orenburg Petroleum Joint Stock Company allowed to additionally receiving as revenues of the federal budget over \$654 mn.

At the same time we have enough rights to provide control over the progress of privatization in whole (Slide No. 4). Thus, under the law the Accounts Chamber is entitled to assess the efficiency and expediency of the federal property use; control over the receipt by the federal budget of the funds obtained from the privatization of the

public property and management of the federal property objects; and also systematically analyze the results of the audits made, generalize and investigate the reasons and consequences of the variances and breaches disclosed.

In addition the results of the privatization are highly morbid theme in Russia. Until currently the prevailing opinion was that the accomplished redistribution of property illegitimate and unfair, its basic mechanisms were based on dubious legal norms, and a great number of transactions in the privatization of the biggest objects violated even the existing legislation. All this caused uncertainty with Russian businessmen, undermined stimuli for investments and simultaneously created a basis for maintaining constant social tension in the society.

In connection with this the Accounts Chamber by order of the head of the state and in virtue of its powers under the legislation decided to generalize the materials of the 1993-2003 **audits of the privatization of some 250 biggest objects** to understand once more the legal consequences of the privatization. The subject of the analysis, aim and tasks of this expert and analytical action were formulated in the following way (Slide No. 5).

However, given that we regarded our task a bit wider. We proceeded from the fact that it was necessary to **finally summarize the accomplished property redistribution**. Those entrepreneurs who obtained public property into ownership without flagrant violation of law have to get guarantees of inviolability of their property rights. At the same time it was necessary to return to those objects in relation to which in our opinion the executive authorities had not taken sufficient measures as follow-up of our audits.

Simultaneously, in full compliance with audit logic we tried according to our rights to **correlate the set goals and concrete results** of the mass privatization in the socio-economic sphere, to find main types of violations and work out recommendations to increase the socio-significant efficiency of the privatization. Given that we did not pretend to ultimate truth. We proceeded from the fact that the generalization of the materials of our audits would give the executive power, Parliament and society the

possibility to close the discussion over what happened and concentrate on what should be done next.

And we took into consideration Directive No. 1 of the INTOSAI standards according to which the appraisal of a privatization process requires a complex approach, **consideration of the specifics of political environment and the mechanism of the government**. Therefore, we widely attracted experts of different profiles and held consultations with the leading centers of expertise of the country which represent different science schools and had dissenting opinions on the privatization results. With regard to a considerable international resonance of this subject we also held an international conference, in which such competent authorities as Joseph Stiglitz, a Nobel Prize laureate, and Marshall Goldman, a well-known American economist. Because of a great actuality of the researched problems for the Russian business community the heads of the leading national associations of entrepreneurs were also attracted to the preliminary discussion of the results of our work.

А теперь now permit me come to the presentation of **the main conclusions** of our Analysis. As I already said the main difficulty consisted in the systemic legal treatment of the privatization results. In our report we stated that in the beginning of the 90-es the federal bodies of power had no real consensus in regard to the choice of a privatization model, and also the methods and procedures of its implementation. **The legislation objectively was self-contradictory**, inconsistent and the privatization practice did not correspond to the declared task of creating an effective man of property. Moreover, the legislative base constantly fell behind the real processes, did not provide possibilities of control over carrying out privatization transactions, did not permit to effectively counteract to the new forms of economic crime.

However the insufficiency and incompleteness of the legislative base is not a basis for the cancellation or revision of the privatization results. From a legal point of view here the general rule of the presumption of a lawful normative act applies well. If a normative act was in force, was not disputed and did not become inoperative due to the

fixed by court nonconformance to the Constitution, then the decisions taken in accord with it are also lawful.

At the same time the inviolability of the privatization results and rights of the good faith purchasers of public property does not mean that it is necessary to forgo the monitoring of the legality of particular transactions made. If the facts prove, that the privatization of a particular property or asset has been carried out with the breach of law whereby the rights of the state as an owner suffered, then these rights may be and must be restored at law. For example, following the results of the analysis of the execution of our presentations the Accounts Chamber sent materials on a number of particular transactions to the General Prosecutor's office and proposals to the Federal Government to take measures regarding the facts of the most flagrant violations of legislation.

We singled out the following **most characteristic violations** which were committed (Slide No. 6).

Here first of all we would like to single out serious shortcomings in the activity of the bodies of executive power – the excess of power or, vice versa, the nonfulfillment of straight duties which resulted in violating law during particular privatization transactions. In this connection it must be again emphasized the imperfection of the legislation being at that moment in force. For example, the privatization was carried out in the absence of a federal law on the order of differentiating property into the federal, regional and municipal one which gave the regional authorities the opportunity to arbitrary and uncontrolled dispose of many an objects of the federal property. And in a number of regions the privatization went by at all in the absence of the regional legislative base on the basis of the normative legal acts of the high ranking officials.

The second most important group of violations is connected with the **unjustified underpricing of the state-owned assets sold**, uncontrolled disposal of intangible assets and intellectual property, and also with a low efficiency of sales. During the privatization the estimation procedure was used which did not allow really evaluating the cost of the alienable state-owned assets. In some cases the appraisal actually did not take place at all. I will give only one example. In determining the selling price of a

shareholding of one of the biggest oil companies the cost of oil productive capacities being on its balance was not taken into account. As a result the selling price of the shareholding was undercut minimum by \$920 mn.

I would like to separately address on such negative phenomena as **corruption in the bodies of powers** and fraud in the sphere of privatization. In many ways this problem was also conditioned by the shortcomings of the legislation in force at that moment. For example, till the end of 1997 the owner of the purchased property was considered such from the moment of signing a purchase and sale contract irrespective of whether he fulfilled investment conditions or not, which in a number of cases lead to new owners' failing to fulfill their investment commitments. Widely spread became the cases when the head of enterprises set up affiliates and re—registered the most liquid assets of the dominant enterprise in their name. As a result the rank-and-file employees actually became owners of knowingly lame-duck enterprises. And often the scheme of intentional bankruptcy of this enterprise was realized.

How it is difficult to fight crime in the sphere of privatization the following statistics provided by the Ministry of Internal Affairs of Russia show. Since 1993 thru 2003 almost 53 thousand crimes connected with privatization were identified. However following the results of investigation only some 11 thousand criminal cases were taken to court under which brought to responsibility a bit more than 1.5 thousand persons.

Estimating the overall efficiency of the privatization we again in accordance with directive No. 1 of the INTOSAI standards tried to take into account the **general historical context**. It won't be an exaggeration to tell that at that moment the power was in full paralysis which was conditioned by the collapse of the Soviet system and breakdown of the single state. In our Analysis we make a conclusion that the privatization as it was carried out had in many ways forced nature. Already since the late 80-es the spontaneous privatization began. By April 1991 over 3 thousand big enterprises had changed the form of ownership. Meanwhile the getting of control over property was carried outside legal environment, and sometimes by criminal methods. In such a situation the transfer to mass privatization based on formal procedures was an

attempt to stop spontaneous plant takeover and bring it into the course controlled by the power.

And it should be told that by and large this task was solved. The privatization became one of the **most important systemic-institutional changes in the economy of the country**. Within the historically record time Russia saw the formation of non-governmental sector of economy and new market institutions with a relative minimum of social conflicts. And if prior to 1987 there was no institute of private ownership as such in Russia, in 2003 77% of enterprises were private (Slide No. 7). All these years the number of the employed in the non-government sector of the Russia economy had been growing at a rather quick rate (Slide No. 8).

But the problem consists in that the radical changes in the structure of ownership took place so quickly that the quantitative changes simply had no time to lead to the desirable qualitative shifts. In our Analysis we were made to state that the formal denationalization and transfer of property control into private hands **had not led to the achievement of the officially declared goals** – the formation of efficient proprietors and creation of a socially oriented economy (Slide No. 9).

The Russian experience of privatization showed that the transformation of state-owned enterprises **did not guarantee in itself the enhancement of their operating efficiency**, it did not generate in mass order efficient proprietors and did not lead to the immediate growth of labor productivity (Slide No 10). The destatization of property is only one of the components of the more general process of the transformation of ownership relations. No less important task is the provision of the guarantees of the economic realization of new forms of ownership which is impossible without parallel implementation of other institutional transformations – the creation of a competitive environment and effective antimonopoly legislation, fair jurisdiction, developed insurance market and banking system, the formation of able small and middle business.

The Russian experience shows that the guaranty of the effectiveness of an enterprise's work is first of all **management which is qualitative and responsible to owners**. It should be noted that the low quality of management on the part of new

owners was determined not only by their insufficient professional training, but as well by the **absence of due motivation**. Often it was the former directors who became the owners of their privatized enterprises and who with pleasure disposed of their income and tried to write off the expenditures by force of habit to the state. In 90-es Russia saw the formation a sufficiently numerous type of unscrupulous private entrepreneurs, who regarded as a main source of their well-being not the increase of the effectiveness of the enterprises they controlled, but the further redistribution to their benefit of every new state-owned assets.

At the same time **the State itself failed to become a really effective proprietor**. Thus, a due control over management of the enterprises that remained to be in public domain was not established and in a number of cases these enterprises positioned themselves as independent undertakers. So far, it remains to be solved the problem of the efficiency of activities of government representatives in the bodies of management of the joint stock companies with government block of shares.

We had analyzed as well some **social consequences of the privatization** (Slide No. 11). They also turned out to be ambiguous. On the one hand, the chosen model of privatization permitted to prevent the explosive growth of unemployment. At the privatized enterprises the directors avoided in the framework of structural reorganization and recovery of economic activity to carry out mass dismissals of employees who simultaneously were the shareholders of their enterprises. The reverse side of the process was the slowdown of the rate of the structural reforms and the growth of “shadow economy”, as the considerable part of the economically active population was on the payroll at one place of work and got their basic income at another one.

During privatization the principle of equality of citizens irrespective of their place of employment was not also taken into account. The granting of privileges to work collectives while privatizing the state-owned enterprises resulted in the privileged position of the management and personnel of the high profitable enterprises of the primary industries of economy (for example, oil industry) and the neglect of the interest of the employees that worked either in low profitable or unliable to privatization

industries of economy (for example, social sphere). This circumstance became of the reasons of sharp social stratification in the Russian society, which still remains to be the most acute social problem.

I would like to mention another two negative social events caused by the privatization. The destruction of the considerable part of the social infrastructure which in the Soviet time was created and itemized on the balance of some enterprises took place. During the first phases of the privatization new proprietors were not burdened with the obligations to maintain and develop this part of the property complex of enterprises and that often led to the degradation of these objects. At the same time such an important task as initiating employees to the management of their enterprises was not successfully solved.

On the basis of the above said we think that the main direction of carrying out further institutional transformations in Russia must become **measures for a clearer division between the governmental and non-governmental forms of ownership**, and also the consolidation of both as the prime institutes of market economy. To strengthen the institute of private ownership we propose to realize the following measures **in the institutional sphere** (Slide No. 12). Here I would like to pay attention to the priority of the provision of inviolability of the rights of ownership of good faith purchasers without which it is impossible to form a really effective proprietor. For the economics of transition an extremely important problem is also demonopolization, a private monopolist is indeed more out of control than the public one.

Simultaneously we propose a complex of measures to **consolidate the regulating role of the State in the sphere of privatization** and management of state-owned property (Slide No. 13). We proceed from the fact that the State has to get rid of minority shareholdings in the capital of enterprises which do not refer to strategic ones and possess only what it can really manage. Given that I would like to especially underline the acute necessity of taking a physical inventory and creating a cadastre of the objects of public property. Regretfully, this seemingly elementary problem has not

been yet solved. The State is still in the position of a careless proprietor as it does not yet know in full measure what it really possesses.

We should also mention **the urgent problem of the improvement of the system of state financial control** in the sphere of privatization, implementation of the basic provisions of the INTOSAI standards in the part of providing an external control over all basic phases of privatization transactions, including the appraisal of privatized property. Especially as the considerable part of the national wealth has not been yet privatized. That is why we put the question of the necessity to take into account the regional distinctions and other features during the privatization of such socially significant resources as land, forest and water bodies.

Taking into account that the main violations which we identified were in a considerable measure conditioned by the shortcomings of **the current legislation we have prepared a number of proposals for its improvement** (Slide No. 14). As is seen they mainly refer to the prevention of such typical violations as the understatement of the cost of privatized property, fraudulent bankruptcies, insufficiently clear distribution of powers between the authorities of different levels during property privatization, unregulated condition of the matters of the privatization of the objects of social sphere. Given that I would like to pay special attention to the necessity of **legislative limitations on the participation of foreign investors** in the capital of strategically important enterprises. The pendency of this issue is a serious obstacle in the way of foreign investments.

Talking about **the concrete results of our work** I would like to stress that it cause a greatly wide response. We reported on its main provisions to the head of the state. In full accord with the fundamental provisions of the INTOSAI Lima Declaration we strived to act at most straightforwardly and placed the text of our expert and analytical action in the Internet and published a separate book. So interested citizens could and still can familiarize themselves with its content.

In whole its may be said that we have reached the task assigned. Our work permitted to present to the society the more or less objective picture. And this in its turn

afforded ground to establish the legal treatment of the results of privatization and completely close the issue of the possible revision of its results. In July 2005, i.e. about six months later after making public the results of our expert and analytical action the Parliament by the proposal of the head of the state introduced the amendments into the Civil Code, which reduce the statute of limitations on the transactions which may be hold invalid from 10 to 3 years. Taking into account that the mass privatization in Russia ended in the late 90-es, it means **legal impossibility to challenge the results of the most significant privatization transactions.**

At the same time **many our proposals on improving the legislation were brought into effect.** Thus, for example, a number of restrictions on land privatization were introduced. Quite recently, the Parliament on the recommendation of the head of the state forbade by law the possibility to privatize wood lots. Into the law on bankruptcy amendments are introduced which essentially restrict the possibility of carrying out fraudulent bankruptcies. In the nearest months the procedure for the participation of foreign investors in the capital of strategically important enterprises is to be approved by law. During the ongoing municipal reform the process of dividing the municipal and regional property is being systemized.

As is seen the Russian privatization though being unprecedented confirms many universal regularities and first of all the fact that the properly effective control in this field may be provided only by independent bodies of public financial control. And it must be an essential stimulus to expand international collaboration in the sphere of the exchange of the experience of conducting privatization audit with regard to the INTOSAI standards.

Thank you for your time

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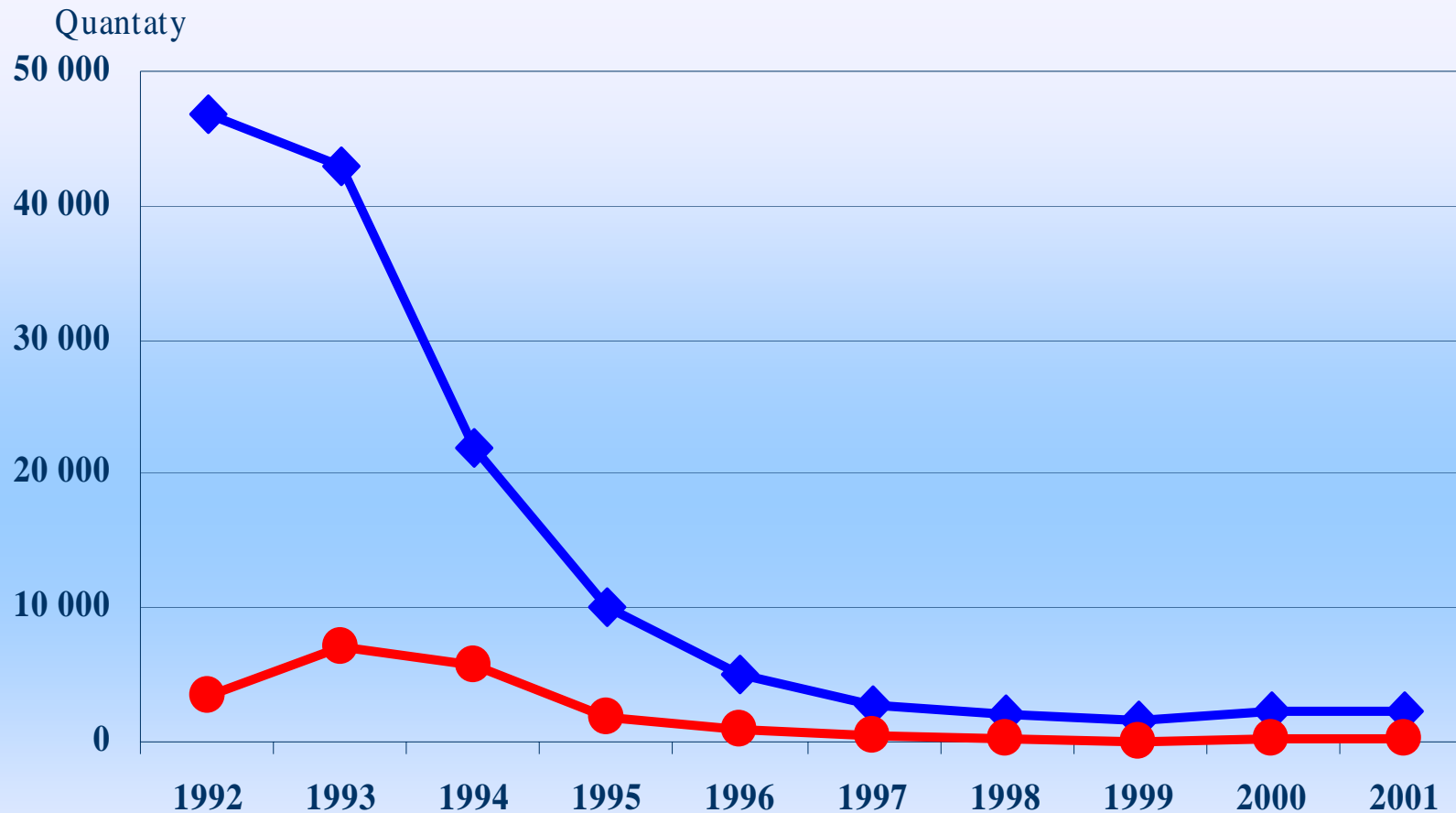
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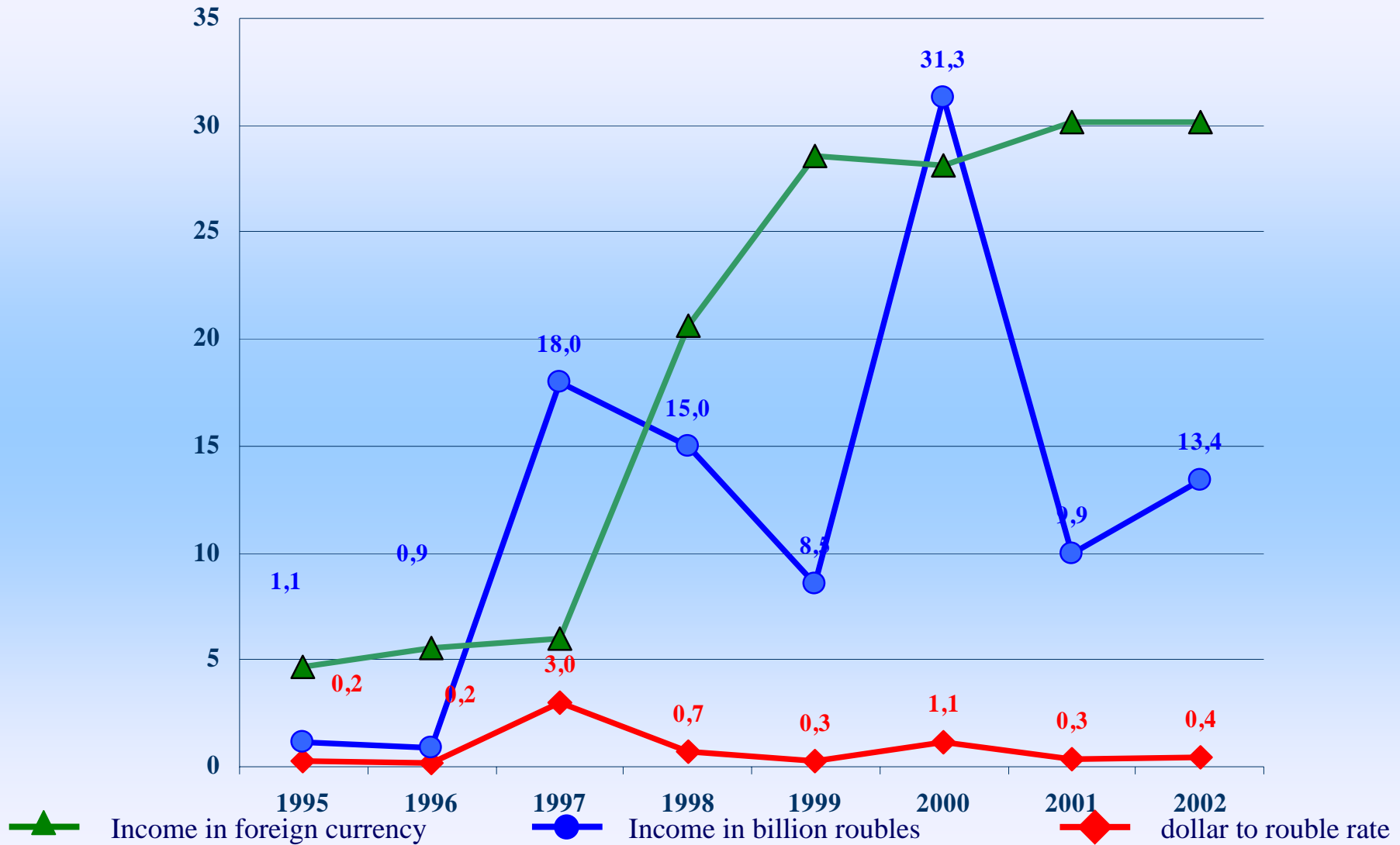
Dynamics of the number of privatized enterprises including enterprises in federal ownership



- ◆ - the number of privatized governmental and municipal unitary enterprises (objects) including:
- - in federal ownership



Income from Privatization of State-Owned Enterprises in 1995-2002





INTOSAI Directives on Providing External Control over Mass Privatization

Directive 24. State Investor Information

SAls shall control the process of public information on transactions realized within the program of mass privatization. The volume and quality of the educational campaign shall be sufficient so as a potential investor may take an adequate decision.

Directives 25. Intermediaries

SAls shall control the legality and adequacy of the control system of the activity of intermediaries – investment funds, trusts, and brokers, providing the management of private investors' stocks.

Directive 26. Process of Realization (Assets)

SAls shall control the key stages of the process of realization including the dissemination of information, procedure of price fixing, receipt of money, registration of property after sale, coordination of the listing of an enterprise's shares on a stock exchange with the corporate management.



Powers and Rights of the Accounts Chamber of the Russian Federation in the Sphere of Control over Privatization and Administration of the State Property in Accordance with the Federal Law “On the Accounts Chamber of the Russian Federation”

Determination of the effectiveness
and expediency of the use of federal property

Control over receipts to the federal budget obtained from the use
of the state property (including its privatization and sale),
and also from the administration of the objects of the federal property

Systematic analysis of the results of the audit made, generalization and study
of the reasons and consequences of the revealed deviations and violations



Subject of the Analysis, Objectives and Tasks of the Expert and Analytical Action

Subject of the analysis

The legal foundation and practice of the activity of the public authorities in privatization of the state property in 1993-2003

Objective of the expert and analytical action

The analysis of the processes of privatization in the Russian Federation during 1993-2003 with regard to the previous audits conducted by the Accounts Chamber of the Russian Federation and on the basis of the materials received from the state authorities of the Russian Federation at the request of the Accounts Chamber of the Russian Federation.

Tasks of the expert and analytical action

The analysis of the activity of the public authorities in the sphere of privatization of the state property in 1993-2003; examination of the reasons and consequences of the revealed deviations from and violations of law in the process of privatization; development of recommendations on the improvement of legal and institutional conditions of carrying out privatization at the current stage.



Most Characteristic Violations in the Process of Privatization

Shortcomings in the activity of the bodies of executive power (excess of power or vice versa the nonfulfillment of straight duties), which resulted in violating law during particular privatization transactions

Unjustified underpricing of the assets sold

Uncontrolled disposal of intangible assets and intellectual property

Simulation of tenders

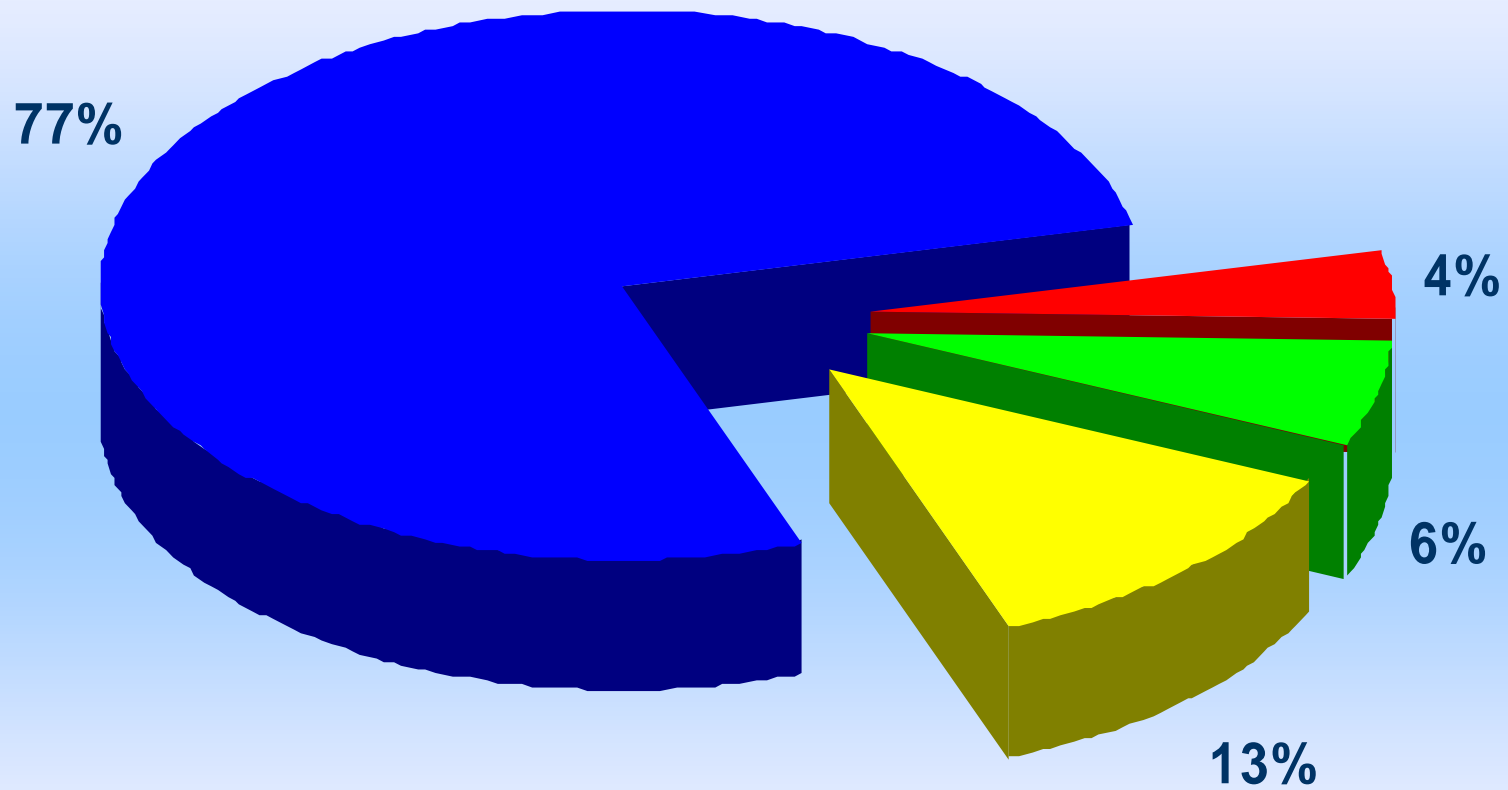
Low effectiveness of sales

Absence of external independent control over the pre-privatization preparation of state-owned assets and the results of privatization transactions

Corruption in the bodies of power, insufficiently effective countermeasures against crime in the sphere of privatization



Structure of Ownership in 2003

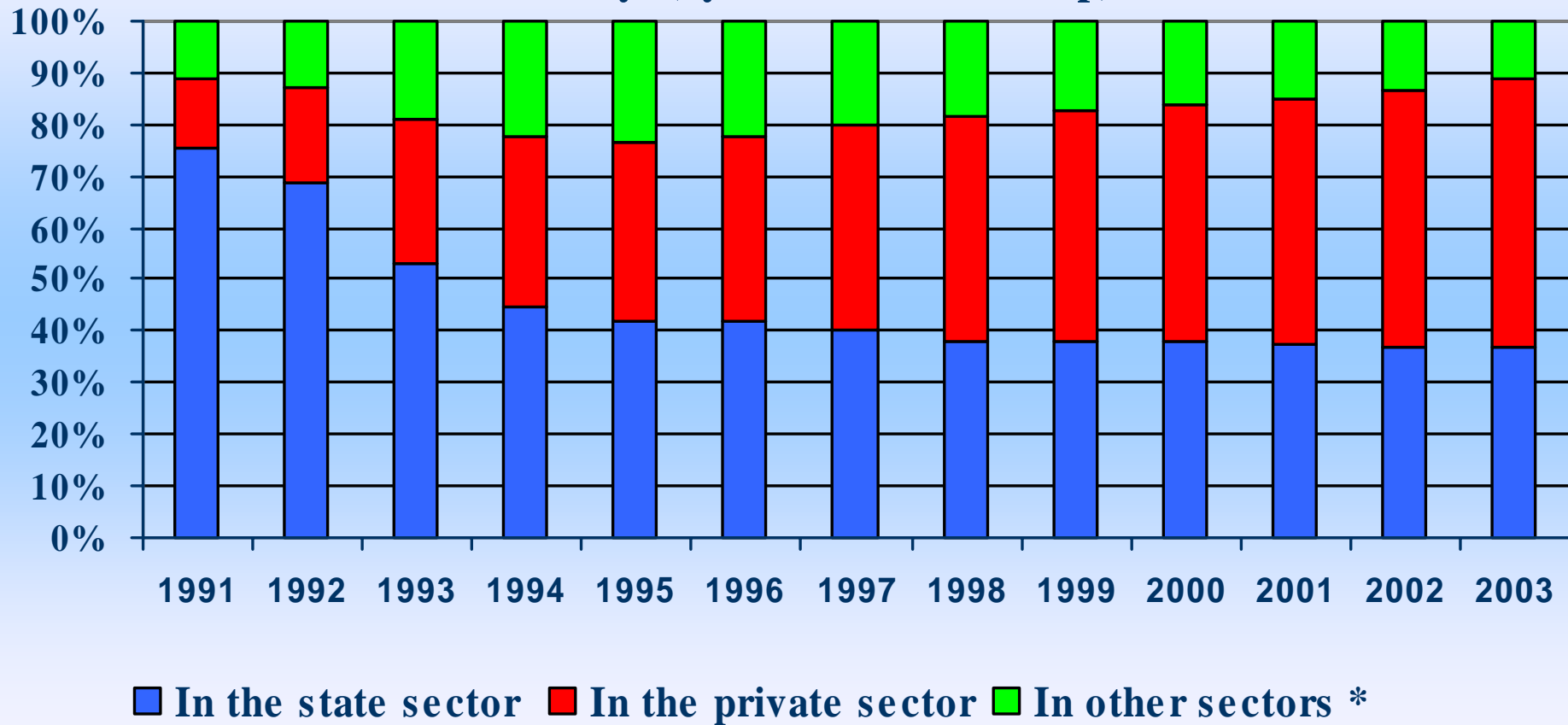


■ Private ■ State ■ Municipal ■ Other forms of ownership*



Dynamics of the Structure of Employment by Enterprises of Different Forms of Ownership

Ratio of the population employed in different sectors of economy (by forms of ownership)





Degree of the Achievement of the Officially Declared Goals of Privatization

A wide layer of effective private owner has not been formed

The restructuring of economy has not resulted in the desirable enhancement of the operating efficiency of enterprises

Investments attracted in the process of privatization were not enough for the industrial, technological and social development of enterprises

A number of industries failed to keep a competitive position of enterprises in the domestic and world markets



Problems Connected with the Formation of an Effective Proprietor in Russia

Rates of privatization outrun the other institutional reorganizations

Institute of ensuring the rights of minority shareholders
is insufficiently developed

Deficit of managers professional and loyal to customers

Deficit of the positive motivation of new proprietors to the long-term
development of enterprises

Insufficient institutional formulation of private and state property



Some Social Consequences of Privatization

Relatively low rates of growth of the officially registered unemployment

Sharp increase of the social differentiation of population

Degradation of the objects of social sphere registered on the balance of enterprises

Alienation of salaried employees from the process of property management



Recommended Measures in the Institutional Sphere

Provision of the inviolability of the rights of ownership of good faith purchasers to the privatized assets

Provision of publicity and transparency of privatization procedures

Development of the effective judicial system as one of the elements of the institutional provision of the guaranties of the observance of protection of the rights of ownership in the process of privatization

Development of effective corporate management based on the transparency of information on the work of an enterprise and observance of the international rules and standards of financial reporting and control

Utmost encouragement of the development of small and medium business and first of all in high technological fields

Activation of measures on the demonopolization of economy and tightening of the norms of the antimonopoly legislation



Recommended Measures on the Strengthening of the Role of the State in the Sphere of Privatization and Management of the State-Owned Property

Carry out physical inventory and create the single system of the government accounting of state-owned property, create the cadastres of federal, regional and municipal property

Reorganize the state shareholding management system, set up a specialized agency for managing these assets and the institute of government corporate managers

Provide privatization of the state—owned minority shareholdings in non-strategic enterprises

Introduce international standards in the field of providing control over privatization in all its stages

Take into account the regional specificity during the privatization of land, introduce restrictions on land privatization in border areas and on ecologically significant territories which are under special protection

Observe the principle of preserving forests and wooded lands which are in public domain



Recommendations on Modernizing Legislation in the Sphere of Privatization and Management of State-Owned Property

Introduce changes into evaluation activity laws with a view to take into account while evaluating the cost of state-owned enterprises intellectual property, brands, etc., intangible assets

Introduce changes into bankruptcy laws to enhance responsibility for the organization of fraudulent bankruptcies, usage of bankruptcies as a instrument of property redistribution

Adopt the special federal law on the order of the distribution of property into federal, regional, and municipal one

Prepare the special federal law on the special features of the privatization of the objects of social sphere

Establish legislative limitations on the scope of the possible participation of foreign investors in the capital of strategically significant enterprises

Make more rigorous by law the responsibility of the managers of enterprises for the untimely submission and improper keeping of corporate reporting