16948

Lessons

The World Bank FPD Note No. 4 April 1994

Mass Privatization Programs

Melinda Roth Alexandrowicz

Mass privatization is a viable alternative to conventional "case-by-case" privatization methods. Recent experience in eastern Europe and the former Soviet Union shows that mass privatization programs are an effective way to privatize large numbers of enterprises in a short space of time. In addition, because these programs have spurred the development of capital markets and therefore the ability to buy and sell shares of enterprises, in some cases mass privatization has proven to be effective in subjecting enterprises to the test and rigor of the market. The long run success of privatized companies will depend on many factors other than the way in which they were privatized. Nevertheless, initial success indicates that mass privatization programs, or some elements of them, may be applicable to a wider range of countries. For example, the Government of Bolivia has announced a "Capitalization Program" that uses the distribution methods of mass privatization schemes. This Note looks at key decisions in the design of mass privatization programs. The "supply-side" issues deal with the "bundle" of firms to be privatized. "Demand side" issues address the buyer side of the transactions. Country examples are illustrative and not comprehensive.[1]

The Supply Side

Choosing What to Privatize

Number and Type: Some countries have reserved mass privatization for larger enterprises, while others have opened it up to residential housing and small businesses, including shops and restaurants. In Russia, virtually all large and medium sized enterprises were included, unless they had fewer than 200 employees or were operating in a few reserved sectors. By contrast, in Lithuania and Moldova, assets such as housing were part of program.

Mandatory or Voluntary: Governments have to decide whether participation by specific enterprises should be mandatory or voluntary. There are obvious trade-offs. Making participation mandatory ensures privatization, but if weaker SOEs are included in a program, then the credibility of privatization could be damaged as citizens become dissatisfied with non-performing

1. A detailed paper comparing the mass privatization programs in the Czech and Slovak Republics, Poland and Russia is forthcoming from Ira Lieberman, Manager, Private Sector Development.

FPD
Private Sector Development Department
Vice Presidency for Finance and Private Sector Development

assets. (One way of mitigating this risk is to create financial intermediaries which allow citizens to diversify their portfolio holdings.)

There have been a variety of approaches. In the Czech Republic and Slovakia, for example, virtually all large SOEs must take part. However, the program gives these SOEs the right to establish their own privatization plans and allows competing plans to be put forward. This helps to keep the process "honest." Different methods of mass privatization have therefore emerged, including direct sales, auctions and tenders, and voucher sales. The Polish Ministry of Privatization adopted a multitrack approach to privatization, including trade sales, public offerings, liquidation and management contracts as well as mass privatization. The Polish Government recently negotiated a pact with SOEs allowing them to choose their own privatization track, so long as they did so within a certain time period. By contrast, in Kazakhstan all SOEs with fewer than 5,000 employees but more than 200 are included in the mass privatization program.

Selling Shares for Vouchers or Cash: Governments need to decide how important it is to generate revenue from privatization. The decision must involve a realistic assessment of available foreign investment and consider the strength of domestic purchasing power. To bolster domestic purchasing power, several mass privatization programs have distributed vouchers to citizens to enable them to buy shares in SOEs. The loss of revenue may only be short term, however. Mass privatization programs may facilitate enterprise restructuring and produce efficiency gains which can then enable the enterprises to contribute more tax revenues to the state budget over the longer term.

Retaining Shares: Governments may retain partial shareholdings to generate revenue from a later sale. Foreign investors might be ready to invest by then, or domestic investor demand may have strengthened. However, governments then have the expense of going through the privatization process twice. In addition, as a minority shareholder, governments may still interfere. The advantage of selling or giving away 100% of the shares of SOEs is that it completes the privatization process quickly.

Monopoly Issues: Most programs have a pro-competition or anti-trust review before privatization. This type of review is directed at monopolies or highly concentrated market structures to assess whether breakup is necessary. For example, in the Moldovan program, any enterprise which has a 35% or greater domestic market share must undergo review before it is auctioned. These reviews can slow down the privatization process, so governments may face a trade-off between speed and competition objectives. Free trade and open borders may eliminate the need for the reviews.

Environmental Liabilities: Environmental liabilities may affect whether or not enterprises are included in the programs. One complication arises from the mix of responsibilities between different layers of government. While mass privatization is a matter for national governments, environmental issues are typically dealt with regionally or locally. The Czech Republic and Slovakia have dealt with environmental issues in two ways. The national-level government either assumed historical environmental liabilities, or enterprises have been given to municipalities to privatize, with revenue earned by the sale then used by the municipality to cover the cost of clean up.

Preparing Enterprises for Privatization

Commercialization or Corporatization: Typically, before privatization SOEs must change their legal status to commercial companies. This new legal form allows the company to offer shares. It can provide a new model for corporate governance that will continue after the enterprise has been privatized. This model usually involves a board of directors (or a similar body), often initially appointed by the Government and then elected by shareholders after privatization.

Valuation: The valuation process is a politically sensitive issue and can impede privatization. Governments will not want to be accused of selling enterprises too cheaply, especially in the case of trade

sales to foreign investors. In eastern Europe and the former Soviet Union book value is often used as a starting price. However, book value is not usually an accurate indicator of a firm's market value. Many nominally healthy enterprises might also have negative value since a high proportion of their assets may be redundant or obsolete. Given the poor quality of financial information it is often better not to waste time and resources on valuation. Mass privatization programs address valuation issues by distributing enterprises without trying to value them, as in Poland, or alternatively by letting markets determine enterprise values in auctions, as in the Czech and Slovak Republics, Lithuania, Mongolia, or Russia.

Selling Mechanisms

Most countries have used some form of an auction to sell enterprises. Auctions can involve bidding with cash or vouchers by citizens directly or through specially created financial intermediaries. The Czech and Slovak program used a central auction process requiring five rounds of bidding in the first wave of privatization. Regional voucher auctions have been used in Moldova and Russia, although a central auction center exists in Russia for the largest companies. In Poland, financial intermediaries will choose the enterprises in which they will have a lead shareholding through a "football draft" type of model.

The Demand Side

Vouchers[2]

The distribution mechanism in mass privatization programs has often involved some kind of voucher, although vouchers are not an inherent requirement for mass privatization. Vouchers are certificates or scrip which are distributed to the population and convertible into either shares of SOEs through some form of an auction or shares of financial intermediaries which will, in turn, own an interest in and manage a portfolio of SOEs. Vouchers address the problem of low domestic purchasing power. Where little domestic capital could be mobilized, or where the existing capital has been deemed to be illegally gained, the voucher concept has offered a mechanism for widespread participation by the population.

Financial Intermediaries

Role: Financial intermediaries participating in mass privatization perform several important functions: they help to diversify risk by providing a fair investment opportunity for an unsophisticated population; they help to develop institutional investors and a functioning capital market; and they help to solve the corporate governance problems arising from widely dispersed shareholdings. In some countries financial intermediaries have developed spontaneously. For example, in the Czech and Slovak program, Investment Privatization Funds (IPFs) were created by private firms, state-owned banks and joint stock companies. The IPFs collect voucher points from the public and invest them in shares. Because of the significant dividends and returns initially promised by many IPFs, the popular interest in the program greatly increased. However, in the Polish program, participating financial intermediaries will be chosen by the Polish Government. The Polish program is designed so that the National Investment Funds (NIFs) can act as agents of change and restructure the companies in their portfolio. One objective is to diversify individual risk by initially having citizens hold shares in NIFs rather than in SOEs directly.

Regulations: The structure and rules of the game are important for effective financial intermediaries. Initially the Czech and Slovak IPFs were subject to only limited regulation based on the rules covering their establishment or from ad hoc government decrees. These limited regulations were insufficient. IPFs did not typically provide a full prospectus with complete disclosure of their capital stock, personal histories of the boards of directors and descriptions of operational charges. There were conflicts of interest in some cases. Therefore, in April 1992 the Parliament enacted the Law on Regulation of IPFs. The provisions

2. A separate Note 5 on vouchers prepared by Melinda Roth Alexandrowicz will be published shortly.

included a disclosure rule, diversification requirements, prevention of conflicts of interest, and rules regulating operations. These provisions were not applied in time for the first wave of privatization. Ironically, the absence of regulations, which allowed the IPFs to promise lavish returns, contributed to the success of the voucher program.

Mechanism for Governance

Mass privatization programs may lead to a widely dispersed ownership structure, creating a potential vacuum for corporate governance. In the Mongolian Ulaanbaatar Hotel privatization, for example, there are almost 13,000 shareholders, with the largest shareholder owning 269 shares out of 335,297 issued (or .07% of the company). Such diffuse ownership will likely result in the inability to effectuate change.

Without a proper corporate governance structure, privatization might become nothing more than a legal change of status for the company. The Russian program is a case in point. Although it has been successful in rapidly privatizing a significant number of enterprises, most privatized enterprises are now owned and/or controlled by insiders. Investment funds in Russia are limited to owning no more than 20% of the shares in any one enterprise. Therefore, investment funds are somewhat limited in their influence in forcing managers to restructure.

Some governments have encouraged concentration of ownership through financial intermediaries or investment funds. The Polish mass privatization program was designed with this in mind. One investment fund will take a "lead shareholding" of 33% of the shares of an enterprise while the rest of the investment funds would hold equal minority shareholdings in the 27% of shares that remain after the employee and the Government holdings are taken into account.

Worker/Management Incentives

Many countries have provided incentives to employees and managers to participate in privatization. Typically, workers either receive some portion of shares free of charge or at a discount or, they often have a closed subscription in which they have the first rights to purchase a certain amount of shares. In Russia, employees have a choice of three options, all of which contain substantial incentives. The most popular option enables them to purchase 51% of the shares in a closed subscription at a multiple of book value (not adjusted for inflation and hence likely to be severely undervalued). Employees can also purchase shares in the voucher auctions to the general public. By contrast the Czech and Slovak program did not favor workers above the general population.

Conclusion

There are a few early lessons to be drawn from mass privatization. Results from eastern Europe and the former Soviet Union suggest that the privatization process should be as decentralized or "bottom up" as possible. This will allow both competition and enterprises to be involved in their own destiny. The development of financial intermediaries should be encouraged but adequate regulation to protect investors should be in place first. Setting deadlines for completion of mass privatization programs is also useful. Even if deadlines are missed, the impetus remains to push the program to closure.

Public relations campaigns to educate the public about privatization in general and about specific selling mechanisms, such as vouchers and financial intermediaries, are an important part of successful mass privatization programs. In addition, privatization must be linked in the public's perception to the overall transition to a market economy.

Melinda Roth Alexandrowicz, Finance and Private Sector Development, The World Bank

This series is published to share ideas and invite discussion. It covers financial and private sector development as well as industry and energy. The views expressed are those of the author(s) and are not intended to represent an official statement of Bank policy or strategy.

Comments are welcome. Please call FPD Note line to leave a message: 202-458-1111. Suzanne Smith is the editor and production manager. Her address is Room G8105, The World Bank, 1818 H Street, NW, Washington, DC 20433.