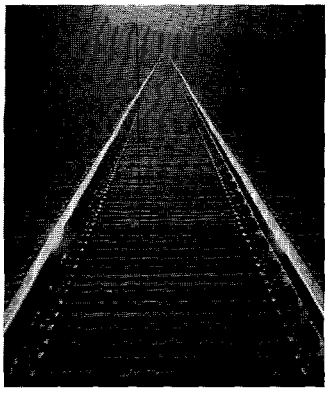
Viewpoint

The World Bank FPD Note No. 31 November 1994

Privatization by Capitalization

The Case of Bolivia: A Popular Participation Recipe for Cash-Starved SOEs

Andrew Ewing and Susan Goldmark



As presidential candidate Gonzalo Sanchez de Lozada ("Goni") was preparing his campaign for Bolivia's 1993 elections, he faced, on the one hand, popular pressure for faster tangible results after a lengthy spell of economic stabilization policies and, on the other, a popular anxiety about certain remedies. While minister of planning in the reform-minded government of the mid-1980s, he had used "shock therapy" to help bring hyperinflation under control. Now, eight years and two governments later, the economy was stable, but hardly growing. Most Bolivians were still very poor, struggling with the region's lowest literacy rates and high infant mortality. Only double-digit rates of growth could make rapid headway. Privatization was one obvious answer. The state was still very much the key player in important sectors such as mining, hydrocarbons, and public utilities. These operations were generally perceived as being inefficient and, in some cases, corrupt. But Bolivians were suspicious of privatization. They feared it meant a loss of jobs, a loss of the nation's patrimony, and a return to (probably Yankee) imperialism.

Then the campaigning president-to-be noticed the popularity of Eastern Eu-

What is capitalization?

Capitalization is privatization with the distinguishing feature that the sale proceeds stay with the company to finance future investment. If, for example, the net fixed assets of an electricity company have a market value equivalent to US$100 million, a strategic investor would pay US$100 million into the company. The company would now be worth US$200 million: US$100 million of fixed assets and US$100 million of cash. In the Bolivian model, a popular participation feature is added: the government share of this new company would be distributed to the Bolivian people. This approach to privatization can mitigate some of the popular doubts about traditional trade-sale privatizations. Also, leaving the proceeds with the company helps to solve the shortage of cash for working capital and investment that commonly afflicts popular participation schemes in Eastern Europe. The approach seems to be relevant in situations where:

- The asset for sale is likely to be of interest to a strategic investor.
- The government can afford to give up the direct proceeds of the sale.
- Popular participation may help avoid political backlash.
- The sector needs significant new investment.

The Bolivian model has some way to go before its performance can be judged. Nevertheless, the approach is interesting enough to warrant the "mid-term" assessment provided in this Note. When and if its success has been clearly demonstrated, the Bolivian model will likely be adaptable for use in other economies.

FPD

Private Sector Development Department

Vice Presidency for Finance and Private Sector Development

Public Disclosure Authorized

rope's voucher schemes for popular participation. He read about the problems eastern Germany's privatization program was having with its leveraged management buyouts. Though these buyouts gave enterprises new managers, the managers had no capital for investment. Combining the appeal of popular participation with the new feature of retaining the buyers' payment in the business, he produced the unique Bolivian model of capitalization. And thus in May 1993, he announced his campaign strategy, "Plan de Todos." The Plan de Todos (loosely, plan for everyone) proposed a simple privatization model for six large state enterprises in key sectors. The enterprises would be offered for sale by international tender. The successful bidder would pay the agreed price not to the government, but into the company itself, doubling its net worth. The cash would be used for investment in the sector, stimulating expansion and efficiency improvements together with job creation. Initially, the strategic investor and the government would hold equal, 50% stakes in the new company. In the original Plan de Todos, the government would immediately *give* its share in equal parts to all adult Bolivians—about 3.2 million people. When this process was done for all six sectors in the plan (telecommunications, electricity, oil and gas, railways, aviation, and parts of mining), about US$2 billion of shares would have been distributed to Bolivian adults and about US$2 billion of new funds would be available for investment by the now privatized Bolivian companies. In addition, the government figured that these funds would allow the privatized companies to leverage another US$6 billion or so of debt, if necessary.

Sanchez de Lozada won the presidential election in July 1993. With the help of World Bank advisors, he has been working to make this capitalization concept a reality.

Special capitalization issues

While the process has been moving along fairly well since then, it has run into many of the thorny issues associated with traditional privatization schemes—sector reorganization strategies, the legal framework, and regulatory considerations (see box on page 3)—and a unique set of capitalization challenges. Aside from the general worry about how a relatively impoverished government can afford to give up the revenues from privatization, the key capitalization issues are:

- How will a strategic investor with only 50% of a company's stock be assured of sufficient control over the company to warrant the investment?
- In the short term, what restrictions will be put on the company's use of the new investor's funds deposited in its accounts?
- If the longer-term purpose of these funds is to facilitate investment in the company and sector, how will this be spelled out, and what sanctions will be applied if the investments are not made?
- How will "all adult Bolivians" be identified? Many Bolivians live in quite isolated areas, and there is no tradition of citizen registration.
- What form will the distribution take?
- Who will safeguard Bolivian citizens' interests? In particular, what is to stop the new majority shareholder from "ripping off" the minority shareholders?

Giving up the revenues

Sanchez de Lozada believed that the privatization revenues would do more for ordinary Bolivians if these funds were under the control of private owners of newly capitalized firms. He had two reasons. First, he thought this would lead to more investment and more new jobs and that eventually the budget would benefit from larger tax streams. Second, he had misgivings about how the government bureaucracy would use the money. He was afraid that large flows of privatization revenues in the hands of the bureaucracy could contribute to more inefficiency and possibly corruption.

Early shift to pension fund mode

Fairly early on, the government decided that giving ordinary shares in six companies to over 3 million Bolivian citizens would create enormous logistical problems. So instead, it decided to use the shares to endow "pension accounts" that would be set up for each adult citizen. The pension accounts would be managed by a number of competing private pension funds. While the capitalization law passed in early 1994 specifically linked the citizens' participation to a pension-based model, none of the infrastructure for this scheme is yet in place.

Investor interests and obligations

A 50% stake in a company is usually enough to ensure management control. However, to avoid any uncertainty and the risk of a negative impact on the selling price, the capitalization law proposes that a management contract be given to the strategic investor for a fixed period of time. After that time, the investor would be able to buy shares in open markets to increase the shareholding beyond 50%.

When the buyer takes over the company, cash balances will be more or less equal to what the buyer paid for it. Potential investors have been quick to see the advantages of taking over a company with a

Traditional privatization issues

After first passing a "capitalization law" to provide a legal basis for the transfer of ownership, the government established a strong Ministry of Capitalization in March 1994. A fairly standardized approach was developed for each of the six sectors. Working groups were set up comprising government officials and senior officers of the affected companies, supplemented with foreign consulting expertise where required. The working group has to develop a strategy for reorganizing and privatizing the sector, and then draft whatever legislation would be necessary to make it happen. Technical, legal, and financial advisors and investment banks would be brought in to help get the transactions done. A series of IDA-financed operations is assisting in this process. The most important is an adjustment operation, financed jointly with the IDB. This operation is designed to help the government cover the loss of transfer payments from the oil and gas and other sectors until proper tax systems can be put in place to restore these revenues. It will also look at possible debt rescheduling and separation payments as companies are prepared for sale. Supporting technical assistance operations are also under way.

The government has recently passed a law to regulate consumer-oriented and competitive parts of the electricity, communications, hydrocarbons, transport, and water sectors. Under the new law, separate "superintendencies" will be established for each of these sectors, but they will all be grouped together under a "general superintendent" in a comprehensive single regulatory agency, with common appeal processes. As of November 1994, achievements and further objectives are briefly as follows.

Plans for capitalizing the *electricity* sector are the most advanced. The separation of generation from distribution and transmission will take place, and generation will be divided into three separate companies. Generation and transmission units will be offered for sale in separate "capitalization" transactions. Investment bankers have been retained, and sales should be taking place in the first quarter of 1995.

Progress in *telecommunications* is also well advanced. Here the situation is complicated by the fact that although a single state-owned company (ENTEL) has a monopoly on long-distance and international telecommunications traffic, local service is in the hands of twenty-odd local cooperatives. The reorganization solution that has been accepted will see the newly capitalized ENTEL make firm commitments to invest in the expansion of the seriously underinvested local networks. The cooperatives will have the option of either merging with the new company or competing in the provision of local telephone services.

Oil and gas is the most complicated sector, and the capitalization strategy is still evolving, with major questions remaining about how (or even whether) YPFB, the dominant state-owned oil company, should be broken up prior to capitalization. Strategic and legal issues should be settled in the next few weeks, and capitalization transactions in the oil sector are expected by mid-1995.

The *railways* sector is also complex. There are two main rail systems, but they interconnect in Argentina, not Bolivia. One of the systems is reasonably profitable; the other probably is not. Some operations effectively get subsidies because they do not pay their taxes. How to organize the railways' assets for capitalization and what to do about subsidized operations have proved to be the hard issues. Mid-1995 is the target for initiating capitalization transactions in this sector.

The previous government had already tried and failed to privatize the national *airline* (LAB). The working group is hoping to stimulate wider interest by proposing that interested investors may capitalize the airline all or in part with aircraft rather than cash. Also included in the sector plan is the privatization of airports and services. Major transactions in this sector are expected in mid-1995.

Capitalization of the *mining* sector is being limited to a relatively small number of industrial smelters. These will be offered for sale with long-term mining leases designed to secure ore supplies while not violating constitutional bans on the sale of mining properties. Various groups of mines and processing units are being considered; it is expected that the first transactions will take place around mid-1995.

healthy and liquid balance sheet. Assuming that an agreed investment program is part of the sales contract, and since planning for capital investment has a lead time, the new owner will, in the meantime, be able to manage these balances as for any other prudent company, with short-term, low-risk investments within or outside of Bolivia. Enforcement mechanisms or sanctions to ensure that the investor delivers on the "agreed" investment plan will be developed for each sector on a case-by-case basis. Local telephone services, for example, are so underinvested that it will be easy to follow the approach adopted in other telecommunications privatizations—numerical regional targets for new installations. The general approach will be to create a climate where investment by a company in its own sector will be a logical and profitable option, making sanctions unnecessary. Contractual obligations will be clearly spelled out at the time of the transaction.

Popular participation issues

Having decided to take the pension account route, the government must now grapple with preexisting financial problems in Bolivia's pension scheme. The government is hoping to solve them in parallel as new rules are developed for capitalization. Clearly, it will be important to ensure that the new pension scheme is not "contaminated" by the old problems.

A citizen registration scheme for the pension accounts based on voter registration is under way. But Bolivians—particularly those already past retirement age—still do not know when and in what form they can expect a "payout" from the scheme—for example, whether it will be in lump sum or an annuity. The first capitalization transactions will almost certainly happen before the pension scheme is fully in place. In the interim, the government needs to settle what will happen to the citizens' shares in the period between capitalization and the establishment of a private pension industry. Who will look after the citizens' interests during this interim period? Who will be the investors' partner? And what share voting rights will this partner have? The current plan is to place these shares "in trust," with the trustee's voting rights limited to a few major categories of decision. This would seem to be a workable and equitable solution, one that would allow time to develop proper answers to the pension scheme questions while not prejudicing the success of capitalization transactions or the rights of the Bolivian people. The final decision will be made within the next few weeks, before any capitalization transactions are concluded.

Finally, with major multinationals as the likely strategic investors, and yet-to-be-established pension funds as the Bolivian people's representatives in the capitalized companies, who will look after the people's interests in the longer term? The safeguard system is still being developed. At this stage it is proposed that even during the period when capitalized companies are being managed by strategic investors under management contracts, the articles of association will require, for certain decisions (for example, related to the disposal of assets or to major capital investments), a "super majority" of shareholders, ensuring that the pension funds represented on the boards of directors of the companies are given a meaningful voice in important strategic decisions. Second, the new pension fund law now being drafted will closely control what pension funds can do with the resources entrusted to them and give strong regulatory powers to pension fund regulators. Eventually, the pension funds, and Bolivian citizens, will be able to trade stock in capitalized companies on the Bolivian stock market as well as in international markets. Although the local stock market is barely regulated as yet, new laws and regulations should improve the situation.

Andrew Ewing, Manager, Private Sector Development Department, Susan Goldmark, Private Sector Development Specialist, Latin America and the Caribbean Country Department III

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 authors and are not intended to represent an official statement of Bank policy or strategy. ♻ Printed on recycled paper.

Comments are welcome. Please call the FPD Note line to leave a message: 202-458-1111; or contact Suzanne Smith, editor, Room G8105, The World Bank, 1818 H Street, NW, Washington, DC 20433, or Internet address ssmith7@worldbank.org.