Privatization through broad-based ownership strategies
A more popular option?

Stuart Bell

The urgent need to privatize a large number of state-owned enterprises (SOEs) in an equitable manner led to the development of voucher-based mass privatization programs in Central Asia, Eastern Europe, and the former Soviet Union. Nonvoucher variations of these privatization programs that pool equity distributed to citizens have emerged in countries as diverse as Bolivia and Zambia. Many other countries have used discounted public offerings to elicit worker participation in privatization or to achieve wide ownership of privatized firms. These three basic techniques for achieving broad-based ownership—voucher-based programs, collective investment programs, and public offerings—offer political and social advantages over more traditional privatization methods. They also should contribute to the development of capital markets. Variations of these strategies are now being applied in some of the least developed countries and may help to “jump start” their stalled privatization programs.

The case for broad-based privatization strategies

Politically popular
Broad-based ownership strategies aim at spreading share ownership to the population at large or to specific subgroups (such as the poor or an ethnic minority). Where privatization is stalled because of a general perception that it benefits only the powerful few or foreigners, popularizing share ownership provides policymakers and legislators with the “political cover” necessary to push contentious reforms through resistant legislative bodies. And because broad-based ownership leads to greater public participation in the privatization process, it reinforces support for and sustainability of the reform agenda.

More redistributive
Unlike traditional privatization methods (such as trade sales), broad-based ownership schemes allow governments to address concerns about the distribution of wealth. Redistribution can be accomplished by issuing vouchers (the number or value of which may vary with the recipient’s age or years of work), by offering discounts on shares, or by limiting participation in collective investment schemes to low-income groups. For example, Malaysia used a collective investment scheme to redistribute wealth to members of an ethnic group that was economically “underrepre-
sented.” In the Republic of Korea, where public offerings were used, low-income groups were eligible for deep discounts on share purchases. The effect of vouchers on incomes has been substantial. In the Czech Republic and Mongolia, for example, the market value of vouchers received by each participant was about half the annual per capita income.

**Helps capital market development**

Many of the least developed countries cannot use public offerings because of weak or nonexistent capital markets. However, broad-based ownership strategies can play an important role in developing and deepening capital markets and associated institutions. These strategies introduce the average citizen to share ownership and help to encourage a trading, savings, and investment culture. Voucher-based programs typically involve the establishment of mutual funds, which offer risk-averse citizens the opportunity to invest in diversified portfolios. Share sales and trading between these funds start the process of secondary trading in equity markets. Later, initial public offerings of state-owned equity can be an effective means of deepening capital markets.

**Voucher-based programs**

Voucher programs—adopted in the Czech Republic, Moldova, Mongolia, Romania, and Russia, among others—are attractive to policymakers because they can simplify and accelerate the privatization of large numbers of SOEs, many of which might be unattractive to strategic investors. Although vouchers started out as a tool for mass privatization programs, they can also be used in other kinds of programs. For example, vouchers can be used where there are compelling social and political reasons to distribute ownership widely or to target the benefits of privatization to disadvantaged segments of the population. Estonia is looking at trade sales with voucher auctions.

Voucher-based programs involve the distribution of certificates, or coupons, to participants, who then exchange these vouchers for shares in individual SOEs or for shares in financial intermediaries (voucher funds). These intermediaries, in turn, bid their accumulated vouchers for shares of SOEs. In most cases, vouchers can be freely traded for cash.

Voucher-based programs may involve different types of financial intermediaries. Typically these intermediaries are unit trusts, although several voucher programs employ investment trusts for start-up purposes and plan to transform them into unit trusts once they complete the initial stage of implementation. It is hoped that financial intermediaries will play an important role in the restructuring and governance of newly privatized enterprises.

Vouchers will work best where voucher distribution and trading centers are easily accessible and where there is a competent administrative system capable of carrying out the distribution and registration. Weak institutional capacity makes implementation of a voucher-based program difficult—although massive amounts of technical assistance have enabled Russia and Mongolia to implement successful programs despite weak institutions.

A stock exchange is not a prerequisite for a voucher-based scheme. In fact, the development and deepening of capital markets often is an important byproduct, if not explicit objective, of such programs. However, once vouchers are converted to shares in either a financial intermediary or an SOE, market liquidity is essential if investors are to be able to buy and sell freely. Liquidity is best provided by a well-functioning stock exchange through which brokers may sell shares held by individuals and fund managers may shift and develop their portfolios. Even where a stock exchange exists, however, market shallowness may limit the trading opportunities available to a fund manager and, as a consequence, constrain shareholder exit from the fund.

**Collective investment programs**

Collective investment programs include investment trusts and privatization trust funds endowed with government-owned equity (Zambia), pension schemes funded from the earnings of SOE shares (Bolivia), and non-voucher-based unit trusts (Malaysia). These collective programs differ from voucher-
based programs in two respects. First, they do not necessarily involve distribution of paper vouchers and, as a consequence, are simpler to administer and typically require fewer resources to implement. Second, participants usually are not allowed to freely enter and exit the schemes. In a privatization trust fund, citizens do not individually own shares in that fund or any of the underlying assets. Instead, the assets are collectively owned and held for the benefit of current and future citizens. There is thus no immediate direct financial gain for participants. In cases where privatized equity capitalizes pension schemes, participants can gain access to their share of the fund only through retirement or illness. Policymakers usually will choose collective investment programs when capital markets are particularly weak and constrained, there is little or no understanding of share ownership, there are cultural barriers to individual accumulation of wealth, there is a low level of literacy, and there are logistical constraints, such as a highly dispersed population that is difficult to reach. These conditions mean high transaction costs for secondary share trading. Therefore, a collective scheme that limits entry and exit (an investment trust, for example) may be preferable—or preliminary—to a voucher-based approach. As in Malaysia, collective investment programs can take the form of special unit trusts aimed at increasing the representation of low-income or disadvantaged ethnic groups in an economy. Zambia, with World Bank support, also is taking this approach. It is using a privatization trust fund as a “warehouse” for enterprise shares pending their sale through public offerings or other means. Trustees of these institutions sometimes actively oversee enterprise management and undertake restructuring activities. Though all eligible citizens are “owners” of the shares, they are owners in name only. Citizens derive no immediate tangible benefits under these arrangements: they receive no share of the proceeds or dividends. But they may benefit at some future date from discounted public offerings of the trust fund portfolio. The attraction of privatization trust funds stems from their usefulness as an institutional vehicle for moving SOEs from government ownership to supervision by profit-minded trustees until they can be successfully privatized.

**Public offerings**

Public offerings of SOE shares have been used by many developing countries as a way to achieve widespread share ownership. Jamaica, Korea, Morocco, Nigeria, Sri Lanka, and Tunisia, for example, have all chosen this strategy.

To be successful, public offerings require a well-functioning and absorptive domestic capital market. SOEs best suited for public offerings need to pass a few basic tests:

- They should be legally formed as joint stock companies.
- There should be no major financial weaknesses, planned restructurings, or imminent calls for more equity through rights issues.
- The enterprise and the percentage of shares offered should not be so small that a flotation is uneconomic or not possible under local market conditions and stock exchange regulations.
- The size of the issue must be within the absorptive capacity of the local market.

**Avoiding “orphans”**

One of the most frequent criticisms of broad-based ownership schemes (particularly voucher programs) is that enterprises risk being “orphaned.” That is, ownership can become so widely diffused that there will be no dominant owner to compel good management. The best way to ensure effective corporate governance is to reserve a majority of shares for a core investor. The remainder can be broadly distributed. When a majority of shares are exchanged for vouchers, the political and social benefits associated with broad ownership may come at the cost of some of the economic benefits associated with more concentrated ownership.

Concern about corporate governance has led many governments to build better governance-promoting measures into their voucher programs. They have offered incentives to financial intermediaries to assume this task—at least until secondary trading of
shares can secure the needed core investor. Both the Czech Republic and Russia allowed private financial intermediaries to exchange vouchers for fund shares in the expectation that these funds would accumulate large blocks of enterprise shares and pressure enterprise managers to adopt more efficient practices. This process has been more successful in the Czech Republic than in Russia. In Russia, managers had more political influence over the program design and succeeded in securing large equity stakes in their enterprises. These stakes shield them from outside influence. In contrast, the government in Poland will itself create ten “national investment funds,” hire experienced staff to manage them, and administratively allocate enterprise shares to the funds. Every enterprise will have a “lead fund” that holds 33 percent of its equity, and the nine other funds will each receive 3 percent of that enterprise. Although this strategy has been touted as a more proactive way to address the problem of corporate governance (pending secondary trading of shares), there is a risk that these state-owned funds will fall prey to political interference and prove incapable of imposing restructuring programs on the enterprises. In the end, the most efficient way to achieve effective governance is through the market—by selling shares in response to declining earnings and takeover threats. Secondary trading of enterprise shares is therefore crucial to the success of privatization in general, and broad-based ownership strategies in particular.

This Note is drawn from the author’s paper of the same title, soon to be published as a World Bank Discussion Paper.

Stuart Bell, Private Sector Development Department