

# Viewpoint

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## Finding Real Owners—Lessons from Estonia's Privatization Program

John Nellis

The Estonian government has quickly privatized more than 90 percent of its industrial and manufacturing enterprises. The Estonian privatization agency, following the approach devised by the German Treuhandanstalt (former staff of which advise the agency), batches thirty to forty firms and advertises them for sale. The prime goal is to find "real owners" capable of running a durable, productive firm. Purchase offers are thus judged not only on price, but also on the quality of business plans submitted, particularly with regard to expected investment and employment creation. Winning bidders negotiate contracts formalizing their commitment. No special concessions are made to workers and managers in the affected firms, but they can and often do submit a bid and a business plan—and they have won the competition in some thirty cases.

In seventeen sales (with more in progress), the Estonians have combined strategic investment with voucher exchanges, a mix beyond the reach of most other transition economies. And now Estonia is addressing, earlier and more comprehensively than most other formerly communist countries, the complicated issue of involving the private sector in the provision of infrastructure services.

So far, allegations of corruption and insider dealing—though not absent—have been fewer than in most other transition economies. And although a fair number of sales have been to foreign buyers, there has been little political protest.<sup>1</sup> Many observers thought that a transition economy could not handle a privatization strategy as politically risky and as administratively intense. But the Estonians have proved them wrong.

### Progress

By November 1995, the Estonian privatization agency had concluded more than 400 sales contracts for medium-size and large industrial firms or parts of firms.<sup>2</sup> These sales generated about US\$200 million in direct receipts—though much of this is being paid in installments. Purchasers contracted to invest an additional US\$160 million in the divested firms and assumed at least US\$130 million in liabilities. The privatization agency estimates that the sales created or maintained some 49,400 jobs—a significant number in a country of 1.5 million people. Besides infrastructure firms and a couple of particularly difficult industrial cases (oil shale and alcohol firms), there is not much left to privatize.

### Small-scale privatizations and "leftovers"

More than 90 percent (over 1,100) of the small business units and assets in Estonia have been divested through auctions, raising some US\$23 million. This process is regarded as substantially complete, since the remaining items appear to be of little interest to investors. "Leftovers"—unsold assets or parts of businesses resulting from the tender method of sale—are constantly being created. Many have been divested, but several with severe financial or environmental problems are not moving and may never be sold. Experience has not yet yielded a hard and fast rule on how long to try to sell businesses before giving up and liquidating them. Some have been sold even after a long stay in the leftover category. A good solution would be for the privatization agency to set a "normal" period of sale—say, one year from tendering—after which liquidation would start.





### Contract control

With 400 concluded contracts, the privatization agency's postsale supervision process is being formalized. The agency reports no problems with investment and employment promises but does have problems with installment payments of the purchase price.<sup>3</sup> In December 1995, the agency said that seventy buyers were having difficulty in meeting their payment schedule. Only once has the agency repossessed a firm when the buyer failed to make payments. In effect, the government is unwilling to renationalize on a large scale or declare the new private firms bankrupt. While still insisting on the need for payment of the obligation, controllers often give the new owners more time. Given these generous enforcement and supervision practices, would it have been preferable to maximize the purchase price and omit nonprice criteria? Agency officials say no; they view investment and employment commitments as legitimate, given the short time horizon of so many investors in the region.

### Public offerings and use of vouchers

Two large and fifteen small "combination" sales have been concluded. These sales combine partial purchase by a strategic core investor with divestiture of a minority of equity through a public offering limited to Estonians, who exchange vouchers for shares. In the two large sales, investment funds reportedly contracted with individuals to use their personal vouchers to buy shares and then to sell their shares to the funds. Share prices were fixed, and both offerings were oversubscribed. Concerns have been expressed that the investment funds, acting in concert, gained a significant ownership stake cheaply, and concentrated ownership excessively, defeating the goal of promoting diffused shareholding. But nobody was forced to sell his or her shares. And from the viewpoint of corporate governance, concentrated ownership by investment funds is superior to widely diffused ownership by small shareholders.

In the fifteen small combination sales now concluded, the privatization agency sold a majority

stake to a strategic investor and offered varying minority stakes for vouchers—using a "Russian auction" pricing mechanism that roughly matches supply to demand. Fifteen similar exchanges are under way. This combined method has several benefits. First and foremost, the scheme mixes the economic and financial gains of obtaining a core investor with the political advantages of giving the public a chance to acquire shares and use its voucher accounts. A scheme that allows people to trade vouchers for shares (even if they quickly sell them) generates political support for the privatization program by counteracting the claim that divestiture benefits only the foreigner, the local elite, or the politically well connected. This is important in Estonia, where claims that the privatization process was nontransparent won votes in the 1995 electoral campaign. Second, the trading of vouchers and shares and the activities of the investment funds promote the development of capital markets.

But the method also has costs. Some critics say that since August 1994, when it was first decided to hold back a minority of shares in divested firms for later exchange for vouchers, the pace of contract conclusion has slowed. This could have occurred naturally, as sales reduced the supply of better opportunities. But critics claim that investors were anxious about who the future minority owners would be, what their rights would be, how the public offerings would be conducted, and how the government would vote its residual shares in the interim. They say that prices paid by core investors have fallen by a greater percentage than prices for shares reserved for the public offerings, that the uncertainty has caused promised investment to decline, and that the core investors are striking deals with investment funds to buy up shares for transfer, at a discounted price, to the core investors. The solution, say the critics, would be to limit voucher use to buying housing and land—the use originally intended for the vouchers—and allow the privatization agency to focus on its proven strategy of selling whole companies to investors. But these views underestimate the political importance of the voucher program. Privatization is everywhere and

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always intensely political. Estonia is but one of many transition economies whose electorate has replaced radical reformers with governments advocating more caution and prudence in reform, particularly in privatization. For all their complexity, schemes in which vouchers are exchanged for shares can provide the level of public support needed to carry out privatization.

### **Voucher value**

An unresolved problem in the Estonian privatization program is that the face value of the vouchers outstanding far exceeds the likely value of assets being sold. And even more vouchers are being created as restitution proceeds slowly. According to estimates by the Ministry of Finance, about 10.5 billion crowns worth of vouchers have been issued: 8 billion crowns in "national capital" vouchers, allotted to all citizens, and 2.5 billion crowns in "compensation" vouchers, given out for injustices suffered in the Soviet period. The ministry calculates that the public has exchanged about 1.2 billion crowns of vouchers for housing (70 percent of which has been privatized) and another 1.8 billion crowns of vouchers in privatization transactions—of which only about 100 million crowns of vouchers were used in the two large combination public offerings. A rough calculation yields a face value for the remaining vouchers of about 7.1 billion crowns, or US\$630 million. The minority percentages held back from all the firms remaining to be sold are unlikely to be large enough to absorb this outstanding stock of vouchers (though the problem is eased if the trading of vouchers allows their price to fall to clear the market).

Citizens may use their vouchers in a variety of ways (including simply selling them to any bidder). They may exchange them for shares in companies or in investment funds, or they may use them to buy the housing in which they live, to purchase land, or to buy bonds from a Compensation Fund. And in November 1995, it was announced that vouchers may be used at face value for up to 50 percent of installment payments for privatized companies. (This should

raise the vouchers' depressed trading value, but cost the government considerably in forgone revenue: as much as US\$10 million to US\$20 million in voucher value could be absorbed.)

### **Infrastructure and land**

Large infrastructure firms remain to be privatized, including the port, the airline, the electricity company, and a majority share of the telecommunications company. If the combination method were used in these sales, a large amount of voucher value could be absorbed through even minority offerings. From a more technical perspective, some Estonians feel that the need for investment capital in infrastructure firms is so great that few or no shares should be reserved for free distribution against vouchers, but the politically constituted policymaking board of the privatization agency has not yet pronounced on this matter. In addition, exchanging vouchers for land might use up a good share of voucher value, but the mechanics of land sale and exchange are only now being elaborated, and the intention is to limit voucher use to 50 percent of the price of a parcel of land. Much time will probably pass before land sales start to absorb many vouchers.

### **Compensation bonds**

Yet another possible use of vouchers is purchasing compensation bonds from the Compensation Fund. This fund also receives half the after-expenses proceeds from privatization sales. Ministry of Finance officials said that by June 1995, 270 million crowns (about US\$24 million) of vouchers had been invested in these bonds, which are paying an attractive rate of interest. One worry is that the fund has to invest in long-term, high-risk restructuring of enterprises, raising questions about the income stream that will be generated to pay interest on the bonds. And, obviously, the more assets sold for vouchers and the more vouchers accepted for payment of installments, the less income will be generated for the Compensation Fund to service the bonds. Estonian governments have so far resisted the notion that vouchers might be redeemed at face



value, so the inflationary potential of vouchers is slight. But unless the government can speed up the exchange of vouchers for land and shares, exchanging vouchers for compensation bonds may be the only recourse for many citizens. It would be politically embarrassing if the bonds' market value fell sharply.

### What to do?

To avoid a discounting of the vouchers from face value, the simple solution is to put more good assets up for sale—and inform voucher holders that they have until a certain date to arrange an exchange. But this solution is hard to implement while questions persist about which assets are up for exchange and under what conditions. Moreover, the government is unlikely to set a deadline while vouchers are still being created by a slow-moving court process. But while the voucher issue is complex and has the potential to cause some political problems, it should be economically containable, given the range of possibilities for voucher exchange and the “safety valve” of the compensation bonds.

### Infrastructural complexity

Before the 1995 elections, the Estonian government had endorsed a privatization program to divest most remaining infrastructure or problem industrial enterprises by selling the majority of shares to the purchaser able to guarantee investments and effective management. The government argued, however, that these large companies first required reorganization to turn them into joint stock companies, division into marketable parts, and the introduction of competitive forces or regulation. In almost all areas of infrastructure, the program recommended founding “holding-type stock companies” to oversee reorganization and privatization. Some of what was proposed was accomplished. (At least one action along those lines had predated the program: a 49 percent share of the telephone company was turned over to a private consortium in 1992.) Many business activities in the port of Tallinn are already in private hands. And it is broadly accepted that any new electricity gen-

eration needed will be privately supplied. But two changes of government have taken place since this program was announced. Although privatization will clearly continue—a majority stake of Estonian Airlines was recently put up for bid (with a closing date in January 1996)—there has been neither a formal acceptance nor a modification of the previous policy statement. It would be reassuring if the government reconfirmed its principles of infrastructure privatization: creating a market structure to promote competition where possible, imposing credible and efficient regulation where necessary, and locating core investors to provide governance.

### Conclusion

In scope and pace, Estonian privatization has been a success. No privatized firm has yet failed, and the privatization agency reports that most divested firms are expanding their employment. The partially privatized telephone company has improved the quantity and quality of service markedly since the involvement of private partners. But these promising results are tempered by the fact that the seventy privatized firms experiencing problems with installment purchase payments are only being admonished. Although four of five privatized firms are current on their obligations, how long they will stay current if there is no penalty for nonpayment or partial payment is another question. But this problem—though significant—is not overwhelming.

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<sup>1</sup> The electorate's dissatisfaction with some aspects of privatization contributed to the 1995 defeat of the incumbent coalition. But it could be argued that it was the few instances of insider trading, rather than the scope and pace of the program or the involvement of foreigners, that caused the dissatisfaction.

<sup>2</sup> This section updates an earlier Note by the author (“Privatization in Estonia: Major Accomplishments and Remaining Problems,” Note 19, July 1994).

<sup>3</sup> Estonian purchasers can pay 20 percent down and the balance over a period of three to ten years. Foreign buyers supposedly must pay all at once, but most create a local company to take advantage of the installment plan.

*John Nellis, Senior Manager, Private Sector Development Department (member of the World Development Report team, 1995–96) (email: [jnellis@worldbank.org](mailto:jnellis@worldbank.org))*