The role of Investment Privatization Funds in Mass Privatization programs

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Abstract* – This paper addresses the issue of Privatization Funds, presenting the role they played in the context of transitional process to a market economy. We underline the crux important of the design of mass programs in achieving the desired infusion of private property and control in the economy. Unfortunately Romania failed once again to address this problem efficiently.

***Keywords:* privatization, funds, investment**

I. INTRODUCTION

Economic theory documents the important role assigned to the Investment Privatization Funds, both for the implementation phase of mass-privatization programs and ex-post, for the developing of financial institutions and capital markets. Their performance can therefore serve as a mirror for the success or failure of mass privatization programs.

Czech Republic and Russia were the first to implement mass-privatization programs. While IPFs have faced different business environments and initial conditions in the two countries, some important commonalities emerge. Most importantly, the development of IPFs into portfolio managing investment funds appears to have been hampered by a lack of regulatory oversight and investor protection that has undermined the creditability of capital markets and restricted the funds' ability to raise new capital on the market. In response, many IPFs have gone out of business while the remaining funds have been transformed into holding companies or have sought shelter in financial groups.

However, IPFs have faced different business environments and initial conditions in the two countries. Specific problems have arisen. Czech reforms were taken by surprise by the apparition of cross-ownership phenomenon which translated in important policy options that had to be addressed ex-post the implementation of the mass privatization program. On the other hand, In Russia, a prerequisite of the reform programs was a painful compromise to the existing managerial structures, with the result of a long term control of the economy by insiders, which made any attempt of outsider investors to participate actively in corporate governance futile.

After a brief presentation of the general theoretical framework on the privatization in the context to transition to a market economy and the role IPF's played in the process, this paper will present Czech and Russian experience in implementing mass privatization, with a focus on IPFs success in emerging as active corporate governance agents.

Although a general there were no blueprints to guide strategists' efforts to design an adequate privatization program, one can use a large range of theoretical tools to explain and deal with privatization issue. Thus, economic analysis stemming from different fields and schools of economic theory (liberal, Keynesian and institutionalism) provides a wide range of arguments in favor of privatization. They are summarized bellow.

II. PRIVATIZATION, A NECESSARY STEP IN THE TRANSITION TO A MARKET ECONOMY

First of all, privatization results in a new private and institutional ownership structure replacing the old state-administrated system with its low efficiency pressure and distorted market and price signals. There is little doubt that private ownership should lead to an incentive system in which costs of production are minimized according to the relative price structure and the output structure is oriented toward market. Without changing the underlying incentive structure of the enterprises, firms will continue to perpetrate the same weaknesses that contributed significantly to the collapse of communist systems. Furthermore, privatization is expected to remove the inefficient allocation of resources through reinstalled healthy competition. Third, privatization, in connection with deregulation and demonopolisation is expected to reform the inherited economic structure, characterized by extreme horizontal and vertical concentration. The collapse of communist has found ex-communist countries with highly energy-intensive industries, with obsolete technologies and without traditional markets for their products. Under these circumstances privatization was a first step towards the necessary restructuring of ex-communist economies, a tool that led to a fruitful Schumpeterian process of “creative destruction”. Lastly, a socioeconomic argument in favor of privatization is strongly relates to Hayek’s conception of a pluralistic society of owners as a basis of a modern market economy and even democratic society. This has to do with the creation of a middle class witch is the basis of a modern and prosperous society (Schusselbauer, 1999).

III. TRADEOFFS BETWEEN DIFFERENT METHODS OF PRIVATIZATION

Tradeoffs between different methods of privatization methods of privatizations have attracted widespread discussion in the economic literature concerning the transition process of the former communist countries to market economic systems. Since the privatization of state-owned enterprises and the development of an autonomous private sector are fundamental stages on the transitional process, different methods to privatize state-owned enterprises have been proposed. These proposals can be divided basically into direct and indirect methods of privatization. The direct methods include forms such as public auctions, tenders, public invitations, capital privatization and employee and management buy-outs. Indirect methods include different distribution schemes elaborated to privatize a large bundle of state-owned enterprise in one mass-privatization program.

In deciding which method of privatization to employ, first we have to consider the tradeoffs between efficiency and redistribution. In economic history and theory, the efficiency versus distribution tradeoffs has sparked endless discussions. It can be traced as far back to Aristotle and his question concerning how big the state and the redistribution through it should be. This applies to the privatization process as well. On one hand there is a general consensus that privatization is Pareto-improving through efficiency enhancing ownership transformation. On the other hand the same process is influenced by the concepts of fairness and distributional consequences of the methods applied. In addition, political and administrative constraints play a major role in restraining best choices and enforcing a search for second-best solutions to overcome the shortcomings and deal with the number and size of state-owned enterprises to-be-privatized. According to the traditional categorization of policy objective (Musgrave, 1959), efficiency, macroeconomic stability and distributional equity can be achieved independently within the framework of a neoclassical model. The privatization process, however, does not permit strict separation of efficiency from distribution issues since methods applied affect both issues in opposite direction.

According to Schusselbauer, 1999, higher efficiency and productivity gains can be identified where direct methods of privatization have been used. Carlin and Aghion (1996) analyze the relation between ownership structure post-privatization and radical restructuring. Equity take-over by foreign investors is more likely to lead to far-reaching adjustments, significant investment and managerial know-how. Other forms of privatization have lead especially to reactive restructuring which enables the privatized company (merely) to survive in a competitive environment.

The establishment of a mass-give-away scheme is related to the limited usefulness of traditional methods because of capital scarcity and the lack of savings to absorb the huge amount of state assets. Mass-privatization is thought to meet both efficiency and distribution objectives as a “second-best solution”. On efficiency side it has the advantage of speeding up the privatization process. Empirical studies clearly show that the speed of ownership change is of decisive importance in reducing the privatization vacuum and allowing external financing souses to enter into enterprise (Schusselbauer, 1999). On distribution side, clearly mass-privatization through vouchers is fair as it distributes the national wealth among citizens. It is also fair insofar as averts political controversies inherent in selling to foreigners “prized” national industries. Moreover, for those managing the to-be-privatized firms, voucher privatization was not perceived as a thereat to their position because it was expected to result in dispersed and thus weak class of stockholders.

IV.THE EMERGENCE OF MASS PRIVATIZATION FUNDS

However, mass privatization could result in a large number of investors with only small stakes, unable to monitor the management. The solution to the problem of dispersed ownership was the creation on Investment Privatization Funds (IPFs). They designate a new class of financial intermediaries allowed to collect vouchers from the citizens and invest them in the enterprises to-be-privatized. By pooling investment capital, IPFs would contribute to the consolidation of shares, an essential precondition for effective corporate governance. By amassing a diversified portfolio, IPF dissipate risks, both for them and for their shareholders. They also were expected to gather data about enterprises which would enable them to make informed investment decisions. By signaling to other investors’ attractive investment objectives, IPFs were expected to improve the overall level of information available to the market. Finally, IPFs were expected to contribute to the overall development of capital market. They were also expected to make an important contribution to the overall volume of transaction on capital markets. However, as the present paper will shows mixes results concerning their success as significant contributors to the development of capital market.

V. THE DESIGN OF IPFS IN MASS PRIVATIZATION PROGRAMDS

The collapse of communist systems left ex-communist countries with very different initial conditions. Hungary and Poland have started reforms much earlier. In Poland private property in business was allowed since ‘70 and in Hungary since ’80. As a result, a private small enterprises sector emerged in these countries much earlier. Consequently, enough time was allowed to build there an adequate business culture. Active worker’ s unions (The Solidarity was established in Poland in 1980’) contributed to the birth of a corporate governance culture, with workers participating in the management of their company, similarly to the situation in former Yugoslavia. The earlier startup allowed these countries to employ different methods of privatization, where managers played a major role in the privatization of their companies. At the time when political change took place, privatization was already advanced in both countries. In an attempt to speedy-up the privatization pace, Poland decided to employ mass privatization. Political dissensions regarding which enterprises had to be privatized and the management of IPFs postponed the implementation of the mass privatization program several years. In Hungary only direct methods of privatization were employed. Besides the much more advanced pace of privatization in Hungary, a possible factor that might have prevented Hungary to use a free distributional scheme was the considerable foreign debt of the country. Simply put, Hungary needed money to service its foreign debt.

Czech Republic and Russia were the first to implement mass privatization programs. They were followed by at least 13 ex-communist countries, which have chosen to implement mass privatization programs. We can distinguish four basic schemes of mass privatization (Katharina Pistor and Andrew Spicer, 1996):

- The Restricted Market Model
- The Free Market Model
- The regulated market Model
- State-controlled Model

The Free Market Model offered the highest degree of choice to citizens as primarily voucher holders, but also to IPFs. The establishment of the IPFs is left to the market. The role of the state is typically limited to stipulating the procedures for establishing an IPF, including the conditions it must fulfill for acquiring a license to operate as an IPF. An investor (it can be a physical person or a juridical firm) sponsors the establishment of an IPF.

Main countries which implemented the Free market model are shown in Table 1.

Table 1. Main countries which have implemented the Free market Model

Country	Date of MPP
Czech Republic	1992-1994
Russia	1992-1994
Slovak Republic	1992-1993 (partial MPP)
Moldova	1993-1995
Lithuania	1991-1996
Georgia	1994-
Kyrgyzstan	1994-
Ukraine	1994-
Bulgaria	1995-

In the Free market model IPF is dependent on the Investing Fund which has sponsored it. The later is entitled to perceive a management tax which can be computed either as a percentage of the IPF’s assets (2%) or as a percentage of the IPF’s annual profits (20%). Of course, a third party can manage the IPF, provided that the sponsor does not have the expertise to do it.

But this is more a theoretical possibility. Once the requirements to acquire a license to operate as a IPF, it is reasonable to assume that the sponsor also has the expertise to manage the fundMoreover, the IPF has little or no personal. The sponsor of the fund has the right to appoint personnel to participate in the Supervision or Management Board of the companies in its portfolio, provided it has managed to amass enough shares in that company. The Free Market Model left the citizens the possibility to invest either directly into the enterprises to-be-privatized or indirectly, in IPFs which afterwards invested in the enterprises. IPF competed against each other for the voucher capital. IPFs acquire their assets in voucher’s auctions, where they compete also with other investors. Both Russia and Czech Republic have opted for this model.

Main countries which have implemented the Restricted model are shown in table 2.

Table 2. Main countries which have implemented the Restricted Model

Country	Date of MPP
Kazakhstan	1994-1996
Uzbekistan	1996-

The Restricted Market Model provided a limited choice to the voucher's holders. They were precluded from investing their vouchers directly into the companies which were privatized. They had the possibility to choose only from the existing IPFs and as a result IPFs competed only against each other in voucher's auctions. Consequently, the degree of competition depended entirely on the number of existing IPFs. Their establishment was left to the market forces. Kazakhstan and Uzbekistan's mass privatization programs fit under this scheme.

The Regulated Market Model does not leave the creation of the fund to the market. Poland chose to apply this model. IPFs were created by the state but were privatized later. Voucher's holders could invest in IPFs only. In addition IPFs' portfolios were highly regulated. They were allowed to acquire a controlling stock only in a limited number of companies, although the composition of the initial portfolio could be changed later through transactions on the secondary market, including swaps among the funds.

VI. CONCLUSIONS

Tradeoffs between different methods of privatization methods of privatizations have attracted widespread discussion in the economic literature concerning the transition process of the former communist countries to market economic systems. Mass-privatization is thought to meet both efficiency and distribution objectives as a "second-best solution". IPFs were designed to ensure ownership concentration after mass privatization programs in ex-communist countries.

Design of mass privatization program was crux for subsequent success of privatization. Unfortunately economic literature documents only one successful story namely in the case of Czech mass privatization program. Mass privatization in Russia resulted in inefficient insiders' privatization. Romania has chosen a State Controlled Model. Five IPFs were entitled to gather citizens' vouchers. They were created by the state. The vouchers' holders had the possibility to invest either directly in enterprises which were privatized or in the existing IPFs. However, only 30% of the capital of state owned enterprises had been distributed through mass privatization program. Another 30% was privatized through a different state controlled fund using direct methods of privatization. Since most of the state owned companies were highly decapitalized, the privatization process resulted in prolonged delays and a highly dispersed ownership structure.

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