ANNALS of the ORADEA UNIVERSITY.
Fascicle of Management and Technological Engineering, Volume VI (XVI), 2007

PRIVATIZATION FUNDS AS INSTRUMENTS OF CORPORATE MANAGEMENT

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Abstract: This paper addresses the issue of Privatization Funds. After a brief presentation of the role they played in the context of transitional process to a market economy, we will focus on IPFs success as active corporate governance actors in Russian and Czech mass privatization programs. Existing evidence is mixed: In Russia IPFs have failed while in Czech Republic they do have potential to succeed but need adequate legislative support.

Key words: Privatization Funds, success, business environments.

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.

The role of Investment Privatization Funds in Mass Privatization programs

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.

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).

Tradeoffs between different methods of privatization

Various 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.

The emergence of Investment 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.

The design of IPF in mass privatization programs

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). Appendix 1 presents a comparison of Mass Privatization programs across countries.

- The Free Market Model
- The Restricted 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. Thereby the IPF is dependent on the Investing Fund which has sponsored it. The later is entitled to perceive a management tax[1] 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%)[2]. Moreover, 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.

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.

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

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[1] 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 fund

[2] This was the situation in Czech Republic

decapitalized, the privatization process resulted in prolonged delays and a highly dispersed ownership structure.

Performance of IPFs after mass privatization process. Evidence from Russian and Czech mass privatization programs

As argued before, IPFs were created to facilitate the ownership concentration. Extensive literature points out that effective corporate governance needs ownership concentration. Vishny and Shleifer (1986), Mc Connell and Servaes (1990), Vishny, Shleifer (1997) find a positive relation between ownership concentration and corporate performance in US. They all argue that diffuse ownership yields significant power to managers, whose interests do not coincide with shareholder's interests. Consequently, managers could purse non-value maximizing activities such as self dealing, quiet life or empire building.

However, a second strand of literature (Coase 1998) argues that a positive relationship between ownership concentration and corporate governance might be spurious. Coase argue that ownership concentration is the result of firms' performance: when transaction costs are low, as in developed economies, investors would simply choose the optimum portfolio holdings, which makes ownership concentration endogenously determined. Moreover, the US is a good example of dispersed ownership and at the same time effective corporate governance.

Given the possibility of ownership structure being endogenously determined, great attention was given to Mass Privatization in Czech Republic. Mc Coffee (1995) and Classens and Djankov (1999) argue Czech Mass Privatization is a natural experiment on corporate governance because of its unique design which alleviated the endogeneity problem and thus offer valuable information to the debate on the causality issue. The design of Czech mass privatization precluded the adjustment of ownership to firms' characteristics: the decision to change ownership was taken by the state while the rules of biding process prevented participating agents from obtaining optimal ownership structure.

Russia' mass privatization program design does not offer the same advantages because it has resulted in massive insiders' control. Endogeneity of ownership concentration is a major concern in Russia's case: insiders in most profitable firms were more likely to want to acquire shares in their company then insiders in less profitable firms. However, mass privatization is Russia did generated concentrated ownership. Thereby Russia's case provides further evidence on the relationship between owners' type and firm's profitability after privatization. Thereby, although the design of Russia's mass privatization does not constitute a perfect setup for an experiment on corporate governance, it is still help us understand the relation between ownership and profitability.

After a short overview of Czech and Russia mass privatization programs and their characteristics, I will turn to empirical findings on the relationship between ownership concentration and owners type on one hand and firm's performance post-privatization on the other.

Overview of Czech mass privatization

Czech mass privatization took place in two waves. The first started in October 1992 and ended in June 1993; the second started in January 1994 and ended in October the same year. In total 988 enterprises have participated in the first wave and 861 in the second one (Classens, Djankov, 1999). The firms privatized in the first wave mainly consisted of manufacturing firms and excluded large, vertically integrated firms. They were given more time to restructure and split in small business units. The second wave included those newly created firms and utilities companies. Firm had to submit privatization proposals to the founding ministry. At the same time outside investors were entitle to submit privatization proposals. Within a short period, 60% of Czech economy was transferred into private hands. If an investor had been identified prior to voucher privatization, those shares were not offered in the voucher rounds. As a result 442 sales happened outside mass privatization, although they involved largely small firms (Classens, Djankov, 1999).

A large number of IPFs emerged on a voluntary basis. More then 430 funds were created in the first wave and an additional 120 in the second one. In the first wave IPFs were organized as joint stock companies, while in the second some were established as unit funds. As a result of marketing campaigns, IPFs attracted 72% of all points in the first wave and 64% in the second one[3].

Mass privatization in Czech Republic was dominated by large state-owned at that time banks. They sponsored the establishment of IPFs. The result was a hybrid between German bank oriented system and Anglo-Saxon system. The main difference between Czech system and German Model is that German Banks are the owners of the stakes in private companies while in Czech Model, Banks only control the IPFs whose shareholders own stakes in the privatized companies.

Specific to the Czech Model is the phenomenon of cross-ownership that has resulted after the mass privatization. As explained earlier, banks sponsored IPFs which invested voucher capital in privatized companies. But afterwards banks were privatized and the existing IPFs had the possibility to buy stakes in competing banks. The legislation in place concerning IPF specifically precluded this phenomenon. However, Banks found ways to elude the regulation. One way to do that was to established subsidiaries, which in turn established IPFs. Cross-ownership phenomenon implied a potentially collusive system where disputes in companies' boards could lead to a stalemate. The potential winner of such a situation was the management and ultimately the state provided that the later still maintained stakes in privatized companies. One hypothesis is that the government, although at first was taken by surprise by the cross-ownership problem, it finally tacitly approved it.

[3] All citizens of 18 years and older could buy, for a nominal fee of approximate 30 USD a package of vouchers worth 1000 points. With these points individuals were allowed to bid for shares or could offered their points to IPFs.

Cross-ownership phenomenon has an additional meaning. It also refers to the possibility that the Investment Fund (the bank for example) could own in its turn shares in its affiliated IPFs. This could further amplify the agent – principal problem, already in place in the case of IPFs. In short, it is possibly that IPFs would act as agent of their mother Investment Fund, rather then agents of their shareholders. By their appointed Boards' directors they could obtain inside information which they could use it later for trading.

Czech legislators thereby confronted an important policy option. Should regulation aim to move the system towards the German Model or should they embrace the Anglo-Saxon Model. They favored the later for two reasons. First it appears that the benefits of the German Model are being lately questioned. Second, it is possible that German Model would function properly only under conditions specific to German economy. Circumstances being different in Czech Republic, it is thereby possible that the German approach would not be the best approach. Thereby Czech legislators opted for an Anglo-Saxon model. Specific to this model is the erection of "fire-walls". Their role is to force Investment Funds to act in the benefits of their shareholders and not of the bank which has sponsored the creation of the IPF as it happened in Czech experience.

Overview of Russian mass privatization

Russian mass privatization resulted in massive insider's ownership. On average insiders (management and workers) controlled 70% of the stakes of privatized companies. This is in sharp contrast with the situation in Czech Republic where employee owned only 4.4% of the shares. Outsiders held on average 21.5% the rest remaining in State's ownership. IPFs played an insignificant role. They manage to control only approximately 6% oh he shares in privatized companies (Katharina Pistor and Andrew Spicer, 1996).

In an extensive study of Russian experience of mass privatization, Pistor, Spicer and Frydman conclude that the insiders' control phenomenon was a necessary compromise the privatization's planners had to make in order to dislodge the existing state-controlled structures. In other words, it was a profound hostility towards the communist structures which drove the design of mass privatization scheme in Russia. Ironically, the same argument is invoked by their Czech counterparts. A more plausible answer for the insider's control problem in Russia resides in specific socio-political realities in place in Russia at that time. We also have to mention that Czech Republic had the chance to be governed by competent people. Vaclav Havel, president at that time was considered a national hero for his opposition to communists before the Velvet Revolution. And he was wise enough to listen to competent economic advisors like Vaclav Klaus and Dusan Triska.

Conclusions

After the mass privatization process ended, IPFs had to survive with the acquired portfolio. Several trends were obvious in both countries. First of all, the number of IPFs decreased significantly. In Russia from the 650 licensed IPFs only 350 were active in 1995, according to a governmental estimate (Katharina

Pistor, Andrew Spicer, 1996). There were 67 mergers among IPFs and 69 of them transformed into joint-stock companies. Overall the analysts consider that only 25-30 of them have played an important role on the stock market and managed to acquire an active portfolio with long-term perspectives of survival. Since many of the IPFs were relatively small this trend is not surprising. Many of them simply went out of business.

Many of the funds simply have not managed to earn sufficient profits to survive. One important reason for this is the illiquidity of the securities markets and of the market for the funds' shares. Although the mass privatization programs ended, state continued to maintain control over major economic players. In Czech Republic, Banks dominated the creation of the IPFs. But they were controlled by the state which postponed the privatization of the banking sector. This impacted negatively on the efficiency of banking sector, which was unable to support the restructuring of the newly privatized companies. As a result their efficiency did not improve significantly. They were unable to pay dividends which translated in illiquid financial markets and further on the profitability of the investment funds. Moreover, IPF were unable to generate a market for their shares. In Russia once the mass privatization ended, most IPFs traded the most lucrative shares. As a result they were left with a poor portfolio. The remaining shares were under-evaluated, being trade at a market value much lower than the nominal value of the funds' shares. The illiquidity of capital markets in both countries was further amplified by the lack of trust of population in IPFs. In Czech Republic the existing funds, made unreasonable promises to attract voucher capital. Being unable to fulfill their promises, people lost their trust in the funds as financial intermediaries. The very fact that people chose to invest their capital vouchers into newly created IPFs (in the second wave of mass privatization, in Czech republic were created 221 new IPFs) rather than in the existing ones make a compelling argument for the generalized lack of trust in IPFs as financial intermediaries. In Russia things were even worst. Thousands of unlicensed financial companies took advantage of loose regulations and attracted populations' savings (i.e. Pyramidal Schemes). 80 millions. Russians invested in such schemes and 50-70 trillions rubles were lost.

Another issue that impacted negatively on the overall IPF's profitability was the double taxation problem, which hindered IPFs attempt to attract new investment. Vouchers Funds faced a double taxation system. The fund itself paid taxes on its profits. Fund's investors also have to pay taxes for the dividends paid by the fund. Under these circumstances, a strategic investor paid fewer taxes if he chose to invest directly into a company rather then in an IPF.

However, few IPFs managed to overcame the cash-flow issue. They managed to gather a lucrative portfolio and to restrain from trading it immediately after the mass privatization ended. They also managed to acquire large stakes which afforded them to actively participate as corporate agents' post-privatization. Another explanation for their success is that some of them were part of financial groups, especially in Czech experience of mass privatization. As a result they faced less severe financial constraints, having an easier access to loans when they needed them. Most importantly, the successful IPFs managed to diversify their portfolio of activities. They offered a large range of financial services, from investment and reengineering expertise to arranging credits for companies. This additional revenue complemented the revenues from management tax and afforded IPFs to gain profits[4].

Empirical studies document the failure of Russian IPFs as active corporate governance agents. It seems that the overall Russian mass privatization failed to result in an increase in firms' performance after privatization.

In Czech Republic the evidence of the IPF's funds is mixed. Many have disappeared due to the cash-flow problem. Few have managed to survive. They do have the potential to contribute to better corporate governance, provided they benefit from a coherent supportive legal framework to give them the right incentive to do so.

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[4] As explained earlier, one has to distinct between IPFs and the Investment Company which has sponsored it. Their revenues and costs differ. To be more precise, the management company was entitled to get the management fee.