Privatization in Estonia
Major Accomplishments and Remaining Problems

John Nellis

Estonia has one of the best overall economic reform and, in particular, privatization records of any part of the former Soviet Union. An estimated 50 percent of state-owned enterprises and business units had been transferred to private ownership or control by the end of May 1994. True, Russia has moved even faster on privatization; its divestiture over the last two years of almost 70 percent of its industrial sector has been near miraculous. But since Russian privatization is mainly a transfer of controlling stakes of shares to insiders—workers and managers—questions remain as to whether these new owners will undertake restructuring to the extent and at the pace required. In contrast, Estonian ownership transfer is taking place in a reformed macroeconomic environment, and it does not emphasize payoffs to insiders. Instead, Estonia has adopted a range of divestiture methods aimed at putting assets into the hands of those with the incentives and skills to use them wisely. In addition, bankruptcy is operating as a parallel privatization process; this spurs the Estonian Privatization Agency (EPA), the company, and sometimes the potential purchaser, to complete preparations and close the privatization deals.

What are the factors that have made this success possible? First, good policy, including the ending of soft credits to enterprises; a currency board system that links money creation to hard currency reserves and keeps inflation at modest levels; liberalized prices; an open trade regime; and the encouragement of foreign investment. Second, good politics, with active leaders so far persuading the populace to tolerate the painful but (it is hoped) temporary adjustment. Third, good history, with strongly developed national and commercial traditions. And fourth, good geography, with Scandinavian and Finnish markets and investors close by.

Other post-communist countries would do well to examine the Estonian program.

Range of divestiture methods
The divestiture methods include:
- restitution of homes, farms, and businesses expropriated during the communist period
- auctions for small-scale business units
- a tender process for medium and larger firms thought to be of interest to foreign or domestic investors
lease arrangements for parts or all of a set of enterprises
joint ventures combining foreign, private management and capital with government-owned assets
an active bankruptcy process, which liquidates insolvent, nonperforming state firms and turns the assets over to private entrepreneurs
a voucher program in which those holding vouchers will soon be able to exchange them for shares in privatized firms, for shares in investment companies that are being created, for housing, and for land.

By the end of May 1994, these efforts had led to:

- 125 signed contracts through the tender process
- over 1,000 small business units auctioned off, representing about 85 percent of the small businesses originally designated for sale
- 340 leases for all or part (sometimes quite small parts) of enterprises
- 200 joint ventures
- an estimated 200 bankruptcy proceedings (most of which are thought to deal with state-owned entities).

Four tenders conducted by mid-May 1994 have generated US$63.4 million in sales proceeds (with more to come as contracts in process are signed). Buyers have contracted to invest more than US$30 million in the privatized firms and to guarantee more than 14,000 jobs. Between 30 and 50 percent of sales through tenders have gone to foreign investors or to domestic purchasers with foreign partners or foreign financial backing. Most of the items sold are small in size; very few of the privatized companies propose to maintain more than 500 employees, and only two have contracted to maintain 1,000 or more workers. Nonetheless, in a country of 1.5 million people, the tender program is important. Bids on a fifth tender were submitted in late May 1994. EPA officials estimate that the tender process will be completed by mid-1995.

Evolving process
A program of trade sales of up to twenty large companies, supported by the European Bank for Reconstruction and Development, is in active preparation. The idea is that some larger companies require detailed financial engineering or the hiving-off of social assets. The EBRD will become the privatization agent for a group of firms. It will undertake a minimal amount of cleanup, and sell these companies within twelve to eighteen months. Yet another twenty large companies will be privatized through a public offering effort supported by the Phare program of the European Union. The intention is not simply to privatize but also to:

- promote the Estonian equities market
- provide the first opportunity for citizens to trade privatization securities (vouchers) for shares of firms
- divest the state’s portion of a group of existing joint ventures.

This will work as follows: The EPA will attempt to find a core investor to take a majority stake in several high-potential firms. Once a core investor is in place, the rest of the shares will be offered to the public, for vouchers, cash, or both. If these first transactions combining public offerings and vouchers go well, this method could be used to privatize large infrastructure enterprises, such as the port, the airline, and utilities such as telecommunications.

A number of problems remain

Speed. Even the comparatively fast-moving Estonian experience underlines the importance of decisiveness and speed in the privatization process. Several companies held back from previous tenders (by sectoral ministries), on the grounds that they could be sold more advantageously at a later date, are now in operational trouble—and in two cases, bankruptcy. One can add these examples to a growing body of international experience supporting the view that delaying privatization often results in deteriorated assets, decreased revenues for the state, and probably decreased welfare and efficiency for the economy.

Control of contracts. The tender process has resulted in 125 contracts, and more are being concluded. The contracts now need to be monitored and enforced. The EPA is presently setting up a Contracts Control Office with five or six staff. Experience shows that
monitoring numbers of persons employed in the privatized firms is fairly straightforward; seeing that installment payments are made on time is more difficult, and keeping track of promised investments is much more difficult. The ultimate weapon to deal with noncompliance is repossession of the business or object. To the EPA’s and the government’s credit, one repossession has already been carried out.

Leases. The more than 300 leases pose problems. Many are contracted to last until 1999 or longer, and in most cases the annual payment is very small. Government policy is, rightly, to fully privatize the leases, as fast as possible. The question is how. EPA officials would prefer to simply auction off the leases to the highest bidder, but the law requires that a valuation be made before an auction—and this would be troublesome, given the legal and technical difficulties of sorting out the renter’s improvements and investments from the state’s property. A variant would be to convert the leased companies into joint-stock companies, then give the leaseholder shares representing the value of improvements made during the leasehold, and allow the government to auction off the remaining shares. However, in this case valuation is also difficult. The tender process avoids this complication, but for other reasons is still not as simple or as fast as auctions. What to do? Leases should be converted to full private ownership by whatever means the government and the EPA find most expeditious—through auctions if possible, but through tenders if necessary. If no acceptable bids are received through the auction process, leaseholders might be allowed to purchase the company for a nominal sum.

Joint ventures. A June 1994 amendment to the Privatization Law states that joint ventures may continue to be contracted. Yet giving sectoral ministries complete freedom to negotiate joint ventures runs the risk that nontransparent, corrupt sales may be concluded. The proposed solution (though it too has risks) is for the EPA board of directors to review and approve joint venture contracts concluded by other ministries.

Bankruptcy. Estonia has one of the most active bankruptcy programs in the ex-socialist countries. A creditor or group of creditors with nonperforming loans petitions a court, which assesses whether the terms of the Bankruptcy Law are met and appoints a trustee. Bankruptcy aims solely at protecting the creditors; there is nothing that resembles a “Chapter 11” provision allowing the debtor a chance to restructure.

The process does not appear to be monitored, though a register does record the liquidation of enterprises and the reason for the liquidation. As of mid-May 1994, it had received notice of the completed liquidation, due to bankruptcy, of twenty-six enterprises. An estimated 200 bankruptcies are in process. Most are likely to be state-owned companies. The conclusion is clear: bankruptcy has emerged as an important alternative route to formal privatization as a means of divesting state-owned property in Estonia. However, it poses some problems, the principal one being that it takes legal precedence over—and can block or even cancel—privatization. The June amendment to the Privatization Law allows delay for six months of the application of a bankruptcy action, for firms in an active privatization process. A “grace period” of this nature is desirable. More ominously, it has been suggested that the weakness of the courts, the fact that no government agency was monitoring bankruptcies, and shortcomings in the accounting system all contributed to the occurrence of some “dirty games.” The proposed solution: a more active role for the courts, more monitoring by the Ministry of Justice, and education for creditors so that they monitor one another. These actions sound sensible, but they might slow privatization and weaken or damage this active and decisive bankruptcy regime. Before taking any action, the government should carefully consider the costs as well as the benefits of regulation and enforced coordination.

Vouchers. There is growing concern that the total supply of assets tradable for privatization securities will be insufficient to meet the demand. Estimated total demand forthcoming through vouchers is about 20.5 billion kroons, or US$1.6 billion. As noted, vouchers are or will be exchangeable not only for shares in enterprises or investment funds, but also for the housing in which one resides and for land. On the supply side, a rough estimate is that housing
will absorb about 6 billion kroons of vouchers, land a further 4.5 billion kroons, and enterprises 5 billion kroons, for a total of 15.5 billion—still leaving a surplus of artificial demand of over 5 billion kroons. However, many if not most of the restitution or "compensation vouchers" will not be issued until the special commissions resolve restitution claims, a process which could take a few years and result in the issuing of vouchers long after the housing and enterprise stock has been claimed.\(^1\)

There is also a concern about voucher tradability. At the end of May 1994, the Estonian Cabinet approved a bill allowing complete tradability of vouchers among Estonian citizens and residents. Despite the opinion of the Bank of Estonia that making vouchers tradable would not significantly or enduringly contribute to inflation, anxiety persists. It seems clear that as long as the vouchers are ultimately redeemable only for assets—and cannot be redeemed for cash by a government office or bank—then any trading internally for local currency would not add to the money supply and would not, in itself, have a major or enduring inflationary effect. Another concern is that making vouchers tradable defeats their prime political purpose—transforming Estonian citizens and residents into owners. When vouchers become freely tradable, some percentage of holders will choose to dispose of the gift they have received by selling them to anyone who pays an acceptable price. The proper economic response to all this is to allow voucher trading to proceed. If a voucher holder wants to sell for cash rather than hold shares (or buy housing or land), that is his or her choice; and no claim can be made that the individual is worse off for having made this choice.

**Debt.** Last is the issue of debt. The revenues being generated by sales of enterprises are not sufficient to cover the debts and liabilities of the privatized firms because, in the tender process, purchasers often obtain assets rather than going concerns; and even when concerns are sold, the buyer may contract to assume only a portion of the enterprise's debt. The result is a debt overhang with which the government must deal.

The government began to deal with the debt problem by trying to clear interenterprise debt. A cross-cancellation exercise carried out for enterprises held by the Ministry of the Economy (which has one of the largest portfolios) will clear between 80 and 100 million kroons of arrears. Changes modernizing the accounting and taxation laws should allow the ministry's companies to take another 120 million kroons in write-offs. Still, these two steps account for only 40 percent of the debt held by this important group of enterprises. Other ministries presumably are in a similar situation. Ultimately, someone will need to assume these debts. The government must decide who can and who should absorb these losses. An important argument in favor of forcing creditors to absorb some or all of the losses is that it will send a strong signal that the government will not bail out creditors (including utilities and other state-owned enterprises).

Lily Chu and Paul Siegelbaum offered many helpful comments on this Note.

\(^1\) The German Treuhandanstalt's Office of Contract Control employs 500 specialists—but they have thousands of contracts to monitor. Reportedly, some 20 percent of the Treuhand's contracts are already in dispute. It is reasonable to ask whether the benefits of using such contracts outweigh the costs of negotiating and monitoring them.

\(^2\) If this happens, one solution being considered is to allow holders to exchange these vouchers for government interest-bearing bonds. In effect, the government would purchase the vouchers. This approach has serious budgetary implications, and the issuing of bonds without backing is definitely inflationary. Another idea is to link "compensation vouchers" to some new form of private pension fund.

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No FPD Notes will be published during August. Publication will recommence in September.

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