Lessons from International Experience

Policy and Management Requirements for Privitization

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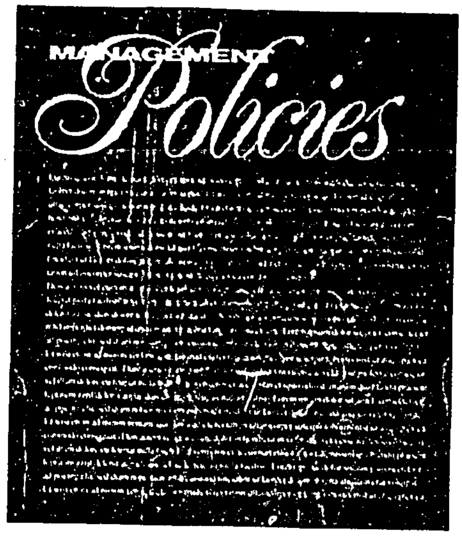
Governments throughout the world, especially in developing nations and in the former socialist countries of Eastern Europe, have been trying to implement privatization policies for more than a decade. The economic and financial problems that arose with the worldwide recession of the late 1970s, the debt crises faced by many African and Latin American countries during the early 1980s, and the shift to market economies in Asia, Latin America, and Eastern Europe during the early 1990s stimulated governments to privatize their inefficient, state-owned enterprises (SOEs) and refocused attention on the crucial role of the private sector in economic growth and development.

The current surge in international privatization had its roots in the period of deregulation in the United States and Canada in the late 1970s and in the movement toward divestment of public transport and utility companies in Britain, France, and Germany in the early 1980s. The reorientation of the World Bank, the International Monetary Fund, and other international financial institutions toward macroeconomic adjustment, economic stabilization, and market-oriented development policies and the succession of political leaders with conservative ideologies in aid-giving, Western industrial countries during the early 1980s also brought political pressures on developing countries to adopt market-oriented economic reforms.

The privatization movement developed such a momentum in the early 1990s that, even in countries that have not sold SOEs on a large scale, governments are experimenting with a variety of arrangements for eliciting broader participation of the private sector in providing goods and services that had previously been offered only by public agencies.[1] The World Bank reports that



during the 1980s alone, more than 70 countries experimented with some form of privatization, and nearly 7,000 known privatizations of SOEs took place.[2]

The Challenges of Privatization

The process of privatization in most countries has occurred far more slowly than most economic reformers had anticipated, however, and the vast majority of sales of state enterprises have taken place in Europe. The World Bank estimates that during the 1980s, about 70 percent of the sales of state enterprises occurred in more developed countries, primarily in Germany. Latin America and Eastern Europe accounted for 12 percent each, Africa for 5 percent, Asia for 2 percent, and the Middle East and North Africa for about 1 percent. Although the pace of privatization has increased during the early 1990s, the value of state enterprise sales has been substantially higher in Western industrial countries than in developing and emerging market countries. The World Bank reports that in the three years from 1990 to 1992, privatizations worth more than $73.4 billion took place in industrial countries and ownership transfers worth about $48 billion took place in developing countries.[3] Moreover, substantial progress on the divestment of large numbers of SOEs has been limited to a few countries in Europe and Latin America. The success of privatization in Central and Eastern Europe has been achieved largely through auctioning smaller enterprises that required little capital investment and through liquidation. Joint ventures and acquisitions by foreign investors were the primary means of privatizing the more profitable and promising large SOEs. Weaker and more problematic SOEs have been difficult to liquidate or divest, especially those that employ large numbers of surplus workers. Enticing the private sector to participate in providing goods and services that have long been the province of government agencies has also been slow even in the rapidly growing economies of East and Southeast Asia.[4]

Despite formidable challenges to privatization in some countries and its slow pace in others, international experience suggests that private enterprises and nongovernment organizations are now playing more important roles in providing goods and services previously provided only by SOEs or government agencies. At the same time, it should be apparent that although the private sector offers advantages in providing many goods and services and in financing, operating, and managing some types of infrastructure, it cannot simply displace government, and it cannot profitably or efficiently provide all of the functions of public agencies. Privatization tends to be more successful where markets are already operating efficiently or could be made to do so with effective policy reforms.[5] It is likely to remain slow in countries that lack strong capital markets, where the

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private sector cannot easily gain access to credit, where there is strong political opposition by government officials, labor unions, or other vested interests, and where government limits eligible buyers of SOEs.

But even where conditions for privatization are favorable, governments and the private sector face serious management challenges in implementing privatization policies. Two challenges are particularly important: first, establishing and managing the appropriate economic policy environment for privatization; and second, establishing and managing privatization procedures to ensure the successful transition of SOEs to private ownership and operation.

Managing the Economic Policy Environment

In former socialist and many developing countries, the first and most important challenge is that of establishing an appropriate set of economic policies for privatization and private enterprise development and managing the economic reforms necessary to support an emerging private sector. Experience suggests that neither domestic nor foreign investors will participate heavily in privatization in countries where economic and political risks are high and economic uncertainty threatens the ability of privatized companies to survive and expand. Experience has shown that managers of the privatization process must create an economic policy environment conducive to the growth of a sound market economy.[6] The elements of economic reform that are necessary to support privatization and private enterprise development include:

- *Structural adjustment policies*–including policies to create market mechanisms that allocate economic resources and set prices for both production input and consumer goods; financial liberalization; and the reduction of price controls.
- *Economic stabilization policies*–including balance of payments deficit reduction, debt rescheduling, control of the money supply, reduction of subsidies, and wage restraints to prevent high levels of inflation.
- *Trade and investment reform policies*–including programs for export promotion, foreign direct investment, exchange rate adjustments, and reduction of investment restrictions and trade barriers.
- *Political reforms*–including appropriate degrees of democratization, decentralization of decision-making powers, and deregulation of industry and services to allow private enterprises to operate efficiently and effectively without undue government intervention and control.
- *Private sector development programs*–including incentives and support for the development of small and medium-sized enterprises, the restructuring of large companies, and the attraction of investments in domestic industries by multinational corporations. The management of an economic environment conducive to privatization entails selection of appropriate policies, proper sequencing of policy reforms, and effective implementation of policies after they are enacted.
- *Redefinition of the roles of government and public employees.* The transition from a socialist to a market economy or from a government-controlled industry to a private industry also requires a redefinition of the roles of government and public administration. The U.S. National Academy of Public Administration insists that if privatization is to succeed, a fundamental distinction must be made between "government as a financier, authorizer, and overseer of services and government as a producer or provider of services." The academy emphasizes that privatization should encompass a broad set of arrangements under which government "remains involved as the financier or authorizer of services but relies on the private sector or the market for the actual provision and delivery.[7]

In Chile, the government has been particularly successful in creating and managing an economic environment conducive to privatization.[8] Beginning in the early 1970s, the government adopted stabilization and structural adjustment policies that combined fiscal and monetary controls, exchange rate restrictions, wage adjustments, and budget deficit reductions with comprehensive tax reforms and controls on the ability of the central bank to lend to state enterprises. Chile liberalized its foreign trade policies to stimulate exports. The government transferred more than 500 state enterprises to private ownership and liquidated those that were not viable as private enterprises.

To promote private enterprise, the government of Chile extended nondiscriminatory treatment to all productive sectors, adopted policies to promote savings and investment, and substantially reduced the size, debt, and expenditures of the public sector. Social policies were enacted, also, to reduce extreme poverty and expand access to education and health services so poor people could take advantage of employment opportunities as the economy grew. Nearly all of the 600 enterprises that had been under state control in 1973 had been privatized or liquidated by 1990. The government was relieved of paying subsidies to unprofitable SOEs and received more than $2.5 billion in revenues from divestitures. The economy grew substantially during the 1980s and early 1990s. The transition in 1990 from a military to a civilian government and the democratization of Chile's political system took place in an environment of economic stability and growth that allowed the private sector to expand and develop.

Managing the Privatization Process

The second challenge that faces governments in privatizing public functions or enterprises is to effectively manage procedures for transferring SOEs to private ownership and for eliciting the participation of the private sector in providing "public" goods, services, and infrastructure. Managing the privatization process is complicated, but international experience has yielded a set of important management principles:[9]

- *Clearly identify the objectives of privatization.* Setting realistic priorities and goals is essential to developing appropriate processes and procedures for privatization. Objectives may include increasing efficiency, reducing debt, promoting

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competition, raising revenues, and budgetary relief. Governments that do not develop strong priorities or set realistic goals cannot effectively select appropriate methods of privatization. Germany's objectives were perhaps more clearly stated than any other country's: to transfer ownership of East German SOEs as quickly as possible while ensuring that the new owners restructured the companies into viable production and employment units. These clear, simple objectives allowed the German government to transfer a large number of East German SOEs successfully in a relatively short period of time.

- *Create an effective privatization agency.* Privatization is a complicated process whose successful implementation–with minimum bureaucratic delay–requires an agency or organization that has the necessary resources, authority, and skilled personnel. The World Bank suggests that the most effective means to manage the privatization process is to centralize responsibilities for *policy making* in a single ministry or agency. At the same time, responsibilities for *implementation* should be decentralized to banks, financial institutions, management consulting firms, or the managers of state enterprises themselves, with appropriate supervision provided by the national privatization agency. Most governments–such as those in the Czech and Slovak republics–have created Ministries of Privatization to take temporary ownership of joint stock companies until they could be sold or liquidated and to oversee the process of SOE restructuring. Hungary established a state property agency to manage the privatization process and a state asset management company to oversee the restructuring of firms in which the state would retain a majority or minority stake. Germany created an autonomous agency–the Treuhandanstalt–that was given responsibility for privatization and control of SOEs until they were restructured. Other governments have given the responsibility to the ministry of finance or industry.[10]
- *Select appropriate methods of privatization.* Various means are available to privatize state-owned enterprises or elicit the participation of the private sector in providing public services. These include: restitution of nationalized property; auctions of small companies; direct sales and stock offerings; liquidation; employee or management buyouts; free or subsidized distribution of shares; management, service, or leasing contracts; joint ventures; build-operate-transfer agreements; and public-private partnerships. Each of these methods has different characteristics, requirements, advantages, and weaknesses.[11]

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- Experience with privatization over the past decade has clearly shown that no single method is the most appropriate for divesting all SOEs or eliciting the participation of the private sector in all functions. Governments must choose the methods that are most appropriate for achieving their objectives. In making the selection, they must consider the conditions of, and trends in, the sectors or industries in which SOEs operate and the current organizational forms, financial conditions, records of performance, management capabilities, and assets of the SOEs that are to be privatized. They also must understand the characteristics of the public services in which the private sector will participate.
- *Develop clear and transparent procedures.* The World Bank's review of privatization in developing countries concludes that "transparency must obtain in every privatization transaction; this is a major lesson of experience."[12] The World Bank's report suggests that transparency can be achieved by utilizing "clear and simple selection criteria for evaluating bids; clearly defined competitive bidding procedures; disclosure of purchase price and buyer; well-defined institutional responsibilities; and adequate monitoring and supervision of the program." Lack of transparency in regulations and procedures has made privatization more difficult in China and many Eastern European countries and opened opportunities for widespread corruption in some African, Latin American, and Southeast Asian countries. Nontransparent procedures undermine effective business transactions and increase the perceived risks to potential investors and participants.
- *Develop and apply appropriate assessment and valuation methods.* Before offering SOEs for sale or eliciting the participation of the private sector in economic activities, the government must realistically assess the structural characteristics of the industry in which the public enterprise operates as well as its competitive position, market prospects, operating costs, and asset utilization.[13] A realistic basis for valuation of state enterprises is essential to privatization. Privatization agencies must choose the appropriate method: discounted cash flow, liquidation value, replacement value, accounting or book value, technical value of assets, or comparative value based on similar companies in the industry. The most efficient and effective method usually is to allow the market to determine the price through auctions, share offerings, or competitive bids. Often, privatization agencies set values on SOEs unrealistically–based on the presumed book value or technical value of assets–without considering that private investors usually assess value on the basis of expected future cash flows generated by an investment or by estimated "market entry" value.

- *Allow for restructuring, liquidation, or bankruptcy of SOEs that cannot be sold.* Governments in Indonesia, Russia, China, and Bolivia quickly discovered that they must reform or restructure SOEs before private investors are willing to purchase shares or take over their operations. This may require organizational and managerial changes, restructuring debt or eliminating liabilities, and developing new markets with as little additional investment as possible. In Poland, Russia, Peru, Bolivia, and most African countries, many SOEs are insolvent or unprofitable, or lack adequate liquidity to interest private investors. These SOEs must be liquidated or allowed to go into bankruptcy. In Hungary, Poland and the Czech Republic, bankruptcy laws were essential to allow unprofitable SOEs to go out of business and divide assets among those with claims against the companies, to restructure money-losing SOEs with assets worth more than liquidation value, and to allow creditors to collect at least some portion of the debts owed by SOEs.
- *Establish and implement equitable bidding and contracting procedures.* Special care must be taken in managing the bidding process so that potential investors, contractors, and participants understand it and the public perceives it as being fair and open. A well-managed process involves the development of clear, open, and equitable criteria for qualifying participants, for evaluating bids, and–in the case of divestment–for dealing with existing liabilities. The bidding process also should specify the form and means of payment and requirements for future investment plans, technology transfer, maintenance of employment, and the criteria and time schedule for evaluating tenders. Unless the government pays adequate attention to ensuring a fair bidding process, privatization will be subject to charges of corruption, favoritism, or unfairness.

One of the more successful privatizations that has taken place in developing countries involved the transfer of ownership of the National Commercial Bank in Jamaica through share offerings.[14] A carefully prepared program for offering shares in the country's largest bank led to an extensive marketing campaign to demystify the stock market for average Jamaicans. These citizens had no experience with investing. The program included strong restrictions on the percentage of shares that any single investor could obtain, conditions to ensure small purchasers access to a substantial portion of the stock,

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creation of a network to facilitate the collection of share applications and distribution of stock certificates in a country whose postal system was unreliable, and conversion of the government's retained stock in the bank to nonvoting status. Rothschild advisers to the Jamaican government also helped develop an employee share scheme, special financing for employee share purchases, and a pricing schedule that would allow widespread participation. The carefully crafted procedures for bidding allowed 30,000 Jamaicans–a 170 percent oversubscription–to purchase, within two weeks, the 51 percent of the bank that was being offered to the public.

- *Enact appropriate legal and institutional reforms.* If privatization is to succeed, macroeconomic reforms must be accompanied by institutional development policies, including programs to foster and support the creation or strengthening of an effective system of property rights, financial institutions, labor markets, and legal institutions that can legitimize business transactions and adjudicate or resolve conflicts effectively, and marketing and distribution channels. Changes often must be made in labor laws, credit regulations, and wage and price controls before private investors are willing or able to participate effectively in privatization. Governments also must remove the unnecessary restrictions and regulations that inhibit private companies from operating effectively and provide or encourage low-cost credit programs that allow privatized companies to expand.
- *Strengthen private sector management capacity.* One of the most effective means that governments in the United States, Canada, and Western Europe have used to strengthen the management capacity of private organizations to provide public services has been to offer them contracting opportunities. Contracting can be most effective in situations in which efficiencies in service provision arise from economies of scale, greater productivity can be obtained from hiring skilled labor or specialized professionals, and contractors can use part-time labor or less labor-intensive methods of operation than the government uses. Contracting can be effective if private companies are freed from the severe labor and wage restrictions that constrain many government operations and have the flexibility to seek minimum cost approaches to service delivery.
- *Provide, at least initially, assurances to protect current employees.* Vociferous employee opposition can easily undermine privatization. Protecting workers whose operations are privatized or whose agencies contract with the private sector can help reduce initial opposition. Options include allowing employees of public corpo-

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rations or agencies to form their own companies to contract for service provision or acquire public assets, establishing employee share ownership plans, and requiring private companies that take over state enterprises to give preference in rehiring to laid-off SOE employees. Phased-in privatization by geographical district or stages could reduce opposition. The hostility of public employee groups may be contained by ensuring that fair wages and working conditions are provided by private companies that take over from public agencies or win contracts to provide public services. Some governments retain "golden shares" in SOEs that can be used to sell or distribute stock to workers. Others help groups of employees form their own companies to provide services directly to the public or privatized enterprises.

- *Allay fears that the poorest groups will be excluded from privatized services.* In countries with large poor populations, governments may have to offer privatized companies assistance or subsidies for providing services to the poor. Regulated utility or transportation companies, for example, can be allowed to charge high enough rates to industries or richer customers to provide "cross subsidies" for their poorest customers. These partial subsidies may be a better alternative for governments than continuing to underwrite the costs of inefficient and ineffective public enterprises or agencies. Voucher schemes that allow low-income groups to purchase services directly from the private sector are another means of overcoming exclusion problems and expanding the market for services.

Reorienting Government's Role

All of these management principles imply a reorientation of the role of government in the economy. In a market-oriented system, government cannot operate effectively using only directives and commands; effectiveness depends more on negotiation, persuasion, participatory decision-making, and coordination. Government officials must develop the capacity to manage contractual relationships. In a market economy, government takes more responsibility for enforcing regulations that protect the collective welfare, ensure open competition, and promote the advantages of market discipline without constraining the market with unnecessary or unrealistic controls. Public officials and employees must be trained in "adaptive management," in negotiation and interaction, in effective regulation, and in understanding how private companies operate.[15]

Finally, in some countries it may be necessary for government not only to manage the privatization process, but also to provide incentives and support to the private sector to participate in privatization. In Poland, for example, the government is allocating substantial amounts of money to cleaning up the bad debts of banks to make them attractive to private investors. The government of Bulgaria is attempting to buy the bad debts of SOEs before offering them for sale, thereby reducing the debt burden on new owners. The success of Germany's privatization program can be attributed not only to its effective management of economic policy and of the privatization process but also to the large amount of resources the German government offers investors in East German SOEs.[16] In many cases, the government relieved the SOEs of a substantial portion of their existing debts, took over many of the costs of dealing with environmental damages caused by the SOEs, and subsidized more than 50 percent of the costs of the investment in SOEs through grants, tax benefit packages, investment allowances, and special loans. The German federal and state governments also offered investors support in the form of local infrastructure or preferential financing and help in creating training courses for employees and with research and development. Without these incentives, Germany could not have been as successful as it was in privatizing East German SOEs so rapidly.

One of the strongest lessons of international experience with privatization is that managing the economic policy environment and the privatization process effectively is crucial to establishing a business climate in which domestic and international investors can have sufficient confidence to take the risks associated with assuming ownership of state enterprises. An economic policy environment conducive to creating and sustaining effective markets and an efficient set of procedures and organizations for transforming state enterprises are necessary, if not sufficient, conditions for developing private enterprise, especially in former socialist or government-controlled economies. ■

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