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REVIEW AND ASSESSMENT OF PRIVATIZATION PROSPECTS

PORTUGAL

REPORT BY

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EXECUTIVE SUMMARY

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This document reports on the results of a 10-day mission to Portugal to review and assess privatization prospects in the country.

Public enterprises exist in Portugal largely as a result of nationalization undertaken following the 1974 Revolution. Some 60-odd enterprises, primarily in the banking and basic industrial sectors, were directly nationalized and their ownership by the state is guaranteed by the Constitution. Another 500-odd enterprises were indirectly nationalized because they were majority or minority-owned by those enterprises which were directly nationalized. The Government can divest itself of these enterprises rather freely.

Privatization efforts to date have focused on the indirectly nationalized companies. Over 20 of them have been sold to the private sector through a combination of private and public placements of equity shares. The current Portuguese Government appears to be determined to continue privatization efforts to the maximum extent allowed by current law. However, the minority status of this Government limits its ability to carry out its privatization program without first achieving a certain political consensus. The outlook for such a consensus appears to be positive, but ultimate success of substantial privatization efforts is likely to also hinge on a number of other issues, such as the development of adequate capital markets, the easing of restrictive labor laws, the development of adequate management resources, etc. The recent entry of Portugal into the European Common Market will almost certainly facilitate the privatization process by liberalizing the economy and fostering freer markets.

To accelerate the pace of privatization and enlarge its scope, the Government needs to formulate a privatization policy

and a divestiture plan based on a comprehensive survey of public enterprises. The survey needs to focus primarily on the directly nationalized enterprises where the divestiture is likely to be more complex and time consuming but the impact is likely to be the greatest. A parallel effort should focus on identifying short-term privatization opportunities among such enterprises. At the same time, the Government should look for easier and more short-term targets among the indirectly nationalized companies. Another short-term target is the structuring of contracting out opportunities among municipal services.

Overall, despite the legal and constitutional obstacles, we believe that privatization shows substantial promise in Portugal given continued Government support and the application of proper planning and technical inputs.

MISSION ACCOMPLISHMENTS

The Mission to Portugal was characterized by a very ambitious program of interviews arranged by the USAID Mission in Lisbon and by the U.S. Consul in Porto. In the span of eight working days, we had meetings with a total of nearly 50 individuals, most of them high-level office holders and leaders in the Government, the legislature, public and private enterprises, labor unions and other important Portuguese institutions. A schedule of interviews is attached to this report.

As a result of this ambitious schedule, we spoke with a wide cross-section of Portuguese decision-makers who would in one way or another influence and shape the process of privatization in Portugal. In addition to collecting a wealth of information and opinions on the progress, process and prospects of privatization in the country, we feel that we were able to inform our hosts and stimulate interest, ideas and dialogue on the potential of privatization in Portugal and how it can be implemented in the context of the country's social, economic and political setting.

We were also able to formulate certain concrete proposals for short and medium-term action to accelerate the privatization process in Portugal. These proposals along with the underlying conditions and rationale are presented in this report.

We wish to acknowledge here the most generous assistance and steadfast effort of the USAID Mission in Lisbon without which the accomplishments of this Mission would have been greatly diminished.

CHAPTER I

PURPOSE OF THE PROJECT AND SCOPE OF WORK

I. PURPOSE OF THE PROJECT AND SCOPE OF WORK

The purpose of this project was to conduct a reconnaissance visit to review and assess privatization prospects in Portugal. The scope of work is as follows:

1. Meet with USAID/Embassy personnel, GOP officials, business leaders, union officials and the Luso-American Development Foundation to discuss strategies for privatization, assess government commitment to privatization, the readiness of state-owned enterprises for privatization and the general political/economic/legal environment for privatization.

2. Develop recommendations on the steps necessary to develop and implement a country strategy for privatization.

The visit was conducted by Dimitri Plionis and Cesar Pereira, Partners of Arthur Young, during the period April 1-12, 1986. George Ferris, who was in Portugal at the same time on a related mission to review the financial markets, contributed greatly to this effort.

CHAPTER II

COUNTRY ASSESSMENT

II. COUNTRY ASSESSMENT

A. Host Government

1. Top-Level Commitment

The current Government of Portugal, politically a right-of-center government, appears to be strongly committed to the concept and practice of privatization of state enterprises as allowed by current law (See Section B.1 below). The Government has repeatedly spoken about its desire to "rationalize" the nationalized sector. This notion actually was first promulgated by the previous Socialist-dominated Government. However, that government did not have the time or perhaps the will to take drastic steps towards denationalization.

2. Enunciated Policy

As stated above, the current Government has declared a policy of denationalization. As an example, a directive issued by the Ministry of Industry in January 1986 requires all state enterprises under its jurisdiction to file forthwith divestiture plans for all their holdings (indirectly nationalized companies) so that they do not hold more than 51 percent in any of them. Although this move retains government control, it is considered as the first step towards further reduction of government ownership when due process allows. On the other hand, we found no evidence of a well defined plan for privatization and there are a lot of opinions and questions within the Government and outside as to how to proceed. And there are a number of skeptics who doubt the sincerity of the Government.

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3. Power to Implement

The current Government is a minority government and, therefore, a politically weak government. However, an election just took place last fall and the parties which support the Government do not seem to have much to gain from elections in the near future. Moreover, there seems to be a broad political consensus on the need for privatization among the parties currently supporting the Government and among many Socialists in the Opposition. Initiatives in this area, therefore, have a good chance of being approved, possibly including a constitutional revision which will allow for broader privatization (see B.1 below).

4. Mid/Lower Level of Commitment

The situation here varies. We found several key executives of state enterprises who were openly for privatization of their enterprises (although opinions about the political feasibility of the proposition varied extensively). There seemed to be little, if any, opposition to privatization among the people with whom we spoke. We did not talk with any people at lower levels. However, we suspect that opposition might be higher among their ranks.

5. Accessibility for Dialogue

Officials both within the Government and among the Opposition Socialists seemed to be quite accessible within their busy schedules and discussed the subject rather openly. Some in the private sector, however, and especially in the North, complained of lack of easy access to and paucity of meaningful dialogue with the Government.

6. Awareness/Availability of State-Owned Enterprise (SOE) Costs

Availability of information about the full costs of SOEs is sketchy. Regular financial reports on SOEs are not published and, when published, do not provide sufficient information for a full assessment of their costs to the Government. However, the previous (Socialist-dominated) Government published a lengthy survey of 18 state-owned industrial enterprises which provided a reasonably good picture of the burdens imposed by these enterprises. In 1984, SOEs showed losses of 63.2 billion escudos ($380 million). Three companies are responsible for most of the losses: CNP (petrochemicals) with losses of 26.3 billion escudos, SETENAVE (shipyards) with 13 billion escudos, and QUIMIGAL (basic chemicals) with 19.1 billion escudos. The general impression is that the financial situation of most public enterprises ranges from bad to dismal. Overall, there is enough awareness among the key players in the Government, most of the political parties and within the community to generate significant pressure in favor of privatization.

7. Private Sector Influence on Policy

Many key actors in the current Government come from the private sector and, in that sense at least, the private sector exerts substantial influence on the Government. However, the private sector appears to be institutionally weak, lacking a unified and well articulated voice (or even consensus) as to broad policy issues. Dialogue with the Government seems to be mostly along rather narrow sectoral interest lines. Also, although key Government and SOE managers can fairly claim affinity to the private sector, many are really high-level technocrats, members of a well-educated and highly-intelligent public management elite, rather than "businessmen". They do not necessarily identify themselves with business interests (in neither a broad nor a narrow sense).

8. <u>Officials' Dependence on Outside Income</u>

This does not appear to be a major problem.

9. <u>Open Economy vs. Managed Economy</u>

The Portuguese Economy is clearly a mixed economy, but tends to be highly managed. This style of management has deep historical roots in Portugal, dating back to the time when Royalty made key economic decisions which tended to favor certain economic elites, while the majority of the population did not partake of most of the benefits. This style continued right through the Salazar era and in fact it became institutionalized into a politico-economic patronage system. With the advent of the Revolution in 1974, this system was rejected only to be replaced by a highly centralized communist-type system. In the last ten years, the country's economy has been quite liberalized by comparison to the historical norm. However, in absolute terms, it remains a highly centralized economy. The recent (January 1, 1986) entry of Portugal into the Common Market should help to accelerate the pace of liberalization.

10. <u>Previous Experience with Privatization</u>

Privatization of government-held enterprises has been limited to a number of indirectly nationalized companies (those which were owned by directly nationalized enterprises). IPE, a government entity which holds

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several dozen such companies, has divested itself (partially or totally) of about fifteen companies since 1982 (mostly through private placements). Privatization has also occurred in a different sense by allowing privately-held companies in a number of nationalized sectors (most notably banking and insurance) to compete with government-held ones. Finally, entry into the Common Market will force abolition of certain Government monopolies, such as grain marketing (EPAC). In a yet different show of privatization spirit, the Government has allowed two directly nationalized companies in the maritime sector to go bankrupt (which apparently is not constitutionally prohibited and received parliamentary approval) and has reconstituted them allowing up to 49 percent private ownership.

B. Political/Economic Environment

1. Legal Barriers to Privatization

As alluded to above, Article 83 of the Constitution makes the nationalizations of 1975-1976 "irreversible conquests of the working classes." This article applies to those enterprises in the basic sectors (banks and major industrial sectors) which were directly nationalized. The consensus is that indirectly nationalized companies can be denationalized following due process. Certain articles of the Constitution (Article 83 most likely included) can be amended by a four-fifths majority of the Parliament at any time (a practical impossibility), or by a two-thirds majority during certain windows of opportunity, the next one being in 1987. Many people believe that the political consensus on privatization will probably push through some sort of liberalization next year. In any event, the Portuguese have exhibited uncommon ingenuity in circumventing formal obstacles as long as there is political will for doing so. Proof of that is the remarkable degree of liberalization that has been achieved to date in the face of a largely communist-inspired Constitution.

One other possible obstacle is the existence of legal issues arising from inadequate and still unsettled compensation of previous owners of public enterprises. The potential impact of this obstacle is unclear.

2. Economic Stability

Although there are a number of troublespots (inability to control public sector spending being one of them), the Portuguese Economy has performed relatively well in the last several months, following a period of almost brutal austerity imposed by the previous Socialist-dominated Government. GDP growth in 1985 was estimated at 2.5 percent following a period of negative growth and is projected to reach 4 percent for the current year. The balance of payments is solidly in the black and exports registered a 9 percent growth in 1985. Inflation has declined ten percentage points in 1985 (to 19.3 percent), although the budget deficit remains high. Unemployment is steady at about 11 percent. These results were achieved before the country's accession into the Common Market. It is expected that following entry, such positive results should continue and even accelerate.

3. Political Stability

The Portuguese political environment, with 16 different governments since the 1974 Revolution, must be characterized as one of instability. The minority status of the current Government does not do much to alter this characterization. However, there seems to be some sort of a consensus emerging concerning the fundamental direction of the country. The above-cited emerging consensus on privatization is but one manifestation of this trend.

4. Unemployment Level

Unemployment has held steady for the last several years at between 10 and 11 percent.

5. Physical Infrastructure

Compared to other European countries, Portugal's physical infrastructure is clearly substandard. However, EEC entry should help improve this situation.

6. Regulatory Climate

Consistent with the highly-managed economy described above, the country's regulatory climate is far from liberal. Again, EEC entry should help liberalize the regulatory structure.

7. Parastatal Share of the Economy

Estimates are that the 60-odd statutory SOEs account for about 15 percent of industrial employment, 18 percent of Gross Fixed Capital Investment and about 20 percent of GDP.

8. Reasons for Parastatals

Most of the SOEs now in existence were nationalized in a 16-month period which began in March of 1975, when

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communist elements took effective control of the Government, following the Revolution of the previous year. It was, therefore, ideologically motivated and came as a violent reaction to the Salazar regime and its successor, the Caetano regime. The country is gradually recovering from that complex.

C. Business Climate

1. Role of Informal Sector

We did not find any evidence of an informal sector of any significance.

2. Management/Entrepreneur Pool

This was identified during our Mission as a real problem. There is an acute shortage of good managers and entrepreneurs and there is widespread concern about the capacity to manage large enterprises. In part, this is the result of the 1974 Revolution which led to an exodus of much management talent, but cultural factors also play a very important role. The Portuguese culture relegates business and commerce to a fairly low status. This situation is changing, but rather slowly.

3. Ethnic Minorities

None worth mentioning. Portugal has one of the most homogeneous populations on earth.

4. Permits to Start/Expand Business

The current law, dating from circa 1912, is very burdensome. We did not get exact statistics, but the process of starting/expanding a business is not only bureaucratic but also creates negative incentives. We heard of a new commercial law which exists in draft form and presumably streamlines the business formation/expansion process.

5. Freedom to Hire/Fire Personnel

The current regime, born of the Revolution, is highly rigid. Labor rigidity is one of the major impediments to economic modernization. The only way to reduce the work force at present is either through natural attrition or by paying hefty termination penalties which few companies can afford. The current Government has also announced its intention to liberalize the labor laws. One proposal which is likely to receive parliamentary approval will make economically-justified collective dismissals easier. This would be a positive development for privatization.

6. Preferential Treatment of SOEs (Restriction of Competition)

There are still many sectors of the economy which are the exclusive domain of SOEs. However, as mentioned above, the banking, insurance, fertilizer and cement sectors have been opened up to competition by private enterprises. Such liberalization is now extending to other sectors, such as grain marketing and the newspapers (with the recent sale of majority government ownership in the most profitable daily).

7. Tax Climate

The current tax structure and the business incentive structure in general can be characterized as average in terms of attractiveness to local and foreign investors. There are positive and negative aspects. For example, the system is skewed against common stock earnings, but there is no capital gains tax. Overall, the investment climate provides neither powerful incentives nor powerful disincentives. Against this backdrop, foreign investment has been increasing rather fast. (There are no significant limitations on foreign ownership.) Domestic investment has been declining however (except in exporting sectors), and private sector confidence is far from restored, mostly because of the events of the last decade which had a much worse effect on domestic investors than on foreign investors.

8. Accounting/Auditing Requirements

The current requirement for review and certification of financial statements are perfunctory. It is a statement of compliance with the law rather than an opinion on financial statements. This is definitely an area that requires improvement.

9. Other Donor Presence/Support

The World Bank and the IFC have been active in Portugal. The impression we formed was that the World Bank programs have not had a resounding success. A 1983 proposal for a World Bank public enterprise restructuring loan has been put on hold indefinitely by the Portuguese Government.

D. Financial Markets

Financial markets were the subject of a companion mission sponsored by AID concurrently with the privatization mission. A separate report has been prepared on the subject and should be reviewed in conjunction with this one. (That

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report is submitted as an attachment to this report.) In summary, financial markets are just now developing in Portugal. The two stock markets (in Lisbon and Porto) are thin and volatile and would be unable to handle large issues of shares. Only about 10 percent of the companies which could be listed in the stock exchanges actually are. In part, this is due to the fact that tax treatment of bonds is much more favorable than that of equity shares. Efforts, however, are underway to improve the capacity and sophistication of financial markets.

E. U.S. Influence

The U.S. is phasing out its bilateral economic development program in Portugal. The USAID Mission consists of two U.S. personnel plus a small number of Portuguese staff. However, the U.S. and Portuguese Governments have agreed to form the Luso-American Development Foundation (LADF) which will continue to provide funding for development-oriented projects. The LADF is a Portuguese institution operating under a structure which includes both Portuguese and American personnel, with an American director. Descriptive material on LADF is attached to this report.

The U.S. Embassy is certainly supportive of privatization. The Ambassador is personally interested in seeing that the Portuguese Government obtains as much information as possible on the concept and receives the assistance it needs to evaluate it in the Portuguese context.

CHAPTER III

PRIVATIZATION ISSUES AND RECOMMENDATIONS

III. PRIVATIZATION ISSUES AND RECOMMENDATIONS

In this chapter we present a discussion of issues relevant to the success of privatization efforts in Portugal, conclusions about privatization prospects and recommendations for action. We begin with an overview of the public enterprise structure in Portugal as a background for the discussion.

A. Overview of Public Enterprises in Portugal

Public enterprises in Portugal can be classified into two categories according to their legal/constitutional status:

- Statutory
- Non-statutory.

Statutory public enterprises are those which were nationalized directly and explicitly in the 1975-6 period. Their nationalization has been enshrined into Article 83 of the Constitution and their denationalization requires constitutional amendment. In addition to the 60-odd enterprises (mostly banks and basic industrial enterprises), which are 100 percent state-owned, this category includes a number of other companies which were typically joint ventures between Portuguese and foreign concerns but where only the Portuguese stock was nationalized. The state's share in such companies varies widely.

Non-statutory public enterprises are those which were indirectly nationalized (partially or totally) when their parents or stockholders were statutorily nationalized. These are estimated to number in excess of 500 and as a rule they are partly or wholly owned by banks or industrial enterprises. These companies are not subject to the requirements of Article 83 of the Constitution. Originally, these companies were transferred to IPE, the government entity which was

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established to manage the government's portfolio of indirectly nationalized companies. However, it was nearly impossible for one entity to manage such a large number of holdings and the majority of them reverted to those public enterprises which had owned them originally. IPE was left with 80-odd holdings in its portfolio.

The potential and mechanisms for privatization are quite different for the two classes of public enterprises. Holdings in non-statutory enterprises can be sold virtually without legal impediments. In fact, a fair number of them have been sold already; about 15 by IPE, and some (e.g., KOAA SEIKO) have been liquidated. The major issues with respect to these holdings are their readiness (or attractiveness) for privatization and the method to be used for the sale. In some cases, liquidation may also be a relevant consideration.

Privatization of statutory public enterprises is a much more complicated problem, primarily because of the constitutional restrictions, but also because of political and other considerations.

B. Privatization Issues

In this section we discuss a number of key issues which must be addressed in developing and implementing an approach to privatization in Portugal. Some of these issues relate to the mechanism which can be used to increase private sector control in nationalized enterprises and sectors. Four types of mechanisms are envisioned:

- Transfer of ownership rights to the private sector
- Liquidation (sale of assets)
- Transfer of control to the private sector
- Deregulation of markets for inputs and outputs of public

enterprises.

Other issues relate to such ancillary but crucial factors such as labor and management considerations and the need for restructuring of public enterprises. Furthermore, we examine prospects for privatization in the agricultural sector and in municipal services. We close with a review of the expertise available in Portugal to carry out privatization.

- <u>Issues Related to Transfer of Ownership Rights to the Private Sector</u>

  Under the current legal/constitutional framework, transfer of ownership rights from the state to the private sector is possible for non-statutory public holdings and for statutory public holdings where the stock and not the company itself was nationalized. For the latter, the nationalized stock cannot be sold; however, additional stock can legally be issued without limitation and this mechanism can be used to privatize such enterprises by simply issuing enough stock so that 51 percent of the total stock is in private hands. This technique has been used in the case of COVINA.

  Sale of state holdings can be effected in a number of ways, usually categorized as private or public placements. Private placements have been used primarily by IPE to dispose of some of its holdings. In some cases, additional stock was sold to a joint venture partner. A private placement is usually appropriate for small holdings (either in absolute value or in percentage).

  One special case of private placement is sale of stock to the company's work force under some type of employee stock ownership plan. We discussed this option extensively and have the following observations. Many found this option interesting and somewhat politically attractive. However,

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it is clear that the financial incentive structure for this type of ownership is virtually non-existent in Portugal. Moreover, reservations were expressed about the need for a sophisticated or informed work force, the availability of a certain level of disposable income among workers, the availability of credit for worker groups and the availability of well-developed professional management, all of which were thought to be in short supply. Nevertheless, at least one union (UGT) expressed relatively strong interest in obtaining more information and possibly in being involved in an employee ownership program.

Public placements involve issuance of stock to the public. Two methods have been used: public auctions of state-owned stock (used by IPE in a number of cases), or stock issues through the stock market for enterprises listed in the stock exchange. The first issue of stock through the stock exchange (MARCONI) took place in the late 1970's and was rather unsuccessful in the sense that the stock was purchased primarily by the state-owned banks. More recently, IPE has sold other holdings through the stock exchange with a greater degree of success.

Two key considerations in public placements is the level of functioning of the stock exchange and the availability of buyers. As mentioned earlier, the stock markets in Portugal are thin and volatile. Their capacity to handle a large number of issues is limited, although improving. A test of that capacity is the upcoming sale of 1.2 billion escudos through the Lisbon stock exchange by a casino operating company. Measures to improve the stock markets and capital markets in general are currently being proposed. For the foreseeable future, however, one must assume that there are capacity limitations and, therefore, the timing and pace of public enterprise divestitures through the stock markets will be very important. Unless such divestitures are implemented

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very gradually, there is a risk of creating wild price swings and depressing price levels.

As to the availability of buyers, it is of course a function of the attractiveness of the enterprise and the prices asked. Assuming that the actual or potential financial condition of the enterprise is good enough to create demand and that the prices asked are commensurate with such condition, there is a good chance that buyers will be available. Such buyers are likely to be institutional investors. Institutional investors, once limited largely to banks and insurance companies, are now increasing in numbers with the creation of investment funds, trust funds and pension funds. Foreign investors are also likely to participate in certain offerings. It is expected that relatively few individual or corporate investors will participate in offerings of public enterprise stock. This is in part due to a lack of sufficient incentives, in part to lack of confidence and, finally, to the absence of a tradition to own stock.

One way to facilitate acquisition of stock by private groups is to allow payment by indemnity bonds (bonds used to compensate owners of nationalized enterprises) at their face value. Assuming that this does not create a political problem (i.e., resistance to the idea that enterprises may revert to their original owners), it would substantially increase the availability of buyers; if not immediately (most of the indemnity bonds currently in existence have been redeemed), then when full compensation is completed (bonds issued to date represent only a small fraction of the original value of nationalized enterprises). If a political problem arises, this method can still be used by limiting the total value of the issue which can be purchased with indemnity bonds.

As mentioned earlier, the prevailing constitutional theory is that the state must own 100 percent of the statutory public enterprises. However, this theory has not been tested, and the idea has been put forward that legislation could be passed which would allow private sector ownership of statutory public enterprises of up to 49 percent. The constitutionality of such legislation would almost certainly be contested by the communist party and other elements and would come before the constitutional tribunal. In the past, the composition of this tribunal was such that the legislation would probably be found unconstitutional. With the composition of the tribunal changing with every election, it is likely that this idea might be given a chance at some future point. Even though the result of the legislation, if it stands, would not amount to transfer of majority ownership, and, therefore, would not be recognized by many as true privatization, it would bring privatization a step closer and would demonstrate a political consensus which would undoubtedly raise the chances of constitutional revision at the next opportunity.

Theoretically, it may also be possible to devise a scheme whereby the private sector, with 49 percent of the equity, might have effective control of the enterprise through some kind of structuring of voting and non-voting stock. However, the legal feasibility of such a scheme is unclear and, moreover, it is likely to cause political problems as "unauthorized" privatization.

The government has recently introduced a new instrument, the participation bond, which at this point is only a means of raising capital since it confers no ownership rights to the holder. However, this is seen by many as a step in the right direction since such bonds were issued in France and later were converted into voting stock as a means of privatization.

One last issue related to the transfer of ownership of public enterprises is that of the debt overhang which burdens many public enterprises. Most people agree that such debt should in most cases be taken over by the government and the enterprise should be left unencumbered if it is to have any appeal to investors.

- <u>Issues Related to Bankruptcy and Liquidation of Public Enterprises</u>

If a public enterprise is not financially viable under free market conditions and cannot be sold to the private sector, it should be considered as a candidate for liquidation. Liquidations of public enterprises have occurred in Portugal among non-statutory public enterprises (for example KOAA SEIKO, a subsidiary of QUIMIGAL). Although bankruptcy under the current commercial law can be a never ending process ("no company ever goes bankrupt in Portugal" is a saying often heard) primarily because of actions by the creditors, when the Government is the owner, the process can be simplified.

Bankruptcy of public enterprises has also been carried out even with statutory enterprises (there apparently being no constitutional impediment). The cases in point involved CNN and another maritime public enterprise which were declared bankrupt by Government Decree and subsequently reconstituted as new state companies under commercial law with up to 49 percent ownership participation by the private sector. Apparently, the precedent established also allows for bankruptcy and liquidation without subsequent reconstitution, which opens up the way for disposing of non-viable statutory public enterprises or parts of such enterprises. The due process provides for the Decree Law to be challenged in Parliament and for it to be voided if defeated, thus allowing the political process to work.

- <u>Transfer of Control to the Private Sector</u>

  Effective control of a public enterprise can be legally transferred to a private entity, even for statutory public enterprises, through a management contract. This creates another alternative for "privatization" in cases where other alternatives are not possible for whatever reasons. When such contracts are long-term and properly structured, they can be an effective way to introduce privatization, especially where the option to buy is available.

- <u>Deregulation of Markets for Inputs and Outputs of a Public Enterprise</u>

  Deregulation is a way to achieve many of the benefits of privatization without affecting the ownership structure. When the markets for inputs and outputs of public enterprises are deregulated (i.e., they become free and competitive), not only does the overall production process become more rationalized but often the public enterprise is eventually supplanted by the private competitors, thus achieving the ultimate goal without going through the process of ownership transfer.

  This deregulatory process was recently introduced in Portugal when the markets for banking and insurance services (as well as for fertilizers and cement) were liberalized. This has led to the creation of private companies in the two first sectors, thus reinvigorating these sectors. The same is occurring in the grain markets where competition is provided by domestic and foreign suppliers.

- <u>Labor Issues</u>

  In light of the restrictive labor legislation (see earlier discussion), labor issues have a potential for seriously hampering the privatization process by restricting the ability of the buyer to restructure the enterprise into a profitable one. However, there are several ways to deal with this potential problem. To begin with, the Government can offer to find jobs for excess labor elsewhere in Government as it has done in the case of the reconstituted maritime companies. Also, the private buyer can reduce personnel by a combination of attrition and termination deals with the workers (this is the common way of dealing with the problem). In addition to these solutions, the Government has pledged (and it has a good chance of passing) legislation to ease the restrictions for economically justified collective dismissals. Thus the labor issue does not loom as formidable as it might seem.

- <u>Management Issues</u>

  As mentioned earlier, competent management is in short supply in Portugal. In the long run, the solution to this problem will be found in proper education, training and incentives for the development of managerial skills. In the short run, managers for privatized enterprises will come from among competent managers currently serving within the public enterprises and others from outside, relying on the incentives and signals provided by the private ownership and free markets to increase their efficiency and effectiveness.

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- ### Restructuring of Public Enterprises

  Restructuring of a public enterprise is frequently necessary to prepare the enterprise for divestiture. The main objective is to rationalize the operation of the enterprise and organize it into those viable units which can be sold profitably and those which may need to be liquidated. In that sense, restructuring is conducive to privatization.

  Restructuring, however, is often used by governments as a way to improve efficiency without any intent of divestiture. This, of course, cannot be characterized as privatization although it is often called that.

  We feel that restructuring (financial, organizational, strategic) has a proper role as a facilitator of privatization in Portugal. For some enterprises, such as QUIMIGAL, it is the only way that they will ever be made financially attractive enough to be sold.

- ### Other Privatization Prospects

  In the foregoing, we focused our attention on the industrial and financial public enterprises. Large estates in the South (especially in the Alentejo provinces) were also nationalized following the revolution. Most of them still operate under public ownership and suffer from all the problems affecting the rest of the nationalized public enterprises. In our survey, we chose not to focus attention on privatization possibilities in the agricultural sector because of the political sensitivity and intractability of divestitures in this sector.

However, upon our return to Washington, we were approached by a private group which is interested in a joint venture with a publicly owned estate which may ultimately facilitate divestiture. This is further detailed in Section 4 as a recommended action item.

Another sector which presents substantial opportunities for privatization is the municipal government sector. During a visit with the Mayor of Lisbon, we heard about his idea to privatize cemeteries. We took the opportunity to introduce him to a much wider range of privatized services in American municipalities. The Mayor expressed interest in learning more about the practice. We feel that much can be done in this area and have developed an action item (see Section 4).

- <u>Available Expertise in Portugal to Carry Out Privatization</u>

As has been mentioned several times above, the Portuguese already have experience with several methods of privatization and have the essential requisite skills. Even without any outside assistance, it is likely that the privatization process will progress, but it will do so deliberately and will probably fall short of the potential scope of the concept's applicability. We feel that outside assistance can be helpful in facilitating and energizing the process in the following areas:

- Asset and business valuation
- Restructuring of large enterprises
- Making large public placements
- Attracting foreign investors

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- Structuring complex management contracts
- Structuring employee ownership schemes
- Developing an overall privatization plan.

C. Summary and Conclusions

Privatization in Portugal is favored by:

- A committed Government
- An emerging political consensus for privatization which could pave the way for substantial easing of the existing restrictions to divestiture of public enterprises
- A track record of successful divestitures and other privatization initiatives.

Privatization still faces numerous obstacles, including:

- Substantial legal and constitutional impediments
- Political weakness of current Administration
- Lack of private sector confidence
- Relatively weak capital markets
- Labor market rigidities
- Discouraging finances of many public enterprises
- Vested interest in the status quo among certain managers

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of public enterprises, labor groups and other groups

- Lack of coherent plan and approach to privatization.

We believe that the progress made to date justifies optimism and that the obstacles identified can be dealt with in a manner which allows a far greater degree of privatization than that which has been accomplished to date. This will require a systematic review and analysis of the nationalized enterprises and other holdings with the objective of developing a national privatization plan and approach. It will involve a sector-by-sector review of state ownership, including both successful and unsuccessful enterprises. Criteria should be developed for screening and prioritizing those sectors in which the Government should divest itself of public enterprises and other holdings as well as the mechanisms which are appropriate for such divestitures. The plan will also identify supporting measures and policies that the Government needs to undertake to provide the proper environment for privatized enterprises and to alleviate the consequent side effects of divestiture. The plan should also include a step-by-step implementation program beginning with one or more pilot projects to demonstrate and validate the planned approach. One of those pilot programs should include employee ownership as a privatization alternative to explore the feasibility of the concept in Portugal.

Our review of non-statutory public enterprises focused on IPE holdings. IPE is currently responsible for the Government's holdings in about 70 enterprises. IPE has developed a strategy and a plan and is working on restructuring and selective divestiture of its holdings. The same is true with other statutory public enterprises holding shares in other enterprises (especially the industrial ones, following the ministry's directive to partially divest their holdings).

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Recommendations

We recommend that the following actions be taken to continue and accelerate the process of privatization in Portugal:

For Statutory Public Enterprises

1. Survey of Public Enterprises

   We recommend that the Portuguese government perform a comprehensive survey of statutory public enterprises with the following objectives:

   - Establish a comprehensive data base of information on financial and operating performance of public enterprises by sector.

   - Review the Government's goals and rationale for ownership in each sector and each major public enterprise.

   - Analyze the Government's current and projected revenues and outlays by sector and for each major public enterprise.

   - Develop and analyze alternative ways for achieving the Government's objectives in each sector.

   - Review in detail past and current privatization efforts to glean lessons and information which can be used during the planning process.

   - Analyze all the data and information collected above and assess the merits and likely impact of divestiture in each sector.

As a by-product of this effort, we recommend that a comprehensive public enterprise performance monitoring system be developed which can continue generating the information necessary for policy-making regarding privatization.

2. Develop National Privatization Policy and Plan

Following completion of the survey, we recommend that the Government develop a national privatization policy and plan. The following steps are envisioned:

- Develop and enunciate privatization goals and objectives.
- Develop criteria for selecting candidate public enterprises for privatization to achieve the articulated goals and objectives.
- Use the criteria to select and prioritize candidate public enterprises for privatization.
- Review and analyze alternative privatization methodologies (see Section III.2) for high priority public enterprises. (We recognize that one particular alternative, transfer of ownership, is currently not available for statutory enterprises. Consideration of this alternative should be reviewed in light of political and other relevant factors prevailing at the time of the study.)
- Develop a plan and timetable for privatization for the next 3-5 years, taking into account the combined and accumulated impact of the planned actions on the

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important groups (such as labor); and detail a program for curbing undesirable side-effects. Assess the financial impacts of the plan on public finances and other key economic variables.

3. Conduct Pilot Divestitures

Select pilot enterprises for privatization in each priority sector (in accordance with the above plan) and proceed with privatization, at the same time testing methodologies and validating estimates of the benefits and costs of privatization. At least one of these pilot projects should test employee ownership as a privatization method (unless the concept is deemed non-viable as a result of the initial assessment recommended).

The above recommended steps are closely related and are meant to be undertaken sequentially over a period of 1-2 years, but need to start immediately.

4. Pursue Short-Term Privatization Initiatives

In parallel with the initiation of the short-to-medium term sequence of steps outlined above, we recommend that the Government continue to pursue short-term privatization initiatives. As explained above, experience has shown that it is possible to pursue a number of privatization options with statutory public enterprises such as deregulation, management contracts and liquidation (with or without reconstitution). We recommend that a review of statutory public enterprises be undertaken over the next few months to identify short-term privatization opportunities and structure specific privatization initiatives for them. This effort will serve to build a momentum for privatization and to yield information and models for the longer-term effort.

For Non-Statutory Public Enterprises

4. **Develop Privatization Policy and Guidelines for Non-Statutory Public Enterprises**

   Privatization of non-statutory public enterprises seems to be performed in ad hoc and uncoordinated fashion. We recommend that a uniform policy regarding privatization of non-statutory public enterprises be developed. This policy should be operationalized into a set of guidelines for use across governmental units.

5. **Review Nationalized Bank Holdings**

   Within the policy and guidelines developed under the previous recommendation, we recommend that the Government undertake a review of nationalized bank holdings. This category of non-statutory public enterprises presents special opportunities for privatization. While industrial sector holdings usually have a structural relationship to their parents, this is not the case with bank holdings. In most cases, banks own enterprises as a result of non-performing loans and/or defaults and they are not structurally or economically related to them. Privatization of bank holdings should, therefore, be easiedr to justify and possibly accomplish.

her Recommendations

6. **Promote Privatization of Municipal Services - Lisbon**

   This is to be accomplished in the following steps:

   - Provide the Municipality of Lisbon with information on privatization options and activities at the

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municipal level in the U.S. and elsewhere.

- Organize a visit by the Mayor and/or senior municipal officials in the United States to witness first-hand privatized services at the municipal level.

- Develop a plan for privatization of municipal services in Lisbon.

7. Explore Privatization of an Agricultural Estate Via a Joint Venture with a U.S. Firm

A U.S. firm in the field of Agri-Business Management, Western Agri-Management Company, has expressed an interest in joint-venturing with a Portuguese nationalized estate, to develop and market agricultural products in the European markets. This company is proposing to invest in a small share of the enterprise and provide production know-how, marketing advice and market access for growing and exporting cut flowers, fruits and vegetables. Following a development period, Western Agri-Management Company would assist the Portuguese Government in divesting itself of the holding by selling its share to private investors (domestic and foreign), including the workers of the enterprise or their cooperative. In this connection, the company offers to locate and attract inverstment capital and loan funds.

We believe that this may be an interesting pilot project which has the potential of developing an approach for divestiture of agricultural holdings. Western Agri-Management has already had discussions with the management of a particular estate which expressed interest in the idea.

In addition to the above privatization-related recommendations, t is recommended that the Government take steps to strengthen the apital markets as recommended elsewhere and adopt a management evelopment program for public enterprises. Both these steps are onsidered essential to the success of privatization efforts in ortugal.

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APPENDICES

APPENDIX I

PRIVATIZATION/CAPITAL MARKETS SURVEY

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SCHEDULE OF INTERVIEWS

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PRIVATIZATION/CAPITAL MARKETS SURVEY

Consultant Visit April 2 to 12
Sponsored by the U.S. Agency for International Development

Consultant Team:
Dimitri Plionis and Cesar Pereira
consultants on Privatization
Arthur Young International
George Ferris
consultant on Capital Markets
Ferris and Company

A.I.D. Team:
Luz Rezende
José Luís Pinheiro
David C. Leibson
USAID, Lisbon

Wednesday (April 2) - joint meetings full team

7:00 AM - Team Arrival on TWA; transfer to Hotel Tivoli

11:30 AM - Embaixada dos Estados Unidos
Avenida das Forças Armadas
1507 Lisboa Codex
Tel.: 726 6600/726 8880

Honorable Frank Shakespeare, Ambassador

2:00 PM - William F. Gelabert, AID Representative
David Leibson, AID Private Enterprise Officer
Mark Lore, Embassy Economic Counselor

4:00 PM - Fundação Luso-Americana para o Desenvolvimento
Rua Rodrigo da Fonseca, 178 - 5° Esq.
1000 Lisboa
Tel.: 69 28 49-69 29 91/69 29 20

Donald Finberg, President of the Executive Council

Dr. Bernardino Gomes, member of the Executive Council

Thursday (April 3)

9:00 AM - **Secretaria de Estado do Tesouro/Ministério das Finanças**
Secretaria de Estado da Indústria e Energia/Ministério do Comércio e da Indústria
Av. Infante D. Henrique - 1100 Lisboa
Tel.: 87 75 55

Dr. José Alberto Tavares Moreira
Secretário de Estado Adjunto do Ministro das das Finanças e do Tesouro

Dr. Luís Manuel Pego Todo-Bom
Secretário de Estado da Indústria e Energia

2:00 PM - **Central de Cervejas, EP**
Av. Almirante Reis, 115
Tel.: 53 68 41

Dr. Eusébio Marques de Carvalho
Presidente

3:00 PM - **Comissão Parlamentar de Economia, Finanças e Plano/Assembleia da República**
Palácio de S. Bento
Tel.: 60 50 06

Eng. João Cravinho
Representante do Partido Socialista na Comissão Parlamentar de Economia, Finanças e Plano.

5:00 PM - **Associação Portuguesa de Seguros**
Av. José Malhoa, Lt. 1674, 4°
1000 Lisboa
Tel.: 726 8123

Dr. Rui de Carvalho
Presidente

Dr. Seixas Vale
Vice-Presidente da Direcção

Friday (April 4)

I. **Meetings on Privatization** -(Plionis, Pereira, Pinheiro)

9:00 AM - **Investimentos e Participações do Estado, SARL (IPE)**
Av. Júlio Dinis, 11 - Lisboa
Tel.: 76 60 83/86

Dr. Manuel Alarcão e Silva
Administrador e Vice Presidente do IPE

11:00 AM - **Companhia de Investimentos e Serviços Financeiros, SARL (CISF)**
Campo Grande, 28 - 11° - 1700 Lisboa
Tel.: 77 56 15/77 54 39

Dr. José Vaz de Mascarenhas
Director Executivo

12:30 PM (Lunch) **Comissão Nacional dos Cereais**
Av. Conselheiro Fernando de Sousa, 11 - 3°
1000 Lisboa

Dr. Jorge Marcos Rita
Presidente

Restaurant: Paris Orly. Homer Sabatini, Embassy Agricultural Counselor, will attend.
Av. de Roma, 6E
Tel.: 88 23 05

3:00 PM - **Secretariado Permanente para as Empresas Públicas**
Av. do Brasil, 1 - 6° andar
Tel.: 73 20 46/73 24 46

Dr. Júlio Neves
Presidente

5:00 PM - **Câmara Municipal de Lisboa (CML)**
Praça do Município/Paços do Concelho, 1° andar
Tel.: 36 01 82/36 29 51

Eng. Nuno Abecasis
Presidente

6-8:30 PM- **American Club of Lisbon**
Cocktail at Clube dos Empresários
guests of David Leibson
Avenida da República, 38
Lisboa
Tel.: 76 63 80

Friday (April 4)

II. **Meetings on Capital Markets** (Ferris, Rezende)

9:00 AM - **BPI - Banco Português de Investimento** (Sucursal de Lisboa)
Rua Castilho, 39 - Edifício Castil, 13° H
1200 Lisboa
Tel.: 57 96 43/57 96 93

Dr. Fernando Ulrich
Director

10:30 AM - **Bolsa de Valores de Lisboa**
Praça do Comércio (Ministério das Finanças)
1100 Lisboa - Tel.: 87 94 16/87 94 17

Dr. Carlos Alberto Rosa
Presidente da Comissão Directiva
(Representante da "Bolsa de Valores de Lisboa" na "Comissão Dinamizadora do Mercado de Capitais").

12:30 PM - **The Chase Manhattan Bank, N.A.**
(Lunch)
Rua Alexandre Herculano, 50 - 7°
1200 Lisboa
Tel.: 52 11 95

Dr. António Guerreiro
Director

3:00 PM - **Banco de Portugal** (Annex)
Rua Febo Moniz, 2-4
1100 Lisboa
Tel.: 52 20 53

Dr. Teodora Cardoso
Directora
Departamento de Estudos Económicos

Dr. António Cabral
Director Adjunto
Departamento de Estudos Económicos

5:00 PM - **Grupo Espírito Santo**
Rua de S. Bernardo, 62 (à Lapa)
1200 Lisboa
Tel.: 60 91 68/60 92 68

Dr. Carlos Monjardino
Administrador

Monday, (April 7) (Meetings in Porto, full team)

8:45 AM - Breakfast Meeting at Sheraton with U.S. Consul Jacklyn Cahill

10:00 AM - Banco Português de Investimento (BPI)
Rua Tenente Valadim, 284
4100 Porto
Tel.: 69 99 51/65 484/69 48 42

Dr. Artur Santos Silva
Presidente

Dr. Rui de Faria Lélis
Director, Função Jurídica e Mercado de Capitais

Dr. Manuel Correia de Pinho
Estudos Económicos e Estatísticos

Dr. João Paulo Rocha Pinto
Mercado de Capitais

Other BPI Staff

1:00 PM - Lunch hosted by BPI
Restaurante "O Degrau"

3:00 PM - Banco Português do Atlântico (BPA)
Rua Sá da Bandeira, 23-29, 6° andar
4000 Porto

Dr. Morais e Castro
Presidente

BPA Staff

8:30 PM - Dinner at the Porto Sheraton with leading businessmen active in capital market operations

Eng. Avila Ramos
Director
EFACEC
Arroteia - Leça do Balio
Matosinhos
4465 São Mamede de Infesta

Eng. Alberto Resende
Administrador
Empresa Industrial de Santo Tirso
Rua Cândido dos Reis, 104
4000 Porto

Dr. Hernâni Carqueja
Administrador Delegado
Soja de Portugal
Rua Gonçalo Sampaio, 271-1°
4100 Porto

Sr. Vasco Faria
Vice-Presidente
Associação Industrial Portuense
Av. da Boavista, 2671
4100 Porto

Dr. Jorge Armindo Carvalho Teixeira
Director Financeiro
A. Paulo Amorim & Filhos, Lda.
Apartado 2
Mozelos - Feira
4535 Lourosa

Dr. Belmiro de Azevedo
Administrador
SONAE - Indústria e Investimentos, Sarl
Via Norte
Maia
4470 Maia

Tuesday (April 8)

11:15 AM - Car at hotel

11:30 AM - Associação Industrial Portuense
Av. da Boavista, 2671
4100 Porto

Sr. Vasco Faria
Vice-Presidente

Sr. Jorge A. Ferreirinha
Membro do Conselho Executivo

Dr. Nelson Machado
Adjunto do Secretário Geral

Dr. Serafim Correia
Director do Gabinete de Estudos

Dr. Rui Peixoto Duarte
Técnico do Departamento de Estudos e Responsável pelo Núcleo de Assuntos Europeus

Lunch Free

3:00 PM - Associação Comercial do Porto
Bolsa de Valores do Porto
Palácio da Bolsa
Rua Ferreira Borges
4000 Porto

Dr. Ruy Lacerda
Presidente

Dr. Marcelino Chaves
Instituto de Estudos Estratégicos

Srs. Oliveira e Andrea Roque
Empresários

Representantes
Banco Pinto & Sotto Mayor

Capital market consultant will spend Wednesday in Porto for continued meetings and return to Lisbon Wednesday evening. Privatization consultants will return from Porto Tuesday evening for meetings in Lisbon.

Wednesday (April 9)

I. **Meetings on Capital Markets in Porto** (Ferris, Rezende)

10:00 AM - **Têxtil Manuel Gonçalves**
R. Adriano P. Basto, 145
Vila Nova de Famalicão
4760 Vila Nova de Famalicão

Dr. António Gonçalves
Presidente

Lunch free

8:10 PM - Ferris and Rezende depart for Lisbon
TP 483 - Arrives in Lisbon at 8:55 PM.

Mtgs on Privatization in Lisbon (Plionis, Pereira, Pinheiro)

12:00 PM - **Banco de Portugal**
Rua do Comércio, 148
1100 Lisboa
Tel.: 52 20 53

Vitor Manuel Ribeiro Constâncio
Governador

01:00 PM - (Lunch) **Congresso Geral dos Trabalhadores de Portugal (C.G.T.P.)**
Restaurante Clara
Campo Mártires da Pátria,
49 - r/c Esq.
Lisboa
Tel.: 55 73 41/57 04 34

Kalidas Barreto
Membro da Comissão Executiva

Mr. Manuel Lopes
Membro da Comissão Executiva

Dr. Carlos Coimbra
Economista - Gabinete de Estudos

Two other guests

3:00 PM - **Fisipe, Fibras Sintéticas de Portugal, SARL**
Lavradio - Barreiro
Tel.: 207 5181/2

Eng. João Manuel Dotti
Presidente

5:00 PM - **Confederação da Indústria Portuguesa (CIP)**
Av. 5 de Outubro, 35 - 1° andar
Tel.: 54 74 54

Dr. Pedro Ferraz da Costa
Presidente da C.I.P.

Thursday (April 10)

I. Meetings on Privatization (Plionis, Pereira, Pinheiro)

10:00 AM - União Geral dos Trabalhadores
Rua Augusta, 280 - 2°
1000 Lisboa
Tel.: 36 11 01/02/03/04

José Veludo
Membro do Secretariado Executivo
Presidente do Sindicato da Função Pública

União Geral dos Trabalhadores
The U.G.T. is the non-communist oriented Group of Labor Unions.

1:00 PM - Luncheon with prominent Socialist Party Leaders
(Joint Meeting with Full Team)
Bachus Restaurant
Hosted by Johnie Carson, U.S. Embassy

António Guterres
Deputado do Partido Socialista
Membro do Conselho de Gestão do IPE

João Carlos Espada
Professor
Universidade Nova de Lisboa

3:30 PM - Quimigal
Av. Infante Santo, 2 - 6°
Tel.: 60 95 61/60 40 40/67 91 61

Dr. Vasco Ribeiro Ferreira
Member of the Board of Managers

5:30 PM - INAPA - Indústria Nacional de Papéis, SARL
Av. Duque de Loulé, 83, 4°
1000 Lisboa
Tel.: 54 31 18

Dr. Vasco Pessanha
Administrador

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Thursday (April 10)

II. Meetings on Capital Markets

10:00 AM - Banco Pinto & Sotto Mayor
Av. Fontes Pereira de Melo, 7-13, 5°
1000 Lisboa
Tel.: 54 25 54/54 20 78

Dr. António Loureiro Borges
Presidente do Conselho de Gestão

Dr. Miguel Krupenski
Director

11:30 AM - Comissão Dinamizadora do Mercado de Capitais
Ministério das Finanças
Av. Infante D. Henrique
1100 Lisboa
Tel.: 87 75 55/87 90 23/87 91 06

Dr. Artur Luís Alves Conde
Presidente

1:00 PM - Luncheon - see previous page

3:30 PM - Banco de Fomento Nacional (BFN)
Av. Casal Ribeiro, 59
1000 Lisboa
Tel.: 52 22 79/52 34 19

Eng. Francisco Ressano Garcia de Lacerda
Membro do Conselho de Gestão
(Representante do sector bancário na "Comissão Dinamizadora do Mercado de Capitais").

5:00 PM - Banco Espírito Santo e Comercial de Lisboa
Av. da Liberdade, 195
1200 Lisboa
Tel.: 57 80 05/57 90 05

Dr. José António da Silveira Godinho
Vice-Presidente, Conselho de Gestão

Friday (April 11) - Joint Meetings Full Team

9:00 AM - **De-briefing by the consultant team with the U.S. Ambassador**

9:30 AM - **De-briefing by the Consultant Team at the U.S Embassy Staff Meeting**

11:30 AM - **De-briefing with the Luso-American Development Foundation**
Rua Rodrigo da Fonseca, 178 - 5° Esq.
1000 lisboa
Tel.: 69 28 49/69 29 20

Donald Finberg, Dr. Rui Machete and Dr. Bernardino Gomes
Executive Council

3:30 PM - **De-briefing with the Office of the Secretary of State for the Treasury**

Prof. Doutor José António Girão
Director Geral do Tesouro

António L. C. Leite de Magalhães
Assessor do Secretário de Estado Adjunto do Ministro das Finanças e do Tesouro

I. **Meetings on Privatization** (Plionis)

5:30 PM - **Dr. Cesar Bessa Monteiro**
Rua D. Francisco Manuel de Melo,
16 - 1° Dto.
1000 Lisboa
Tel.: 68 15 70/65 29 37/65 78 58

Dinner - **Eng. Fernando Faria de Oliveira**
Director IPE

Rua Castilho, 75 - 1° D
Tel.: 54 24 60-53 60 19-55 91 74

Saturday (April 12)
Departure of the consultant team.

APPENDIX II

PROGRAM OUTLINE OF THE LUSO-AMERICAN FOUNDATION

Luso-American
DEVELOPMENT
Foundation

1. The Foundation

The Luso-American Development Foundation is a Portuguese Foundation created on May 20, 1985, by Decree Law 168/85. Its goal is to contribute to Portugal's economic and social development by promoting cooperation between Portugal and the United States in the scientific, technical, cultural, educational, commercial and entrepreneurial fields.

The Foundation operates under Portuguese law as a private organization which provides public benefit. It has the administrative and financial independence necessary to carry out its purposes

The initial endowment of the Foundation was $38 million contributed by the Portuguese Government as a result of cooperation with the Government of the United States. Increases in endowment from the same source are foreseen in the statutes which established the Foundation.

The Foundation has Directive, Executive and Advisory Councils. The Directive Council determines the basic policies of the Foundation and approves annual budgets, accounts, and reports. It consists of three members – two designated by Portugal's Prime Minister and the third being the Ambassador of the United States.

General administration of the Foundation is the responsibility of the Executive Council, consisting of two Portuguese members designated by the Prime Minister and an American selected by the American Ambassador.

The Advisory Council is composed of eight distinguished representatives of the Portuguese and American business and scientific communities. Four are selected by the Prime Minister and four by the Ambassador of the United States.

The Foundation will give priority to projects which promote rapid modernization of the Portuguese economy; and the role of the private sector will be given particular importance. The Foundation prefers to support proposals to be administered by other organizations, rather than administering projects itself. This approach will enable the Foundation to maintain flexibility in its operations and limit the number of its employees.

Temporary Office Rua Rodrigo da Fonseca [illegible]
1000 Lisboa Portugal
Telephone 69 28 49/69 29 91/69 29 20
Telex 64840 FLAD P

Luso-American
DEVELOPMENT
Foundation

2. Areas of Emphasis

Initially the Foundation has decided to concentrate on the following program areas:

Private Sector Development

To modernize and strengthen the private sector, enabling it to compete effectively in the EEC and other international markets. The Foundation may participate in activities such as expanding capital markets, increasing foreign investment in Portugal, promoting exports, and creating new firms (including joint-ventures) in order to accelerate economic development.

Science and Technology

To develop modern technologies and promote technology transfer which will increase the efficiency and competitiveness of the Portuguese economy.
Particular emphasis will be placed on applied research and projects involving cooperation among industries and universities.

Education

To improve the quality of education, particularly at the secondary and higher levels, including post-graduate and technical training. Academic and research fellowships will be provided according to criteria and priorities which will be established.
Priority will be given to projects aiming at improved management, including educational administration.

Public Administration and Regional Development

To support reforms which will lessen bureaucracy and make public administration more efficient. Support will be given to projects which contribute to regional development, correcting imbalances and improving municipal organization and management.

Culture

To contribute to the diffusion of Portuguese language and culture. Cultural and artistic initiatives which develop a spirit of innovation and progress will be encouraged.
Cultural exchanges between Portugal and the United States also will be supported.
The Foundation will initially give greater support to the first three program areas.

3. Criteria for Approval of Projects

Since the Foundation's ability to provide financial assistance is limited, it will not be possible to support all worthy requests submitted. Therefore, it is necessary to establish selection criteria. The most important guidelines for consideration of projects follow:

- Projects should make a significant contribution to Portugal's economic development. Projects should be realistic, with clearly defined objectives which are included within the Foundation's areas of emphasis.
- The Foundation will support projects which contain innovative approaches, giving priority to projects involving cooperation among Portuguese organizations or collaboration between Portuguese and American institutions. Portuguese institutions will normally be responsible for the administration of projects.
- Support for a project normally will not exceed three years.
- The Foundation generally will not finance more than 50% of the costs of a project, except for some research activities.
- In the field of private sector development, the Foundation will give preference to financing of projects through financial intermediaries and trade associations, cooperatives, etc.
- Financing of equipment, training, seminars and conferences, etc. normally will be considered only when part of a comprehensive project.
- The Foundation will not support current operating costs, charitable activities, or building construction.
- The Foundation will not support partisan political activities.

4. How to Present a Project Proposal

Most Foundation assistance will be in the form of grants, although it may also provide loans or loan guarantees.

Decisions on projects submitted to the Foundation will be made impartially and based on rigorous analysis, soliciting the views of independent individuals and organizations of recognized quality when appropriate. Decisions will take into consideration whether or not proposals are within the Foundation's fields of emphasis and meet selection criteria, as well as the importance of the problem addressed and the financial and administrative capacity of the institution requesting assistance.

Preliminary grant applications (preferably not to exceed ten pages) should be sent to the Foundations's temporary office. Requests should contain the following information:

a) Background information on the requesting individual or organization — name, address, telephone number, person responsible for the proposal; and a brief description of the purpose, history, and activities carried out by the organization.

b) A brief description of the proposed project, including
- The problem the project will address, and the purpose of the project;
- Anticipated specific accomplishments of the project;
- How the project will be implemented, over what time period, and at what total cost;
- Other financial assistance available for the project;
- The names and addresses of any other funding organizations to which the proposal has or will be submitted;
- Indication of American or other organizations whose cooperation in the project is desired;
- A detailed budget showing how the funds of the Foundation and all other contributors will be distributed;
- Indication of how the project will be continued after Foundation support ends.

The Foundation will reply as soon as possible, indicating whether or not assistance is likely. If Foundation support seems likely, the

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APPENDIX III

PORTUGAL

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AN ASSESSMENT OF THE CAPITAL MARKET

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Portugal an Assessment of the Capital Market

George M. Ferris, Jr.
Chief Executive Officer
Ferris & Company, Inc.

April 1986

Arthur Young
A MEMBER OF ARTHUR YOUNG INTERNATIONAL

PORTUGAL: AN ASSESSMENT OF THE CAPITAL MARKET

I. ENVIRONMENT

It appears to be an appropriate time for capital market and privatization initiatives in Portugal.

a. **Economy**

The economy is entering a stage of buoyancy. Oil prices are down, inflation and interest rates are decreasing, and the trade balance is positive and improving.

b. **EEC Entry**

Portugal has joined the European Common Market this year, and this is providing both an expansive attitude and a potential for business activity at a higher level.

c. **Constitutional Change**

By 1987, it will be possible to change constitutional laws with a vote significantly less than the 80% currently required. Now is the time to explore and plan for any such modifications needed for capital market development, and especially, privatization.

* Mr. George M. Ferris, Jr. performed this assessment under a contract with the Agency for International Development administered by the Bureau for Private Enterprise (contract no. DPE-2005-C-00-5060-00).

d. <u>Quality of Ministry of Finance and Treasury Top Officials</u>

The Minister of Finance and the Secretary of State for Treasury both have excellent financial sector backgrounds, and they, along with their staff, have a clear understanding of the importance of capital markets in furthering advancement of the economy.

e. <u>Political Consensus</u>

Although the Prime Minister is of a minority party, there is a chance of forging a political consensus in the near future.

II. KEY QUESTION - PRIORITY TO CAPITAL MARKET DEVELOPMENT

Since the demands on the new Government are great, will the Minister of Finance, using the prestige of his position, give adequate priority to the major prerequisites for capital market development?

III. ESSENTIAL CONDITIONS FOR CAPITAL MARKET DEVELOPMENT

a. Creation and Funding for Capital Market Authority/Commission

A Capital Market Authority/Commission should be established at the cabinet or the sub-cabinet level, and all responsibility and authority for capital market development should be centered therein. This would mean consolidating activities currently handled by different Government divisions, such as the Central Bank, and therefore eliminating present fragmentation. Not only will red tape be reduced by this action, but more importantly, the Government will be able to attract an individual of appropriate standing to serve as chairman. The Authority/Commission must not only regulate and audit investment banks, distributors and brokers to protect public interests, but also sponsor and promote the capital market process. The need for such a body as a first step in effectively mobilizing capital, and thereby increasing productivity, cannot be overly stressed. Without concentrating authority for such, at a high level, it is doubtful if significant progress can be achieved. A similar viewpoint was expressed in the IFC Capital Market Report dated January, 1984. The Minister of

Finance and the Secretary of State for Treasury have too many demands on their time to give the concerted effort and continuing attention required to address the myriad aspects of capital market development.

b. <u>New Commercial Law</u>

The Company Law, promulgated about 1912, does not deal effectively with the modern-day economy. A draft of a new commercial law is being circulated and should be enacted at the earliest possible date. Uncertainly is one condition which slows business activity.

c. <u>Commitment to Strengthening the Role and Audit Responsibility of the Accounting Profession</u>

This prerequisite of capital market development is an evolving process. Lack of tax accountability has a serious dilutive effect on Government revenues, and, as will be described later, it acts as a disincentive to private companies "opening up" to public ownership. However, tax accountability is impossible without professional auditors trained in using international accounting standards and the training of such auditors requires time. Further, falsification of certification should be made a criminal expense. As the effectiveness of tax collection improves, a political bonus will be that the increase in revenues will enable a decrease in tax rates.

IV. ISSUES TO BE ADDRESSED BY THE CAPITAL MARKET AUTHORITY

A capital market can not be legislated into existence. Incentives are necessary to entice the private family businesses to accept outsiders as minority shareholders, to encourage the general public to purchase shares and bonds, and to stimulate the middleman (ie. the underwriter and stock broker) to promote the capital market by educating the potential issuer, as well as the buying public, and bring the two together. These incentives provide the catalyst for capital market development.

a. Incentives for Companies "Going Public"

1. Pricing

   Enabling the issuer to receive a price which recognizes his success and the profitability of his company is the key. In Portugal, all prices must be approved by the Government, and they are set at an adjusted book value. This means that two companies, one more profitable than the other but with the same book value per share, would receive the same proceeds (and the owners suffer the same degree of ownership dilution) if they sell a similar percent of ownership to the public. No successful company will accept minority owners (with the accompanying aggrevations) under such circumstances. Pricing should be determined by the negotiation between the owner and the underwriter who has the responsibility of both representing the issuer and distributing the shares.

Two other concerns are raised by the pricing of successful companies at book value and requiring Government approval. Pricing below intrinsic value encourages "free riding", the abuse whereby the distributer retains a vast majority of the shares for himself, sells only a small number to the public, thereby creating a false sense of scarcity. This causes the shares to rise in price on the market. The distributer then sells the retained shares to the public at inflated prices. Such a practice is detrimental to capital formation. The issuing company doesn't benefit since it receives the lower issue price; the public, by and large, purchases its shares at the inflated market price. Only the middleman benefits.

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The other concern is that Government approval of an issue price implies that the Government is recommending the shares at that price. If the company performs poorly and accumulates large losses, it could prove to be embarrassing to the Government.

2. Tax incentives to "go public"
   Such incentives are very effective in capital mobilization, but <u>only if there is equality of tax accountability.</u> Certainly, a company with wide ownership should be required to have an audit using international accounting standards, which would mean not only that minority shareholders would know the status of the company, but that the company would have to pay taxes on all its earnings. A 30% tax-reduction incentive to go public would then be of little value if a major private competitor is paying taxes on only 25% of its true earnings. All companies receiving bank credit over a certain amount should be required to have an annual audit using international standards.

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3. Tax-free interest on bonds of public companies

If interest on corporate bonds is to taxable, an additional incentive for companies to accept public shareholders would be to allow interest on their bonds to be tax-free, thus, reducing the cost of raising long-term funds through sales of debt issues.

4. Restriction of bank credit

Too often, short-term bank credit is being used to financed long-term capital needs. The Government, through the Central Bank, could resort to setting credit standards for bank lending, but this too will require reliable accounting practices.

5. Reduction of "red tape"

The hassle of "red tape" alone can be a major disincentive to going public. Concentrating regulations of the capital markets in the Capital Market Authority/Commission, which would also be responsible for expanding the capital mobilization process, will do much to remove this disincentive.

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b. <u>Incentives to Attract Stock Investors</u>

1. Comparative yield

In a country such as Portugal, where most investors are yield conscious and don't think in terms of total return (income plus appreciation), it is particularly important that dividends not be placed at a disadvantage to interest earned on savings deposits and Government bonds by the burden of triple taxation. To further capital market development, interest on corporate bonds and dividends on common stock should have at least as favorable a tax treatment as the interest on Government securities and deposits.

2. Investment companies

Investment companies (mutual funds) provide the same advantages to small investors as those available to institutions, namely, diversification, careful selection of a securities portfolio by a professional manager and the continuous supervision thereof. Investing can be further stimulated by providing tax incentives for investing in mutual funds. In the 1970's, Brazil created

"157 funds". Anyone investing in such specialized funds (concentrating in industries the Government wanted developed) for a minimum of three years could reduce their taxes by the amount of their investment. This program accomplished a great deal in introducing Brazilians to the advantages of stock ownership. The growth of institutional investors such as investment companies will both broaden the demand for common stocks and, at the same time, increase the liquidity of the market (the ability of all investors to sell accumulated shares).

3. Lack of capital gains tax

Currently, there are no capital gains taxes for the investor in securities, and this is a positive incentive which should be retained. It has been conclusively proven in the United States that the reduction of capital gains taxes improves total tax revenues.

4. Regulatory climate

An appropriate and effective regulatory climate to protect the interests of the inv...ing public builds investors' confidence. This certainly is a major function of a Capital Market Authority/Commission. It should be remembered, however, that rules and regulations are of no value if there is inadequate staff to assure enforcement. It is essential that the budget for the Capital Market Authority/Commission provide for an effective audit team to prevent "free riding" on underwriting, "insider trading" (acting on non-public information) and other abuses which would place the investor at a disadvantage.

5. Favorable investment experience

Nothing attracts new investors more than hearing from a friend of a favorable investment experience. Conversely, word of an unfavorable investment has a negative effect. It is extremely important, therefore, that in the early stages of equity market growth, shares of well established companies with a favorable earnings trend be available to new investors rather than encouraging issuance of shares in start-up (and risky) corporations.

c. **Incentives for the Underwriter, the Distributor and the Stock Broker**

The greatest protection for the investing public are not the rules and the regulations, but the quality of individuals attracted to the investment banking and brokerage community. Such individuals are ultimately responsible for the growth of the capital market through the education of potential investors and the promotion of ownership of securities. Profitability attracts effective people to a profession, but the profitability must not be a result of taking unfair advantage of the public (ie. "free riding" and "insider trading"). Currently, maximum underwriting fees and commissions are set in Portugal by the Government. It would be more conducive to capital market development if minimum fees were set instead, to preclude predatory competition in an embryonic industry and then fee setting left to negotiation between the issuers and the underwriters. Finally, to encourage the growth of a private sector investment-banking community, government owned banks should probably serve only as distributors, not compete as underwriters. Their wide branch network makes them indispensible as distributors both for underwritings and investment company shares.

V. CONCLUSIONS

The Ministry of Finance of Portugal, with all its responsibilities, must determine what priority it will give to capital market development. If high, then the creation of a Capital Market Authority /Commission is essential to assure the continuing attention needed to resolve the various issues to be proposed for consideration, approval and then sponsorship by the Ministry of Finance. Because the importance of such a body has been stressed by consultants from both IFC and AID, further technical assistance may be available to assist in designing such an entity. Providing examples of similar organizations in Europe would be particularly helpful in convincing the various government divisions currently managing capital market activities that consolidating the responsibility in one high-level organization would greatly improve Portugal's financial system. (The Luso-American Development Foundation has indicated a willingness to consider financing such third-country technical assistance.)