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WHEN IS A PRIVATIZATION NOT A PRIVATIZATION?

Mixed Ownerhsip as a Policy Question in Privatizing

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Introduction

The simplest and most straightforward privatization is one in which the state decides simply to dispose of its entire interest in a state-owned entity to the private sector. A willing buyer is found and ownership of the firm is passed directly to the purchaser, leaving the government with no further interest. Such privatizations are clearly the most desirable form of divestment. However, the government (especially in developing countries) may, for a variety of reasons, be unwilling or unable to undertake full divestment.

The term "mixed ownership" denotes any enterprise in which the private sector and the government share ownership in a firm which was previously fully government owned. The proportion of the private-government mix may range from a substantial majority of the shares remaining in government hands to a token participation in which control is substantially vested in private shareholders. Mixed ownership dilutes the role of the private sector and frequently gives rise to doubts as to whether the enterprise will be operated on strictly commercial lines so long as interests of government (which may be oriented to political or public policy ends) must be taken into account. There are cases, however, where, if the government is unwilling or unable to accept full divestment, it may have to be considered in developing a privatization program.

The purpose of this paper is to provide a basis for discussion of the policy implications for A.I.D. in supporting privatization efforts that involve mixed ownership by government and the private sector.

(1) Reasons Advanced by Governments for Retaining of Participation in a Privatized State Owned Enterprise (SOE)

The government, even though committed to a divestment program, may insist that it is desirable to retain some participation in some SOEs because:

a. Political considerations (chiefly accusations that the government is selling off the national goods to private individuals or ideological stands by an opposition party) may make it desirable for the government to compromise on full divestment at least temporarily.

b. Some SOEs may have popular symbolic value either because their products are well known and are thought highly of in the market or because national pride is involved in the existence of the firm.

c. For public policy reasons, the government may wish to maintain some voice in decision making in the firm either because natural resources are involved, the firm's products are perceived as vital to national security, or the presence of a dirigiste tradition in government circles (as for example, in Mexico).

d. The entity may be too large to be disposed of to a single buyer, domestic or foreign even if the government is willing to privatize. The alternative may be to spin off viable parts of it or to sell as large a share as the market will bear. The government may, then, voluntarily or involuntarily, remain a partial owner.

It is not always easy to convince the government that, once having shared ownership with the private sector, its relationship to the former SOE has undergone a radical change. It may feel that it is required to demonstrate visibly that it has not abandoned the public interest. Even where it retains a minority share, it may seek to exert pressure on management to achieve public policy goals that are not compatible with the commercial objectives of a private sector firm.

(2) The Impact of Mixed Ownership

(A) Perceived Gains

It has been argued that both the government and the private sector derive advantages from mixed ownership. These include:

a. Positive cash flow results from the proceeds of the sale. The greater the share the government is prepared to surrender, the greater will be the proceeds.

b. Continuing future cash flow from a well managed, profitable company.

c. The government may think that a partially owned firm offers the opportunity to achieve public policy ends as well as profit.

d. The private sector shareholders may be reassured that the government will regard the firm with special favor because it has an interest in it.

(B). Real Losses

The disadvantages resulting from mixed ownership would appear to far outweigh its advantages in the long run. Investor confidence is damaged, share values are lowered and if the firm can achieve dynamic profit-oriented private sector management, there will be decreasing opportunities for the government to use the corporation for its own public sector purposes. These disadvantages may be mitigated if the government is prepared to commit itself at the time of sale to the disposal of its remaining share over a short period of time.

a. Reduced selling price or share value

The prospect of mixed ownership may serve to reduce the amount the government realizes initially from the sale of the firm because the value of the shares (or of the firm as an entity) may be diminished through lack of investor confidence in the firm's future. Financial markets will discount share prices because of the suspicion that government will try to use the firm for its own ends. Even if the government claims that the firm will be expected to operate as a commercial enterprise after divestment, private shareholders may still discount prices, particularly if there is evidence that the government has previously used its powers to interfere in management decisions of SOEs.

To reassure stockholders the government must give convincing assurances that it does not intend to interfere in the day-to-day operation of the firm by removing its representatives from direct contact with management and by public announcement of a detailed plan for gradual withdrawal of government over a reasoable period of time Any departure from these arrangements will cause a sharp fall in share prices, to the disadvantage of public and private owners.

Even with partial government ownership, there are definite limits to which government shares can be used to force the firm to serve public policy interests if the firm is operating in a competitive environment. Any action by the government that would seriously damage the interests of private shareholders would undermine confidence in further privatization and would reduce the firm's profitability. Privatization assumes that market forces, not public policy, will be the operative norm.

b. Increased autonomy of management under mixed ownership

The normal commitment of managers in private firms is to work in the commercial interests of the shareholders. Any reduction in control of a corporation by government through privatization creates a corresponding rise in the autonomy of management and in its ability to resist government demands. The government's position as a shareholder is weakened because it is susceptible to the forces of public opinion. Even a minority of private shareholders can exert considerable political influence as a pressure group especially if they happen to be wealthy or prominent in the community, further diminishing government's capability to influence management.

Mixed ownership may, in fact, put an even larger degree of decision making power in the hands of management than would be the case with full private ownership. The private shareholders as a group may not be strong enough to effect management changes whereas, if the government tries to do so, it exposes itself to charges of interference.

(C) Protecting the Government's Interest

The government may be reluctant to initiate privatization because of the fear that it will lose control over national industrial development. It is possible to overcome this fear by demonstrating that the government's interests can be protected after divestment by a variety of devices even where it remains only a minority participant. It can be emphasized that:

a. Although privatization means exposing the corporation to market forces, the success of any mixed ownership corporation depends on the way in which the government's interest in the firm is organized. Its relationship the other shareholders becomes of crucial importance--to an even greater degree if the government retains a majority holding. The problem becomes one of keeping the private shareholders and other potential investors convinced that market factors do control the firm's operations, while at the same time satisfying bureaucratic demands for accountability to the responsible ministries.

b. It may be possible to persuade the government that its regulative powers can be substituted for ownership thus making full privatization acceptable. Government can collect tax revenues from a profitable service company while regulating charges for its services to the public (in the case, for example, of privatized utilities or transport services).

c. Government may be brought to the view that its representatives do not need to sit on the board of the firm in order to ensure that the public interest is served. Indirect representation may well be to the advantage of both parties; by maintaining a distance the government may improve the firm's competitive position..

d. There are special cases of firms whose chief customers have been, and will continue to be after privatization, the government itself. Firms making munitions, for example, come under this category. The fact that there is an assured market for the firm's production may be of some comfort to the private shareholders. On the other hand, it may not allay fears that the government may be able to apply unusual pressure on the firm by threatening to remove its main supply contract.

e. The government can have recourse to a "golden share" provision either to protect what is viewed as a vital policy interest or, in the case of more developed economies, to forestall a take over of the privatized firm by a competing firm. The "golden share" is a mechanism whereby the government is provided in the sale agreement with special voting rights (in effect, a veto) over majority decisions by the board or the stockholders. Some major privatizations in the United Kingdom have included this feature. Its inclusion has a chilling effect on potential buyers, however, unless its use is clearly restricted before the sale is consummated (preferably by legislation) to very specific and highly limited situations. If the government were to be able to use its golden share powers too often or too easily, the whole point of the privatization could be vitiated.

It is possible for the government to retain its policy objectives, while leaving a privatized firm to operate freely under commercial conditions, by the use of a general public policy instrument applying to an entire sector of industry. Incentive packages for petroleum or mineral exploration can be handled in this way, for example, as can provisions for maintaining national or even restricted ethnic ownership (as in the case of Malaysia). Using a generalized sectoral instrument is non-discriminatory and therefore avoids the accusation that a mixed ownership firm is receiving special favors.

A variant on the general instrument (the focussed instrument) can be applied to a regional development objective to promote industrial concentration in a localized area.

f. The government can preserve the ultimate right to require a mixed ownership firm to undertake activities which would clearly not be in its best commercial interests. In such cases, the government should use a directed compensation instrument to compensate the firm for the additional costs incurred. The question of measuring such costs is not always easy, however, and it may lead to prolonged negotiations between management and the government, especially if indirect or overhead costs are involved over a period of time. Too many demands of this nature will eventually reduce the effectiveness of management and weaken the firm by leading to an erosion of investor confidence. Such intrusions into the commercial activities of the firm may not, in any case, be the most cost effective way of attaining the government's objective. It may be cheaper in the long run for the government to engage in such activities without involving a privatized firm.

(D) <u>Separating Commercial and Policy Objectives</u>

Other devices exist for separating the commercial objectives of firms to be privatized while preserving the policy objectives of government. These may include:

a. <u>Splitting a firm into Commercial and Policy Oriented Companies</u>.

The firm to be privatized may be split by selling it not as an integrated unit but as two or more firms, one of which would be designated to carry out policy objectives which are clearly not commercially viable. The commercial activities can be divested as a separate company or companies entirely divorced from government participation subjecrted to the full force of the market. In it the government takes the same risk as the private investor and no effort should be made to rescue it in case of failure. A distinct, wholly government owned company can be created that has a continuing policy role with but with no necessary requirement for profitability.

Examples of such splitting could occur in the case of a capital intensive mining company that would be unattractive to the private sector The cost of exploration and extraction would be borne by the government firm and the processing and marketing of the mineral handled by the commercial arm. In another case, high risk exploration for petroleum resources could be separated from the commercial refining operations and the wholesale or retail distribution of the product. Crude would be acquired from the government company or other sources at prevailing market prices.There is no reason, of course, why the policy oriented company could not have private sector participation, if investors could be found. It may be desirable to establish the policy oriented firm as a holding company for the government shares in the commercial firm; this would, however, require commitment on the part of the holding company management not to interfere with commercial management decisions.

b. The Arm's-Length Holding Company

In order to make even clearer the divorce between policy and commercial interests, there exists the option of creating a collective holding company for the shares of all privatized firms in which the government retains some participation. This company's function would be to monitor the performance of the firms in which the government has an interest and to report back to the responsible officials. It could also be made responsible for conducting the negotiations for the sale of firms being privatized including spin-off portions of larger SOEs. In this way the government can avoid direct involvement that might expose it to charges of political favoritism. Final approval of sales would rest with the cabinet or the ministries to which this power might be delegated. Such a holding company would also offer the private shareholders some protection from arbitrary government intervention that might be detrimental to their holdings.

c. A less satifactory alternative is to create a Cabinet portfolio responsible for managing government shareholdings in mixed ownership firms. Whatever mechanism is used, machinery for performance evaluation and accountability to the appropriate level of government should be in place before a partial sale is completed.

Conclusions

1. Mixed ownership will clearly never be as satisfactory as outright and complete privatization.

2. Where the government insists on mixed ownership, it should be encouraged to examine its reasons closely; it may be discovered that no real public policy objective is to be served. In this case, the firm should be sold 100% to the private sector.

3. Where mixed ownership is unavoidable either for over-riding political, security or other reasons or is seen by government as a transitional step, the major objective should be to divorce commercial operation of the mixed firm from public policy objectives and to make the fact of this divorce as clear as possible to the public and especially to the shareholders.

4. It is desirable that government become a minority shareholder at the outset or if not, that a plan for reduction over a specified period of majority to minority holding be announced at the time of the sale. Even if provision is made for special voting rights (such as a golden share operative only under specified conditions), private shareholders will be reassured if the government's objectives are made clear.

5. It is to the advantage of both the government and the private shareholders that the government demonstrate its arms-length relationship to all privatized firms in which it retains an interest by the creation of a separate company in which the government's holdings are vested. On one side it, it reduces the possibility of politically motivated attacks accusing the government of interference and on the other it serves to increase investor confidence and therefore the price of shares.

Policy Implications for A.I.D

The Agency's position on mixed ownership in a privatization program should be made clear at the outset. The following policy options might be considered:

1. Mixed ownership or partial sale would not qualify as a privatization and no A.I.D. help either in the form of technical or financial assistance would be extended to the sale of any such SOE.

2. Mixed ownership would qualify as a privatization only if the government is committed in advance to a firm schedule for reduction of the government share over a period of time, ultimately eliminating all government participation. Provided this schedule is adhered to, A.I.D. assistance in any normally permitted form would be allowed.

3. Continued mixed ownership would qualify as a privatization without commitment to eventual full private ownership provided safeguards such as those outlined above to prevent government interference with the normal commercial operation of the company are agreed to as part of the sale and made clear to potential investors before a public share offering is made. In such a case, A.I.D. would assist in preparations for the sale.

4. Mixed ownership would qualify as a privatization for the purposes of A.I.D. assistance even if government retained a majority share or if it retained golden share voting rights no matter how small its actual shareholding.

5. Mixed ownership involving a joint venture between the government and a foreign investor or multi-national corporation could receive A.I.D. assistance only under circumstances which would be considered on a case-by-case basis. Normally, the foreign venture partner should be expected to provide a technical evaluation of the enterprise if he is a serious potential buyer.