PRIVATIZATION:

A TECHNICAL ASSESSMENT

Prepared for the

Office of Policy Development and Program Review

Bureau for Program and Policy Coordination

U.S.A.I.D., Washington

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L. GRAY COWAN

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Preface

The purpose of this technical assessment is to provide U.S.A.I.D. Missions and interested host country officials with a basic outline and background on the process and procedures of privatization. It can assist in advising on the policy decision to privatize, to plan divestment and privatization strategies and on the implementation of the privatization policy decision.

Each of the assessment's topics will require further expansion within the political and economic context of each developing country. In its broadest sense, privatization has to be viewed in the light of the present state of private sector and capital market development as well as in the economic policy environment.

It is hoped that the broad principles and techniques discussed here can help with the formulation of Mission privatization plans and with the implementation of privatization actions.

INTRODUCTION: The Background to Privatization

Over the past three decades state-owned enterprises (SOEs) have played a growing and in some cases, pervasive role in developing country economies. The number of public enterprises mushroomed as did their share in productive and service activities. In Mexico and Brazil, for example, SOEs quadrupled in slightly more than twenty years. It is estimated that there are well over 3,000 in sub-Saharan Africa.

While there is no universally agreed upon definition of a public enterprise, the term is generally used to mean any government owned or controlled unit that produces and sells industrial, commercial or financial goods to the public. This definition does not, however, distinguish between wholly state-owned enterprises and those in which the state shares majority or minority equity with private sector owners. The term "parastatals" is sometimes applied to this category of enterprise but there is no generally accepted usage. Public enterprises include not only those producing specific products but organizations such as agricultural or commodity marketing boards involved in both regulating commerce and in operating commercial marketing and input activities themselves.

A. The Rise of the State-Owned Sector

The growth of the state-owned sector since 1960 is attributable in part to the colonial experience during which the administration directed the bulk of economic activity. In the post-independence years, state domination of the economy was accepted since this was the system to which the new governments were accustomed. After independence there was often a deep-seated suspicion of the motives of the private sector derived from foreign control of industrial and agricultural development. Moreover, in many countries popular resentment existed of resident ethnic minorities (as for example, in Kenya and in Southeast Asia) who had exercised control over the distributive sector before independence. There were also both ideological and practical elements to the growth of state control. Socialism was the reaction to the capitalism of the colonial powers; ownership by the state was generally seen, moreover, as the only way to preserve economic independence in the face of a perceived threat of neo-colonialism.

In some cases governments backed into state ownership more or less by default as private sector firms seen as important to development failed either through mismanagement or corruption and the state was forced to assume control (as, for example, in the case of the Philippines). Labor unions were often more content to deal with the state than with private sector owners and the private sector was happy to have the state take the risk, especially in capital intensive industries.

The basis for state ownership often rested on purely pragmatic factors. In many countries, governments concluded that the private sector had neither the capital nor the technical and managerial skills to establish new industries, especially where they were designed as part of an import substitution program. In some cases, the failure of the private sector to respond to what governments felt were good investment opportunities was not perceived for what it really was--lack of interest because of too little profit potential and too high an investment risk. Political exigencies required governments to find jobs in the modern economy for the new urban populations and, at another level, to provide sinecures in return for past political favors or military service. SOEs were not infrequently justified publicly on national security grounds; it was too risky to entrust the needs of the armed forces to private sector producers.

In theory, SOEs were expected to produce profits which would then be ploughed back into new development projects by the government; this expectation was only rarely fulfilled (indeed, in some LDCs privatization has even been considered as a means of creating new funds to develop more SOEs). State enterprises, particularly export or import monopolies, came into being to stabilize agricultural prices, to provide subsidized consumer prices or even as tax collection mechanisms. SOEs frequently satisfied the perceived need for rapid indigenization of the modern sector of the economy and allowed the state to maintain the stance that it was the protector of the interests of the popular majority against rapacious private exploiters, foreign and domestic. Politically, the proliferation of SOEs permitted the consolidation of political power in a single party together with control over the developing economies of the post-independence regimes and they provided a fertile field for the growth of special interest groups.

B. The Failure of State Owned Enterprises

Over the more than three decades of national independence in the developing world, enterprises owned by the state have produced a staggering burden of subsidy costs for their governments. SOE borrowing on the international market added substantially to the overall national debt. The proliferation of state enterprises and their expansion into new fields of endeavor caused LDC governments to realize that they had created a monster that could devour them.

The IBRD's World Development Report, 1983 highlighted the budgetary claims made by SOEs. A sample of developing countries found that net budgetary payment to non-financial SOEs averaged more than 3% of GDP-in some cases, much more; in Sri Lanka, 11%; in Zimbabwe more than 10%. A 5% increase in SOE revenues and a 5% decrease in their costs would have been enough to finance all of Tanzania's expenditures on health and education; similar changes would have financed two thirds of Mali's outlays on education and twice those on health.

So long as the market for their primary products remained reasonably buoyant and development was supported by external donors, LDC governments could continue to enjoy the luxury of high subsidization. But growing demands on national revenues for increased public services and new infrastructure combined in the mid-seventies with the crisis in petroleum prices to add fuel to the search for relief. Governments were reaching the limits of domestic taxation of agricultural and mineral production while mounting debt service payments and foreign exchange shortages only added to the crisis.

The growing indebtedness of SOEs derived from several sources:

--Governments insisted on using them for other than the purposes for which they were originally designed. Conflicting objectives--social and financial--brought conflicting signals from the government so that management was unable to determine what policies were required to meet these objectives.

--Inexperienced management was unable to operate businesses profitably. The blame cannot, of course, be laid entirely at the door of the manager since government pricing and labor policies not infrequently made it impossible for even an efficient manager to overcome the social overhead costs the firm was required to bear. In many cases the manager was asked to produce results from a firm that had been located for political or regional development reasons with little thought to its proximity to markets or accessibility of raw materials. The upshot was that the national treasury made up for the growing negative cash flow if the SOEs were to continue in business.

--Failure by governments to develop effective means for monitoring the numbers and performance of SOEs. Governments often found that, partly as a result of development assistance projects initiated by foreign donors through many ministries, there was little, if any, firm information on the exact number of enterprises the government owned. In the course of an inquiry, the Kenya government, for example, found that it had an interest in some 400 enterprises; the Ministry of Finance was unaware of many of them. Governments were also unaware of the extent of the debts which they had guaranteed in loans to SOEs. They were slow to realize the dangers posed by SOE indebtedness which in many cases accounted for 20% to 40% of total domestic credit. Between 1976 and 1983, SOEs were responsible for $80 billion of LDC debt.

Governments went to opposite extremes in control over their SOEs. In some cases the monitoring function was so loosely exercised that there was no detailed knowledge of the fiscal state of the enterprise. In others, monitoring by government ministries was so close that management lost almost all autonomy in day-to-day decision making. Having to refer operating decisions to the Ministry's representative created a serious bottle-neck to increased productivity.

Official estimates of expenditure on subsidies were often unrealistic or erroneous. Many continued to be paid for political reasons when they could no longer be justified on economic grounds and without serious thought to their ultimate impact on the financial structure of the country SOEs.

Factors beyond the control of LDC governments also contributed to the failure of the SOEs. After having been encouraged by the willingness of public and private foreign lenders to provide capital for the establishment of state enterprises, the loans that had once been so readily available were being drastically reduced by the early 1980s. The foreign exchange reserves that many former colonies had built up prior to independence were exhausted, frequently as the result of investment in ill-advised industrial expansion projects or construction which served only to reinforce the vanity of the new political leaders. Markets for LDC primary products declined, new competitors were entering fields that had formerly had few producers and technological advances were making the equipment of SOEs obsolete. They could no longer produce at competitive prices so that their attractiveness in import substitution programs was reduced.

Reducing SOE deficits became, therefore, a national priority; the solution was seen to be divestment or liquidation of money losers, or contracting out of management in an effort to bring the firms to a break-even point in the hope of possible future sale, or at worst, eliminating the need for subsidy. Some governments accepted the idea that, by creating competition for SOEs through encouragement of private sector enterprises in the same fields, the need for an SOE may be eliminated.

The alternative to divestment was to raise the prices of SOE products and services, if the firms are to continue in business, to a point where the political survival of the government may be called into question. The long range goal was to harness more effectively the energies of the private sector better to meet the growing popular demand for high quality consumer goods and services. Privatization was also seen by some governments as a way to bring income to the national treasury by sale of public assets as well as relief from subsidy bills.

By the late seventies, ideology was beginning to be less of an obstacle to reducing the role of the public sector. Socialism had failed to effectively mobilize and sustain community resources and popular energies for development; on the contrary it nad impeded development by repressing individual initiative, especially in agriculture. The cautious search for pragmatic solutions to their financial problems through greater reliance on the private entrepreneur found support in unexpected socialist quarters such as China and Hungary; in Africa such staunch socialists as the late Sekou Toure in Guinea and Julius Nyerere in Tanzania finally admitted that mistakes had been made in village collectivization programs.

But divestiture of money losing SOEs did not prove simple. Disposal of firms both deeply indebted and with negative cash flow was all the more difficult when there was serious disagreement between the government and prospective buyers on the value of the firm.

Moreover, the major public sector losers were often natural monopolies such as railroads, electric power and telecommunications which were the least likely candidates for divestment.

C. Types of State-Owned Enterprises

SOEs took on a wide variety of forms over the years depending on the state of development of the country and the government's commitment to state ownership and control of the means of production. They may be categorized as:

--Enterprises wholly owned and operated by the state. In some cases these tended to be capital and/or technology intensive operations that were regarded as essential to economic progress or to national security, such as mining or petroleum production.

--Enterprises partially owned by government and partially by private investors. There are many permutations of this type of government control which may be related not only to the degree of control but to the way in which the control is exercised.

--Enterprises owned by government but operated by outside managers under management contract or lease.

--Public services owned and provided by governments, local or national. These include railways, telecommunications networks, national airlines and national health and educational services. At the municipal level they include transportation, refuse disposal, markets and a variety of other local services.

Agricultural parastatal agencies which deal with crop marketing and farm inputs.

D. Defining Privatization

Privatization has been defined, for the purposes of A.I.D. policy as "the transfer of a function, activity, or oganization from the public to the private sector." (PD-14, p. 2) The concept is not new; it can be found in the writing of Adam Smith as early as 1762. The great trading companies of the early period of European empire building, such as the British South Africa Company and the Dutch East Indies company were in private hands until they were taken over by governments as part of the rise of global foreign policy interests.

The current renewal of interest in privatization is a phenomenon mainly of the past five years. It became a matter of national policy in the U.K. with the coming to power of the Thatcher government which undertook the largest scale privatizations ever to take place, British Telecommunications and British Gas. Privatization efforts have spread throughout Western Europe, particularly France, but not as extensively as in Great Britain.

Privatization is a relatively recently recognized term -- its first appearance in a dictionary came in 1983. With increased usage, its meaning has broadened to include the economic setting in which it occurs. The environment in which the private sector is required to operate is an essential element in successful privatization.

Types of Privatization

1. Complete Divestiture

The complete transfer of publicly owned assets to private individuals or firms after which the government bears no responsibility for the operation of the assets, whether they are in the form of a producing company or in the delivery of services. This is the clearest and often most desirable form of privatization, but is often the most difficult to accomplish.

2.Partial Divestiture

In this case the state retains full or partial ownership of the public assets. It may take a number of forms:

--The government may sell a share of the assets to individual buyers either directly or by means of a public stock floatation. The proportion divested may leave the government with either a majority or minority share but the practical effect is to put the current operation of the firm or service in the hands of private managers; the government remains a shareholder with representation on the board. A variety of refinements on mixed ownership is discussed in Chapter II-E.

--Management contracting, leasing, or franchising arrangements which remove the property or firm from direct operation by the government. Managment contracting puts operations in the hands of an outside management group, while leaving ownership in government hands (for a fuller discussion of this, see Chapter II-E). Leasing is usually done by competitive bidding, for a fixed period without surrender of ownership. The lessees are responsible for day to day operation without, or with minimal, government monitoring. Such arrangements may include sharing of profits or the lessees may take equity by adding new capital to the business in a joint venture arrangement. Franchising takes much the same form, although the profit sharing arrangements may be different. (For further discussion, see Chap.II-F). The major purpose of leasing or franchising is to restore an ailing firm to profitability; it may be part of a long-range plan leading to complete privatization, when, and if, the firm becomes an attractive candidate for sale.

--A variation on the leasing arrangement known as the contract plan has been employed in France and French-speaking Africa. Here the government draws up an agreement (usually lasting three to five years) with the management of an SOE which lays down in detail specific performance standards that the firm is expected to meet and for which the managers will be held responsible. Failure to meet the standards will raise the question of management change, if it can be determined that the fault lay with management rather than with extraneous causes over which it had no control.

--Divestiture of wholly owned subsidiaries of a larger SOE, or of services within vertically integrated firms (such as importation and retail distribution of fertilizer) by a process of spinning off. Examples include construction of transmission stations within a national telecommunications system, or airport transport services and duty free shops under a national airports authority.

I. Developing a Strategy for Privatization

A. Initial Considerations

An official expression of interest in privatizing on the part of the government is usually the first step in initiating a planned program. This interest can sometimes be sparked through discreet urgings by international or bilateral donor agencies or the local private sector. Pointing out the advantages of privatization as a solution to some of the pressing financial problems of the Treasury and explaining the privatizing process may inspire the decision to embark on a strategy. Citation of examples of successful privatization in situations similar to the circumstances of the country concerned may be helpful.

In the final analysis, a combination of carrot and stick may be required to prompt the government to action. If the donor agencies and private international commercial banks make clear that failure to reduce the public sector burden on the national budget will result in decreased assistance, this usually is a decisive factor. Privatization may be made an important part of negotiations on a Structural Adjustment Loan. It may also be stressed in policy dialogue on fundamental economic policy change or in negotiations on rescheduling outstanding external private loans to foreign banks. In any case, the decision to seek technical assistance on reducing the public sector has to be made at the highest levels of the administration.

Motivations for Privatization

Before responding to any request, a careful analysis has to be made as to what has led the government to contemplate privatization at this particular time. It is important that the motives of the government in seeking assistance for a privatization strategy be carefully evaluated in advance of any offer to help because they may influence the techniques of divestment and sale that may be utilized. The following factors are among those that play a role:

--A growing awareness of the deficits created by mounting subsidy costs that may be reaching a crisis point. If the interest in privatization is simply a function of the desire to reduce the costs of public sector enterprises, then it is unlikely that privatization will progress rapidly enough to permit sizable and immediate reduction of either debt or subsidies. The government should be aware that it cannot expect immediate or miraculous budgetary results from divestment.

--The government may view privatization primarily as a source of additional revenue for the Treasury from the sale of state-owned assets. Sales will occasionally bring immediate and substantial returns (as in the case of a recent bank privatization in Jamaica or the privatizations undertaken in Singapore). But these will frequently be less than expected if the government has inflated notions as to the value of the assets (see Chapter II-C for discussion of valuation); in any case the revenues will be slow in coming in.

--Some governments see profits from sales as a potential way to avoid, or at least reduce, a rise in tax rates. The British government, for example, has been accused by the opposition of masking its real reason for privatizing, i.e to curry favor with the electorate by keeping taxes low.

--The interest in privatization may reflect a genuine concern on the part of government to reduce the public sector or just a reluctant response to pressures exerted by external agencies. If real political will is lacking, foot-dragging bureaucratic delays can be anticipated and requests to finance all or part of the preparatory planning as well as sales will be made to donor agencies. The LDC government must have the political strength not only to initiate privatization but to see it through over the long pull. The present government may be determined to pursue the policy but there is always the chance that the opposition party will reverse it if that party is successful at the next election. It may do more harm than good if privatization is begun but dropped after one or two efforts, particularly if the results are not satisfactory from these early trials.

--General dissatisfaction with the performance of SOEs may be a force for change. They may have failed to meet popular expectations for product quality or quantity; they may be too ambitious in their product lines or are unable to deliver on time. They may be unable to compete with already flourishing private sector competition (as in the case of petrochemical subsidiaries of Petrobras in Brazil, or the Heavy Mechanical Complex in Pakistan, where a private company produces better quality products), or with imports (even where duty is paid). Technological advance may be making the product or service provided by an SOE obsolescent. Changing world markets or changing consumer tastes may be making SOEs' products more difficult to market; the government may therefore feel that privatization moves can be justified as a result of consumer demand.

Making sure that government officials fully understand what is involved in privatization may take effort and time but it will be well repaid if the process goes smoothly later.

C. Taking the Privatization Decision

Whatever the motivations, privatization is more a political than an economic decision. The host government may be fully aware of the financial drain of subsidies to losing SOEs; the issue it must face is the political risk being taken in eliminating them. This must be a subject of early, detailed discussion regardless of any other pressures to privatize. No government will allow itself to be put out of office for the sake of privatizing, however advantageous it may appear to outsiders. The government must calculate the degree of risk it is prepared to take before any public announcement of the plan. Clearly, the political risk inherent in privatization cannot be completely eliminated but the perceived risk can be reduced to a point where it can be tolerated in the face of the benefits to the government to be derived from reducing public sector expenditure. While the decision on risk must, in the last analysis, rest with the government, outside advice may help to avoid or at least mitigate it to some degree.

Involved in this help may be an estimate of the strength of groups that are most apt to raise objections to divestment. Among these groups may be:

--Bureaucrats within ministries who have benefitted from positions on the boards of SOEs or as ministry representatives overseeing SOE operations. They are unwilling to give up either their power or their perquisites.

--Certain ethnic groups which popular demand may seek to exclude from the purchase of divested firms. These are ethnic groups which, because of education, financial skills, and availability of capital are seen as an economic threat to the majority. Examples are the Indians of Kenya or the Chinese in several southeast Asian countries.

--Labor unions which see in privatization a loss of jobs, weakening of union strength, and evasion of government responsibility for pension and job security rights accrued under a national labor code. They also see the possibility of abrogation of wage pacts by new owners since the state is usually easier to negotiate with than private owners.

--Present managers of SOEs who may lose their positions under new ownership and the politicians or retired military who occupy sinecures on the boards of SOEs.

--The private sector itself may object if it has shared some of the special concessions made to firms in the public sector in the allocation of foreign exchange, tax rates or preferred markets. In some countries "crony capitalism" has given certain members of the private sector a specially privileged position.

--An organized opposition political party, where it exists, may raise objections on partisan or ideological grounds that may have little to do with the merits of the case for privatization.

If the main opposition groups can be identified in advance, there are ways to reduce their objections or deflect their opposition. These groups should be brought into consultation (if possible, separately) at high levels of government as early as feasible. Arguments against privatization are often based on a lack of information rather than on any objective disagreement. Predictions of dire consequences from selling the national goods to the private sector often stem from misinformation, sometimes spread intentionally by opposition interests. An educational campaign directed toward each center of opposition and designed to meet specific arguments will often serve to allay their anxieties. Elements of such a campaign may be:

--In the case of labor, assurances that there will not be wholesale reductions in force with private ownership, at least at the outset. In Bangladesh, for example, the new owners of reprivatized jute mills were required as a condition of sale to employ the same number of workers for one year, at the end of which time they were free to reduce labor to improve efficiency. By the end of the period, attrition, combined with elimination of phantom workers carried on the roles, largely stabilized the work force, greatly allaying labor's fears of mass unemployment.

In Ghana, more drastic action was taken to reduce the 100,000 employees of the Cocoa Board. Some 25,000 phantom employees were eliminated and 15,000 others were let go; the government's target was to reduce the civil service by 5% annually. While privatization of an SOE will almost inevitably reduce the number of employees, at least initially, the Ghanaian action was so drastic that, in circumstances other than military rule, it might well have led to overthrow of the regime. More gradual and phased reduction is less likely to cause political unrest. In Peru, for example, a system of incentives for early retirement has worked well, although it is expensive for the government.

--Opposition from current SOE managers may be reduced by assurances that competent managers will retain their positions under privatization; indeed, the good managers will prefer to remain in their posts if it appears that they will be given greater autonomy in operating the firm. Some board sinecures may have to be retained to soften opposition; this may simply be one of the costs of a successful privatization.

--The bureaucrats who no longer sit on boards as government representatives can be hired into new positions with the privatized firm if they are competent to handle the jobs--they may be especially useful as liaison between the firm and the government.

Detailed knowledge should be sought regarding the size and constituency of the political opposition and of its ability to mobilize its followers. If the arguments that it may use can be ascertained in advance, it is possible to have counter-arguments prepared tailored to the positions of special interest groups. For example, the standard argument of the threat to national security made by the military can be met by early consultation with the most senior staff officers to ensure continuing sources of military supplies from privatized firms as part of the sale agreement.

Political decision-makers are apt to consider privatization plans more seriously if they contain a variety of options rather than recommending a single course of action. Being given the opportunity of choice allows the political leadership to make up its own mind on the one technique with which it is most at ease politically and avoids the accusation that it is being forced to accept advice dictated from the outside.

D. The Public and Privatization

The general public should be informed of the government's privatization plans as soon as they are reasonably well formulated. If an impression is gained that privatization is shrouded in official secrecy, there is a greater probability that there will be a reaction against it no matter what its advantages. Opposition interests can exploit the popular feeling that deals are being made to the advantage of politicians and high government officials to sell national property to private interests. The government should:

(1) explain its motives
(2) make clear why certain industries and not others are being singled out for privatization
(3) the steps being taken to insure that members of the public are not being harmed.

It is of major importance that the government's announcement of privatization plans be carefully timed. A detailed plan should be well thought through by the top political leaders, identifying major program objectives and incorporating a flexible time table for achieving specific goals, before any publicity appears (in the U.K., for example, the privatization of domestic water supply had to be indefinitely put off because of premature announcement without consultation with consumers who feared a steep rise in water rates as a result). The plan should not be so completely cast in concrete that the government cannot respond to public reaction by making changes that will allay popular fears. It cannot be assumed that an issue as complex as privatization will be readily understood and therefore time for an adequate educational campaign should be allowed.

Even though there may be an element of public relations involved, it is essential that the public be allowed to express opinions as the privatization strategy evolves, preferably before or at points where it is possible to demonstrate that changes are being made in response to public objections. Privatization will be more readily accepted if the government is able to create the feeling that it is paying attention to legitimate objections being raised and is sincere in dealing with th se which it can influence.

E. The Role of the U.S.A.I.D. Mission in Privatization Strategy Planning

The Mission can play a crucial role in developing the privatization strategy. The exact nature of this role depends, of course, on the particular circumstances of each country; few generalizations can be made which apply across the board. There are, however, some common factors that may play a role:

--A.I.D. has played a vital role in fostering economic growth over a long period in many countries. Missions have provided the resources which have led to industrialization as well as to agricultural advance. The Agency has not only accumulated a stock of knowledge of the developing countries, their resources, people, and capabilities, but has been a moving force behind change. In most cases, it has gained the confidence of the political leadership and its advice on policy change is listened to, albeit at times reluctantly.

--If the government has built up confidence in the past work of the Mission, Mission officers are in a favored position to suggest changes in the public-private mix and when the government is prepared to make these changes, to prepare the way for privatization. The Mission can be a source of basic information on the entire process at the initial stages, explaining the fiscal advantages of privatization while at the same time pointing out the pitfalls that may result from inadequate planning. It can offer advice on the choice of units to be divested and on the process through which divestment can take place.

--At the second phase, preparation for sale, the Mission can provide some of the technical assistance necessary for company evaluation, legal preparation for change of ownership, and locating suitable buyers. The Mission can play a dual role as a disinterested participant in assisting both the buyer and the seller--the government--in negotiating mutually agreeable terms of sale. Not all of the Mission's advice is likely to be palatable to the government; it may be that the technical advisers provided will suggest liquidation of an SOE as unsaleable with almost total loss of the investment already made.

--For many companies that are candidates for privatization, debt encumbrance may be an insurmountable obstacle to finding a buyer. If the government is not capable of discharging SOE debt and labor obligations before divestment, the Mission may find that, in order to implement privatization, it may be called upon to provide financing. A special local currency revolving trust was established in Costa Rica to take care of the debt question through which SOEs were purchased to discharge debt to the Central Bank. It was anticipated that, as the firms were sold to private sector buyers, the trust would be repaid.

--Since privatization may depend on financial help from A.I.D. in the sale, it becomes important that the Mission itself be clear on the level of support it is prepared to provide prior to advising on strategic planning. Help may be made available only for technical assistance in the form of specialized consultants; direct financial aid in local currency or some other form may be added as part of the assistance under the Mission's privatization plan. The limits of the Agency's contribution should be clear to the government from the outset, otherwise there is a risk that the whole program will be rejected at a later point. Once committed to assisting a privatization program, the Mission cannot afford to reduce its contribution without seriously damaging its credibility. Forward planning of the Mission's resources over the expected period of the privatization plan is necessary.

--Privatization is such an important and long term decision on the part of government that the Mission (and indeed, the Embassy) must be seen to be in full and continuous support of it as a long-range goal. Missions should make clear to the government that officers designated as liaison with officials dealing with privatization are giving or can give their full attention to the question, not just on a part-time ad hoc assignment basis. When personnel changes are made, efforts should be made to see that successors are named who have substantial skills in privatization in order to maintain the government's confidence in the Mission's support.

--The opposite side of the coin is the degree of pressure that can be exerted on the government to proceed more rapidly than local political circumstances permit. Judging this requires familiarity with the decision making process and the personalities involved. Privatization is inevitably slow and complicated. Too much pressure on a privatization secretariat to move quickly only produces irritation; too little gives the impression that the Mission may be losing interest. Mission officers will have to gauge the sentiment of the official as well as the private sectors. Too much pressure to use available local capital for privatization may produce a choking-off effect to the detriment of new ventures that could be started.

--It is important that Missions establish and maintain close contact with field representatives of international donor agencies in strategic planning. Assistance to privatization is a part of World Bank and International Finance Corporation policy and it is playing a greater role in structural adjustment lending. In the case of Morocco, for example, a substantial I.B.R.D loan has been negotiated for rehabilitation of public sector industries, part of which will be eventually used to further privatization. Coordination with host government planners by both U.S. and international agencies is necessary if duplication of effort and overlapping of assistance is to be avoided.

F. The Broader Context of Privatization Strategy

Successful privatization involves much more than just liquidating or selling a failing SOE to a private sector buyer. A privatization program depends heavily on the broader economic context within which it will be carried out. There is little point in pushing privatization if the environment in which the private sector is forced to operate is clearly not sympathetic to individual initiative. For most LDCs, especially those which have been subjected to a regime of state socialism over more than two decades, fundamental changes in both macro- and micro-economic policies will be needed before the private sector can be persuaded to take on new risks. A period of confidence building may be required before local entrepreneurs can be convinced that the government will allow markets to operate with relative freedom and the danger of re-nationalization of privatized firms will take place with a change of political regime is minimized.

These fears are not confined to the LDCs; privatization in Great Britain was beset at the outset by doubts as to the intentions of the opposition Labour party should it regain power. Labour made no secret of its desire to reverse the major privatizations undertaken by the Conservative government. As divestment proceeded, however, it became clear that a constituency in favor of privatizing was being rapidly built up, not only among the new shareholders of privatized firms who saw the value of their shares appreciate immediately but by those who were able to buy the houses being divested by local authorities in many areas. Apart from the fact that the cost of regaining government control over former SOEs was likely to be beyond the resources of an opposition government, large segments of public opinion were converted to support of the privatization program regardless of the party in power.

Privatization planning implies a willingness on the part of the government to accept the concomitant structural changes necessary to make divestiture work. Convincing officials to initiate these changes may require extended policy dialogue on the part of donor agencies in most cases preceding, or as part of, discussion on the decision to privatize. For many who have been accustomed to state management of the economy, change will not come easily. Easing of government controls means reducing bureaucratic power and, in the view of those who still retain deeply engrained suspicion of the private entrepreneur, allowing the development process to get into the hands of those who seek to turn it to private profit.

Necessary long-term structural changes at the macro-level may include:

--Encouraging the development of expanded domestic capital and stock markets through greater sophistication in finance on the part of the local private sector. Establishment of a stock market (as in the case of Thailand, Barbados and Kenya) may be an appropriate mechanism even if the number of companies registered is very small. Privatization may contribute to the growth of a nascent capital market by presenting opportunities for local investors with available capital. With capital and stock market growth, new enterprises may be created to compete with money-losing SOEs, ultimately eliminating the money losing state enterprises as competitors. Donor agencies can provide the technical assistance where needed to create the stock market. (For an extended discussion, cf.. A.I.D.'s forthcoming Financial Markets Development Policy Paper.) In the case of countries where lack of equities in domestic hands does not allow a stock market, other financial instruments may be used to finance privatization such as Employee Stock Ownership Plans, debt-equity swaps, and management contracts (see discussion of these instruments in Chapter III-G).

--Liberalization of foreign exchange restrictions so that the private sector can be assured of equitable access to foreign exchange for modernization of equipment and purchase of raw materials, or other special needs. Preferred access by SOEs to foreign exchange should be eliminated.

--Encouragement of expanded credit facilities available to the private sector through intermediate financial institutions. These should be able to supply medium and longer term credit necessary for the creation of new enterprises or for the purchase of privatized SOEs in contrast to the short term credit provided by commercial lending institutions. Lending by the MDBs directly to the private sector in the LDCs without government guaranty has been cautiously undertaken by the Asian Development Bank but has not yet received enthusiastic support from the other regional banks.

Improvement of the overall environment in which the private sector operates is important for privatization in many LDCs. In some countries (such as Indonesia) there is widespread public suspicion of the private sector that is the product of colonial history or post-independence ideology. Successful long-term privatization depends on a positive public image of the private sector--i.e. that it is not seen as engaging in individual profit at the expense of the collective interest. Changing attitudes is a matter of long-term public education; it is important that the private sector do nothing to reinforce negative public impressions while government is seeking to reduce the state-owned sector.

Fair treatment of the private sector under the tax code is vital in promoting entrepreneurial growth. SOEs have frequently enjoyed a form of hidden subsidy in that they were not required to pay taxes that would have been levied on a private firm. The government should be persuaded that a confiscatory level of tax on profits will only serve to eliminate eventually the sources of revenue. Tax collection should be regularized and entrepreneurs made aware of the rules of the game which should be applied consistently and with as little change as possible over a period of time. Uncertainty is the greatest foe of a profitable firm; it probably matters less what the tax rate on a privatized firm is, so long as taxation is seen to be applied equably and consistently to all taxpayers in a given category.

Modernization of the Commercial Codes under which private business operates is important for privatization. Many LDCs continue to operate under outdated Commercial Codes which were drawn up under a colonial regime and designed to benefit trade with the mother country. Examples of this type of Code are to be found in several French-speaking African countries. It is not usually necessary to replace an entire Code; many of the former provisions may still be applicable under an independent regime. The Ivory Coast, for example, still uses a Code essentially similar to that of France but with modifications and updating for a modern business community. USAID/Mali, for example, is pursuing the modernization of the Commercial Code as part of a policy reform project.

G. Using Government's Regulatory Powers in Privatization

One of the major obstacles preventing LDC governments from embarking on full-scale privatization has been the fear of losing control over the rate and direction of development. Where there has been a history of state domination of the economy and an adherence to relatively rigid planning of industrialization, governments hesitate to turn over to a competitive private sector the power to establish new private enterprises. The argument advanced is that the private sector will act chiefly in its own interests, rather than those of the community. Competitive market forces will become the driving force behind industrial expansion and, as a result, scarce capital resources will be used to duplicate productive facilities already available while other needed consumer products and services will be neglected because they do not present adequate possibilities for profit. The fallacy of this argument is evident; if a market exists, the private sector is likely to see it as an opportunity; if it does not, resources, government or private, spent on creating a manufacturing facility will be wasted.

Governments have also maintained that, unless the state is prepared to create new domestic productive capacity for certain products, the country will have to continue to depend on imports since the market will not be sufficient to warrant private sector investment. Moreover, only the state will be able to provide the necessary technology for new industries.

The fact that such industries may require heavy subsidy over the foreseeable future is usually ignored.

Efforts have been made by some governments to divide their SOEs into strategic and non-strategic categories. Strategic SOEs were expected to produce revenue, were seen as vital to development and were politically highly sensitive; included among them were mining and smelting, railroads, airlines and major public utilities. They would not be considered for privatization; the remaining non-strategic SOEs would be offered for sale.

Most strategic SOEs might in most cases be better operated by the private sector, if buyers could be found for them. In the final analysis, the government retains the right to regulate any aspect of their activity including the pricing of the product or service to the consumer. Properly used, the regulatory power can be exercised to accomplish government policy ends while at the same time permitting private sector operators to make sufficient return on capital so that the business becomes of interest to the investor.

H. Choosing the Candidates for Divestment

A central question to be resolved at the early stages of the privatization strategy is which SOEs are to be chosen for sale. Some countries, such as Guinea, make the decision to work on all fronts at once, the industrial, financial, agricultural and services sectors. Others, because of local circumstances, are much more selective. Depending on the criteria adopted, emphasis may be placed on services or on those industrial units which have required the heaviest subsidy or are judged to be the most marketable.

A variety of factors may play a role in the choice:

--If the government's goal is the largest possible addition to revenue, privatization will be initiated with those units that will be likely to sell for the highest price.

--Firms that show current profitability will be the most marketable. In order to demonstrate that state enterprises can be sold, there may be advantages to disposing of these at the beginning. The next stage will be to try to sell those that are not now profitable but which, if well managed in private hands, may become so. This strategy has been employed, for example, in Grenada.

--The size of the firms being put on the market may be a determinant. Successful privatization of large service industries such as telecommunications, electrical generating and distributing firms or transportation services is clearly in the government's interest because they will produce the highest prices, thereby relieving financial pressures on the treasury and they will have the greatest effect in reducing subsidy costs. Successful privatization of broadly used public services will create popular support for the privatization strategy generally and serve to create a permanent constituency for further divestment. But beginning a program with these units raises serious problems:

--It may be extremely difficult to find a single buyer for these large service units because of the heavy capitalization involved. Moreover, they are in most countries the largest money losers and are therefore the least attractive to the private sector. Finding a buyer may involve sale to foreign owners which, because of the public importance of these services, the government may be reluctant to countenance.

--If a stock floatation is planned as the mechanism of divestment, the cost of expert advice needed from investment bankers may be higher than many LDC governments are prepared to countenance. On the other hand, an experienced investment bank hired to advise on, and manage, the floatation may be able to sell the stock for a higher return than could be received from a private placement.

--Failure to sell a service because a single buyer cannot be found or because it is too large a floatation for the local market to absorb, will create a bad public impression of the entire privatization program and may provide an excuse for government to abandon the whole effort.

--Privatization on a large scale will inevitably mean widespread reductions in the work force to enhance efficiency and therefore afford greater opportunity for objection to privatization as a whole from the labor unions.

Initiating a program with divestment of small industries will be less complicated and can be carried out with greater speed. Local buyers are more apt to be available, costly expert advice will be minimized and fewer employees will be dislocated. However, it has real disadvantages:

--These privatizations will not greatly reduce subsidy costs and therefore the government will not see the sale accrue substantial sums to the Treasury.

--The sale of a number of small SOEs will draw little public attention to privatization nor will it add greatly to public education on the subject.

Where privatization of a large unit is achieved, such as the recent sale of a bank in Jamaica, the government gets the credit and public awareness rises sharply when 40,000 to 50,000 shareholders become the new owners. In Malaysia Government's plans to privatize the telecommunications system received wide press coverage that helped to inform the public. Conversely, in Grenada, the sale of small government-owned SOEs involving only a few dozen employees went almost unnoticed.

The optimum choice would appear to lie midway between the large and small extremes. The first privatization would ideally be a substantial and well known enterprise whose product or service is recognized in the local market. Even more ideally, it would be a successful SOE that has not required subsidy and has been operated by an efficient, business-like management. Such a sale may result in a choice having to be made from among the higher bidders. Unfortunately, this type of SOE is the least likely to be among the candidates for immediate privatization since it is a revenue producer. The government may have to be persuaded that the sale is the best method of creating support for further privatization.

Whatever alternative is chosen, the selection remains a crucial part of the long range strategy. Careful consideration should be given to it, weighing factors such as the strength of the local capital and equity markets, the receptivity of government to foreign buyers and the pressures that can be exerted by opponents before the first privatization is announced. Once the list of priority candidates has been decided on, they should remain on offer over a reasonable period even if immediate sales are not achieved. It is not desirable, however, to allow a firm remain on the sale list for too a protracted a period if no prospective buyers appear since this will only serve to diminish its value.

I. Organizing a Privatization Secretariat

When the decision is made to embark on a privatization program, government should create a central agency or group within the government to oversee the process. The make-up of this group and the powers assigned to it can be of critical importance to the success of the program at every stage but particularly at the outset when procedures are being established.

In creating this agency or group, it is essential that it have immediate access to the highest levels of government decision-making including cabinet ministers and the office of the head of government. Without this, the privatization program runs the risk of being undermined by lower levels of the bureaucracy that may not be in favor of it.

Among the members of the group should be the most senior permanent civil servants in the ministries that will be most intimately concerned with the program over a period of time. These normally would include representatives of the Ministries of Finance (probably at the Permanent Secretary level), Treasury and Planning or Development and a representative of the office of the chief of state. If there is a Ministry in charge of SOEs, it would automatically be included. In general, it is preferable that the Ministers themselves be present at least at stated periodic meetings not only to keep abreast of the state of the program but to make decisions to be recommended to the cabinet level.

Some privatization secretariats include representatives of the private sector to ensure that its point of view is heard in privatization decisions and to maintain investor interest. However, care should be taken in appointing such representatives to avoid any apparent (if not real) conflict of interest. It may be that some private sector representatives may be potential buyers of firms intended for divestment and hence should not be directly involved with decisions made.

The make-up of the privatization group is a matter of internal decision by the government. In some cases, such as Egypt, there may be rivalry between Ministries which may carry over to the question of who should direct the work of the secretariat itself. In Thailand, for example, the Minister of Finance and the Head of the planning authority each clearly believed that privatization was his particular province; in this case the choice must be a political one. Whatever decisions are made, the make-up, structure, and powers of the secretariat must be publicly known.

It is advisable that the group be empowered to make decisions up to a given level, such as approval of offering brochures and collection of information on firms to be divested. It should be able to offer advice for Ministerial consideration on evaluation of the net worth of the firms based on the work of outside advisors for Ministerial consideration. Major decisions on acceptance of sale offerings are, of course, subject to final approval of highest authority (usually the Cabinet or the Chief of State) However, preliminary negotiations with both foreign and domestic buyers on terms of sale can be held by the secretariat and a recommendation, stating the arguments leading up to it, submitted by the secretariat.

Whatever form it takes, a privatization agency within the government that has advisory powers and is able to carry out the mechanics of sales is essential to a coordinated privatization plan. No matter what assistance is given by outside agencies, a secretariat that is close to, and has the confidence of, government should be in a position to make final recommendations on privatization actions. The secretariat also serves as a recognized point of official contact between the government and foreign or domestic buyers so that the divestment process can proceed smoothly without the frustration of dealing with a several levels of bureaucracy.

J. Case History of a Privatization Secretariat--Canada

The Privatization Secretariat organized by the Canadian government presents a good example of how such a group can work effectively. Privatization was a stated plank in the program of the Conservative party and when the party formed a government, no time was lost in establishing a framework for it. Each Cabinet Ministry was required to review the parastatals
under its control and to propose candidates for privatization. The Minister was expected to recommend appropriate sales arrangements and to alert the government to policy issues that might arise in connection with the sale. A Ministerial Task Force consisting of the Ministers of Regional Industrial Expansion, Energy, Mines and Resources and the Minister of State for Finance along with the President of the Treasury Board met weekly to consider privatization proposal papers laid before it. The necessary documentation was prepared by a Privatization Secretariat of twelve seconded senior civil servants headed by a retired private sector executive.

The firms and services that were candidates for divestment were identified in the first instance by the Minister in whose portfolio they rested. The next step was to have a Working Group of senior officials of the Ministry concerned, together with representatives of the Treasury Board, the Ministry of Finance and the Privatization Secretariat, explore the possibilities of sale. This group was expected to examine all the policy issues the sale might pose and come up with recommendations for solution at this point. These issues might include, among others, collective labor agreements in force, questions of pension rights and job security and contractual obligations of the firm. Comment might be made on the overall national interests to be served by a sale, such as savings to be gained by eliminating subsidies, the advisability of permitting foreign ownership in the light of the business in which the firm was engaged (such for example, as the case of an aircraft construction firm, Canadair, when it was proposed for divestment) and the necessity or desirability of government regulation when the firm passed to private hands.

The relevant Ministry might be authorized to have an outside evaluation done by a recognized accounting firm to establish the firm's worth as a starting point in the sale process and to assist in arriving at an acceptable price. The Ministry would also have to consider what legislative requirements would have to be met to make privatization legal. Once this process was complete, the Ministry, in cooperation with the privatization Secretariat, may be authorized to prepare a brochure containing technical information on the company being sold. If potential buyers had already been identified, this information would be sent to them prior to national public advertisement of the sale.

The books of the candidate company were made available to possible buyers and the professional assistance of an investment banking firm was enlisted to assist in the conduct of the sale. In order to ensure that the fullest opportunity was given to buyers to acquaint themselves with the condition of the company and the criteria of sale determined by the Ministry and the Secretariat, a data room was opened in the capital for potential buyers' use. To prevent the possibility of frivolous bids, a deposit of $200,000 was required upon acceptance of an offer. The company was eventually satisfactorily sold after the Minister had rejected a first bid as inadequate.

The Canadian experience is also of interest with respect to the question of ethnic groups and privatization. A criterion of sale imposed by the Ministry, in the case of one particular firm, was that Native Canadian (i.e. Eskimo and Indian) interests should be protected, whoever the buyer, since the company served an area in Northern Canada populated largely by these minority groups. Ultimately, the buyer was a consortium of two Native Canadian groups so that the criterion was clearly met. The Canadian example provides some proof that it is possible to privatize while still taking account of ethnic issues.

II. The Techniques of Privatization--Implementing A Divestment Plan

In many LDCs, making a policy decision is often confused with carrying out the policy. Once having decided to embark on privatization and having developed an outline of strategy, many governments assume that the task has automatically been accomplished; implementation of the policy is the next and most important step. This chapter is concerned with the steps that must be taken to carry out privatization and the order in which they should be approached. Several different issues must be addressed at the outset:

--What must be done to prepare the firms proposed for divestment in order to offer them for sale?

--What techniques and instruments are to be used to sell the firms?

--To whom will the firms be sold, either as units to individual investors or as equity investments to shareholders? What buyers are acceptable and to what extent is foreign investment, either direct or in joint venture, politically acceptable?

--How is the privatization plan to be financed?

--Does the government contemplate complete divestment of the SOEs or does it seek to maintain an equity interest in the divested firms (i.e. partial divestment)? If the latter option is chosen, how does the government protect its public policy interests where it may become,in effect, a minority shareholder?

--For those SOEs that are in such poor financial shape that they are unlikely to attract buyers, but which have potential for profitable operation, is the government prepared to engage in a program of rationalization to bring them to a point where a private investor may be interested?

The government should be aware of the close relationship between the objectives it may have laid down in developing the privatization strategy and the techniques that are used for its implementation. If, for example, one objective is wide distribution of ownership, sale of shares to the general public is an obvious instrument, although it may entail higher marketing costs than would sale to an individual buyer. The trade-off is distribution of wealth to the public, to specific ethnic groups, or to the employees of the divested companies versus maximizing the net sale profits no instrument is without its political or economic costs.

A. Preparing a State-Owned Enterprise for Sale

The great majority of SOEs cannot be simply placed on the market without substantial preparation. Potential buyers will seek detailed information on the condition of the firms that will require some time to assemble and can often best be put together by investment bankers.

A basic analysis starts from the question of whether the firm is currently profitable, is potentially profitable, or whether it is essentially a business which cannot be made to produce a profit and, therefore, should be liquidated. Even revenue producing SOEs might be made even more profitable in private hands and the government could thereby increase its revenues by taxation. Currently unprofitable firms could be rehabilitated and later sold but this involves further capital investment that the government may be unwilling or unable to undertake. Liquidation is the most unpalatable solution since it means writing off much of the previous investment.

Detailed analysis of a firm may reveal that one particular privatization instrument is more suitable than any other, given the nature of the business and the firm's operating experience. This analysis should include at least the following major elements:

1. Financial Performance

--Knowledge of current balance sheets, debt-equity ratio, debt status and corporate financial history.

--Profit and loss on individual product lines; these should be discerned with and without subvention. The product may not be viable without subvention.

--Sources of capital funding and current working capital status as well as rate and commitment of capital expenditure. Terms and restrictions of borrowing powers of the firm--can capital be secured only from government allocation, or from domestic lenders and foreign investors as well?

--Auditing procedures, efficiency of billing and disbursement practices, effectiveness of cost-accounting (if any) and overall cash-flow dimensions. Overall financial performance compared to industry standards in other countries.

2. Technology and Productivity of the Firm

   Appropriateness of technology used, utilization of machinery and labor, performance of operations and scheduling of production. Is the technology outdated; if so what capital investment is needed to bring it up to industry standards and what improvements would be necessary in labor training?

3. Pricing Policies

   SOEs are frequently subject to price distortions of their products by government controlled prices and availability of subsidies. Information is necessary on how prices are set, by whom and through what procedures. What should be the "real" prices as opposed to those made possible by import restrictions and subsidies? Has market research been done on price responsiveness cf the market? Could the firm survive if it were exposed to competitive local market forces in product pricing?

4. Current and Past Marketing Strategies

   The failure to develop a marketing strategy has often been a strong contributing factor to the failure of SOEs. Since they are not in a competitive market, too little attention has been paid to sales and to adjustment of product lines to consumer demand. As in the case of state enterprises in the Peoples' Republic of China, the goal was production even if the product remained unsold. Estimates are needed of new market potential as well as review of current marketing procedures. What media are used in marketing, how effective are they and what are the distribution channels employed? What management information systems can or should be employed to promote new product development and to arrive at more accurate forecasts of sales and marketing costs?

5. Effectiveness of Management

   The blame for SOE losses has most frequently been laid at the door of management, not always justifiably. Government objectives and directives have often frustrated the best of managers. Presumably, a privatized company would not suffer directly from these impediments. Nevertheless, any buyer will want information on the quality of past management and the degree to which coherent policy planning has been used in allocating resources. To estimate this it will be necessary to examine:

--Methods that have been used in evaluating policy options, particularly in the financial area.

--External constraints on policy making.

--The effectiveness of strategic business planning and the quality and quantity of information available to managers for this purpose. What has been past capital investment policy and how informed have investment decisions been? How are priorities determined, alternative investments examined, and past experience appraised?

--Management's personnel policies and their effect on personnel attitudes. Has there been a history of unsatisfied grievances, strikes, and persistent disputes? What methods have been used to communicate with labor and involve unions in organizational management? How restrictive have national labor codes been on the prerogatives of management? What is the state of personnel records and what is management's assessment of personnel turnover? A detailed history of labor relations is an essential part of determining the attractiveness of a firm to the private sector. A firm which has suffered from chronic labor problems which have lowered productivity in the past will take time to recover until a new management is able to create confidence in its personnel practices.

Transfer to private ownership will in most cases mean reduction in personnel; is the government prepared to liquidate pension and other employee benefit rights prior to sale? If not, these obligations will seriously lower the selling price of the firm or may even make it unsaleable.

While a close analysis of the internal financial problems and operating performance of the firm is a prerequisite to interesting a new buyer, equally important is an assessment of the environment in which the company does business. This should include:

--A review of legislation governing the operation of private firms. In what ways does it differ from that under which SOEs operate? Because of deep-seated distrust of the private sector in some LDCs in which the state has taken a primary role in development, the private sector may have restrictions applied to it that are not shared by SOEs. The regulatory framework imposed by the government may include price controls, labor limitations, profit restrictions, and foreign exchange access rules from which SOEs are exempted. Unless the government is prepared to relax some of these restrictions for privatized firms (if not for all private firms), buyer interest may be seriously diminished.

--Detailed examination of the tax structure in which the privatized firm will be required to do business. Tax legislation applicable to privately owned companies, including income tax, profit taxes, transaction taxes and property tax may not have been levied on state owned businesses. If the government is prepared to make either permanent or temporary concessions (possibly in the form of tax holidays) to private buyers of SOEs, the sale can be made substantially more attractive. In the case of privatized services, the buyer will want to be clear on the proposed extent of government regulation of rates, user fees, and limitations on return of capital before making a commitment. The key is equality of treatment; if competing SOEs are to remain, they must be subject to the same regulatory structure as private sector entities.

B. Selling a Firm being Privatized

Once the detailed information on the firm has been assembled, the next step is to seek out possible buyers. If the government has chosen the route of divestment to a single buyer or an investors' group, the question becomes one of locating potential purchasers. Normally neither the government nor donor agencies are equipped to deal with this; it requires highly skilled consultant services drawn from outside the country. The consultant should know in detail the market for the product being produced by the SOE (especially if it is designed for export), competitive market prices for the product, markets in the developed world, and possible LDC outlets. Each product has its own market peculiarities and there is no substitute for a consultant who is a recognized specialist in the field. The consultant's advice on finding possible buyers will need to be followed closely.

Knowledge that the firm is being offered for sale will need to be made available both domestically and internationally. A brochure describing the firm, its background, and its present situation in general terms will have to be written. The brochure should contain the sources and extent of more detailed information and the conditions of sale. If the government has limitations on foreign ownership of the firm, these will have to be spelled out. It is important that the brochure contain sufficient detail so that a potential offeror can judge whether he is interested in pursuing the matter to the extent of making a formal bid. The amount of earnest-money deposit required for consideration of an eventual bid should be specified.

Apart from distribution of the brochure, personal contacts by government officials, donor agency officers and local entrepreneurs will be an additional way of spreading the word. Advertisements in U.S. and European papers (as was done by the Government of Panama in divestment of an hotel), indicating where the brochure may be obtained can also be used.

A number of options are available to accomplish the formal sale. The option chosen will depend on the individual circumstances of the firm, government preference, and judgement of the market for the specific product. Options include:

--<u>Negotiated sale to individuals or investor groups</u>. Not all potential buyers will be acceptable to the government. Many LDCs place restrictions on foreign ownership of local industries; in some cases, they are limited to minority interest if full ownership is not allowed and a joint local partner may have to be found. In such cases, the foreign joint partner may take over the management functions as well as providing capital and marketing skills (this has been planned for some privatizations in Guinea, for example). The government may prefer to retain the remaining ownership in a mixed ownership arrangement. The official position on foreign investment should be clear before the firm is offered for sale.

In the case of domestic buyers, their identity should be made public to avoid the accusation of "sweetheart deals" -- i.e. that the firm is being sold at lower than market value to politically powerful local interests. Any indication that this may be the case will only serve to discourage interest in any future privatization. In some LDCs, possible buyers such as certain ethnic groups, may not be acceptable for local political reasons, even though they may have the capital resources. Here again, the attitude of the political leadership on restrictions on bidding should be made explicit in the announcements.

--<u>Sale by stock offering</u>. In developed countries the most common technique of privatization has been a public share offering, as in the cases of the largest British SOE divestments. Where the capital market is sufficiently organized, there are several advantages to this method in LDCs. It may accomplish the government's goal of redistribution of wealth; even more importantly, it will serve to introduce new segments of the population to the concept of share ownership. If the privatization is successful and share prices rise, it serves to create a constituency for purchase of future privatized shares. This has been one of the major attractions of British privatization, especially in the case of British Telecoms. Sale of public-owned housing to former renters has also created support for private ownership. Wide distribution of shares puts a premium on high quality of management of the firm, however, since much of the operating responsibility will devolve into the managers' hands.

The size of the firm being divested becomes a factor in a stock offering. The offering may have to be so large that it cannot be readily absorbed by the capital market. In this case, the government will have to market the offering in tranches in order to avoid a "choking-off" effect--the drying up of capital resources for other development or industrialization efforts. The government may, therefore, have to remain a partial owner at least for a temporary period but the intention ultimately to divest fully should be made clear at the outset. Timing of the offering is of critical importance. It should not be made, for example, shortly after an offering of high-interest government bonds which will have sopped up, at least temporarily, the available supply of capital.

The most difficult aspect of a share offering is determining the initial price of the shares when they are put on the market. The price can, of course, be set to reflect a market or asset-based price based on the valuation of the firm. This is the simplest option but it does not take into account the advantage or disadvantage to be gained by setting the offering price above or below real market value. Professional advice from investment bankers may be needed to strike the best balance between a good return to the government and an attractively low price to the potential buyer (particularly the small investor), so as to make the shares broadly available in the market. While a lower price may reduce the revenue obtained from the sale, it may be politically desirable as an illustration of the value of privatizing. Setting an initial offering price below market value also helps to assure that the offering will be widely taken up since there is the prospect of an immediate rise in share value, to the satisfaction of first time share owners. Too low a price may have the undesirable effect, however, of concentrating ownership in the hands of those who can afford to buy large blocks of shares, thereby defeating one of the possible purposes of the offering.

Limitations may have to be put on the number of shares that may be acquired by an individual or group and regulations made on the retention period for shares bought. Little is accomplished by enabling the small investor to acquire shares if he is able to dispose of them at a profit to larger investors immediately after the sale. In the case of privatization of services in widespread public use, encouragement to buy can also be given by reducing user fees for new buyers. British Telecoms is an example; telephone subscribers' bills were reduced if shares were purchased. Payment for individual purchase of small numbers of shares on the installment plan can be an added inducement.

Pricing the offering at lower than market rates is an advantageous technique for the government but it has to be handled with considerable care. The wider the share distribution, the greater will be the political pressure for a successful privatization. If the new shareholders lose on their investment, the whole privatization strategy may be undermined. Pricing and sale of the offering is a matter requiring the highest technical skills and considerable experience that in most cases can only be obtained from brokerage firms or investment bankers. Before any firm is called in on consultation, its background and experience in stock offerings should be carefully checked, especially for similar work in LDCs. The government should be made aware that not all investment banking firms have experience in areas where markets are thin; it is worth while to pay one that has had this specialized experience to ensure a successful offering.

--<u>Giving away shares in an SOE being privatized</u>. This somewhat unlikely option may not find much support in LDCs but governments should be aware of it since it has certain unique political advantages. It creates an immediate and widespread public awareness of the positive results of privatization and improves the government's public image -- it can be couched in terms of a return to the people of an investment they have already made from their taxes. It also eliminates some of the overhead costs associated with a public stock offering. But beyond these benefits, it has little to recommend it. It achieves no net revenue for the government; on the contrary, it reduces inflated "net worth" assets since the cost of the company must be immediately written off. The administrative costs of a give-away program are extremely high and little public policy gain is made, since with such diverse ownership, control of the company is effectively vested in the hands of its management. In the few instances where it has been tried, it has not been successful because the value of the shares declined rapidly after the give-away so that the new owners received little of value from the privatization.

--<u>Sale of an SOE to its employees</u>. Employee stock ownership plans (ESOPs) can provide a useful technique for privatization in certain circumstances in LDCs. Interest in such plans has become more widespread in the U.S. in recent years and a number of examples have worked with varying degrees of success.

In most cases, the ESOP takes the form of a trust designed to make possible (with special tax advantages) ownership of a firm by its employees. Through an ESOP it is possible to transfer ownership of an SOE being divested to its employees. Funds generated through the ESOP can provide increased financial resources for the firm while allowing employees to participate in management and policy decisions. The ESOP plan or trust obtains new funds from lenders in the same way as would the corporation under shareholder ownership. These funds are used to buy shares of the company in the name of its employees or for corporate refinancing or expansion. The existence of the Trust serves to insulate the employee-owners from liability in case of failure of the firm.

The problem with ESOPs in the context of privatization in a developing country is that, in the absence of a sophisticated capital market, it is difficult to find financial institutions that would be prepared to loan funds for the purpose of capital increase under an ESOP trust. Commercial banks are inclined in the first instance to short-term lending that would not satisfy the needs of the trust. Private development banks may be an alternative but in many cases their lending policies may not be flexible enough to serve the purpose. Any investor would probably have second thoughts about lending to an employee trust for an SOE being divested. It is likely to have been a money-loser before being offered for sale and rehabilitation costs will be high. The employee owners may be faced with the problem of finding new management before the firm can begin operations.

It has been suggested that one way of financing an ESOP Trust would be to make use of accumulated benefits which (1) would be payable to the employees of an SOE either by the government prior to transfer of ownership to a private buyer or (2) would become the obligation of the new owner. These benefits might include payments required by the Labor Code for seniority rights, pensions, or termination of employment. Under some LDC codes, notably in Central America, these could be substantial; in fact they constitute a serious impediment to the sale of SOEs anywhere in the world unless the government is prepared to liquidate the obligation prior to the sale offering. The possibility exists that these benefits might be used in lieu of other outside financing to purchase employee shares in the firm. This would have the double benefit of establishing employee ownership as well as relieving the burden on the government to liquidate the benefits due. In the last analysis, however, this method of funding is frequently unavailable because the benefits due are often unfunded or underfunded liabilities as a result of state ownership.

It is far from certain, moreover, that the workers could be persuaded to trade substantial cash payments for shares in a company whose future is uncertain. A fundamental problem with ESOPs in LDCs is that the concept of stock ownership is not understood by the average worker. Workers are more likely to prefer cash in hand rather than share certificates, especially where the level of financial sophistication is still comparatively low. Worker participation in management is also a relatively recent phenomenon even in the most highly developed industrial nations of the west; it cannot be assumed that labor in a developing country will, without a long educational campaign, see the value of a seat on the firm's board of directors.

Share certificates, dividends, price-earnings ratios, and other concepts of modern finance are part of the lore of capitalism that is often taken for granted in the developed world but which must be learned by employees presented with the opportunity to become part-owners of the firm for which they have worked. Exceptions to this generalization can be found among developing countries, for example, in the Philippines, Malaysia and, to a lesser extent, Thailand. In Malaysia, the government has for some time been engaged in raising the level of public sophistication in stock transactions by offering shares in a form of mutual fund which has paid handsome dividends; as a result, the offerings have been over-subscribed.

Possibilities do exist for expansion of the use of ESOPs in privatization but the country as well as the firm will have to be carefully chosen. To become operative, the ESOP Trust may require changes in tax law and the labor code which may raise delicate political questions. Successful ESOPs will have to be preceded by an intensive educational effort to explain the advantages and pitfalls of employee ownership. It is important that organized labor be brought into any discussion of privatization by ESOP at the earliest possible moment to ensure that labor fully understands and supports the effort. This becomes critical if the government depends on labor as a political ally. The unions may raise strong objections if it appears that the position of organized labor may be weakened under the ESOP; it will be difficult to strike against the owners if they are identical with the union's members.

If the financial market in the country is sufficiently developed, it would be desirable to establish a secondary market for the shares of a firm operating under an ESOP Trust. This would serve to spread some of the risk to other investors, give the employee owners greater confidence in the future of the firm and strengthen the financial base of the operation.

C. Valuation of Firms Being Privatized

Valuation of the industries or services which are candidates for privatization is one of the most necessary but at the same time one of the most difficult aspects of privatization. The difficulty arises from the fact that there are normally at least two contending parties, the government as the current owner of the enterprise on one side and the potential buyer and future owner on the other. Each usually has a diametrically opposed objective; the government wants to realize as much from the property as possible--at the very least, its past investment (and hopefully a profit), while the buyer seeks to acquire the property as cheaply as possible. One of the pitfalls of a privatization program is that buyers tend to regard the privatization of a firm by government as a forced divestment and will tend to base their offers on fire-sale rates.

Valuation becomes, then, not only a technical question of judging the real market value of the property concerned but a matter of substantial political sensitivity as well. No government can afford to be exposed to the accusation that it is selling off the national goods cheaply to selected domestic entrepreneurs or to rapacious foreign investors (especially multi-nationals) who will seek to exploit the opportunity presented by divestment. Even if the property being sold has been losing money for a long period, with high continuing subsidization needed for it to remain in business, or has been badly mismanaged, the government will have to justify to its political opponents any decision to sell which involves writing down its investment. This is more particularly true if the sale offers the prospect that any new owner's first concern will probably be to reduce the numbers employed by the firm to lower production costs and promote efficiency.

In the final analysis, an acceptable valuation must arrive at a compromise between these two conflicting objectives. Only rarely will the government be persuaded that the sale price should correspond to the objective market value of the property regardless of how the value figure has been arrived at. Ideally, it should be suggested by an agency such as an investment bank, which is disinterested (and must publicly be seen to be) rather than by a group, however distanced from government, that could possibly be interpreted as gaining from the sale.

No satisfactory valuation of a firm to be privatized can be arrived at without close examination of factors extraneous to the immediate circumstances of the sale.

--The macro-economic environment in which the firm has operated is of major importance. The firm may have been unable to break even or make a profit because of factors not under management control, such as government pricing policies, access to foreign exchange, or labor code regulations.

--Social overhead objectives that may be incompatible with effective business practice may have been imposed on the business. If so, an effort should be made to estimate their cost in order to give an accurate picture of the firm's potential if it were able to operate with or without such costs.

--The structure of government control over the firm may have played an important part in its operational inefficiencies. Has official oversight been so rigid as to prevent independent management decisions or, on the other hand, has it been so lax that management was unable to determine precisely what the government's real objectives for the firm were?

--SOEs that have been operated as closely as possible to a private business model usually prove to be the easiest both to evaluate and to sell.

Any evaluation has to take into account the internal politics of the country concerned in an attempt to answer the question, just what is the government's political stake in the firm being divested? What is the strength of the opposition and where does it come from--inside the government as well as from outside interest groups? Has the firm being sold been an important part of the government's past pronouncements on industrialization or indigenization? If so, it may be necessary to mount a public education campaign to create awareness of the reasons for a change in official policy. Successful public acceptance of the sale can serve to raise the value of the property.

It is usually advantageous to look as carefully as possible at the overall objective in privatizing as an indirect indication of the government's view of the worth of the firm. If the government sees privatization primarily as a source of revenue, arriving at a lower sale price will be more difficult. If on the other hand, the government views privatization of SOEs as a way of reducing expenditure or as a means of distributing wealth through stock floatations, thereby encouraging the growth of private sector capability, the selling price may be somewhat more flexible.

Other considerations in valuing may include:

--The legal framework in which the firm to be divested has been initially created. In Thailand, for example, there are several separate legal frameworks within which SOEs have been brought into being over the years. Divestment of a company may require a mere stroke of the Minister's pen, a decision by the cabinet, a royal decree, or legislative action. The value of the firm may be diminished if it appears that lengthy and complicated actions by different arms of government may be needed before the firm can be legally passed to new owners. The legal question may become a factor in the choice of firms to be privatized under a divestment plan. Firms whose ownership may be a matter of simple transfer by authority of a single Ministry (as is the case of many SOEs in the Ivory Coast) will be more readily saleable than those whose transfer will lengthy and complex legal action.

--Is the government prepared to pass legislation to enable a privatization program to go forward expeditiously? In Honduras and Tunisia, for example, enabling laws that included specific reference to firms to be divested were passed preceding serious discussion of sales so that the legal position was clarified at the outset.

--Attention has to be paid to company law and the commercial and labor codes of the country. They may create complications in the sale which will effectively lower the value of the firm. In Latin America, for example, a firm acquires a legal personality which continues to exist, even if it has ceased business operations, by which shareholders enjoy certain residual rights until the firm is declared, often by lengthy court action, to be no longer "alive".

--Labor codes providing for pension and dismissal rights for workers that impose so onerous a burden on the firm that it may prove to be necessary to liquidate it, sell the assets, and reestablish the business in order to start afresh without the encumbrance of pension and employment rights. In Peru a somewhat complicated and costly system of providing for early retirement payments to discharge legal labor obligations has been successfully applied and a similar system is being examined in Panama.

--The value of a firm may also be directly affected by tax legislation applying to private companies, in contradistinction to those owned by the state, particularly in the areas of property or income taxes.

--The possibility of restriction of the business by government regulation must also be considered in those cases where the firm is engaged in producing goods or services which are of general public need or may be of potential national security concern. So-called "natural monopolies" such as electric generating and distributing companies may prove to be unsaleable regardless of their value because of fear that future regulation will restrict return on capital investment.

Finally, the rather murky area of general forecasting of future world economic trends plays at least some role in valuation if the product is being produced for the foreign market and not as part of an import substitution program. For domestic firms, the possibility of increased local consumption, if a higher quality product is envisaged by the buyer, may also figure in the calculation of value.

The technical financial analyses of an individual firm necessary to arrive at an evaluation of its real worth cannot be dealt with in detail here. In broad outline, however, they should take into account:

--The historical evolution of the firm from its establishment by the state to the present need for divestment. What prompted the government to create it -- ideological conviction that state control was preferable, a need that was not being fulfilled in any other way, or a business opportunity from which profit could be made? In most cases, it may have been a combination of all three as well as other considerations. The value of the firm may to some degree depend on whether the government sees the private sector as being able to replace the product produced by the SOE and the potential buyers' views of whether the government is really going to relinquish control of production in this sector.

--In many instances in LDCs, little or no market research was done prior to setting up the firm nor have market changes, foreign or domestic, been followed which might have required changes in the firm's product.

--The motive may have originally been the desire to bring in modern technology to the developing industrial sector. As the firm failed to prosper, it may have been unable to keep up with technological improvements in production so that it may have lost any competitive advantage it originally had. Plant and equipment may be aged and worn so that substantial capital for modernization may be necessary on the part of a buyer.

In all cases, estimates of future cash flows will be required based on a number of different scenarios.

--Depending on the product produced, studies of potential export markets, raw material sources and the possibilities of producing new products for additional markets not previously explored by the firm will play a role.

--If the firm has been heavily subsidized in past, the prospects for profitability under unsubsidized operating conditions will have to be estimated. If the firm has been producing for the domestic market, what are the prospects that this market can be increased, either by improving distribution or by introducing new products? SOEs have not been well known for their response to consumer preferences; indeed, some LDC firms have failed to reach profitability because consumers simply preferred to buy imported products of better quality or greater variety when they were available. Part of the valuation of the firm may rest on estimates of future possibilities inherent in new product lines, not past production records. Obviously, a critical part of the valuation process is the financial analysis of the firm's present condition:

--Full financial records are the exception rather than the rule for LDC enterprises. It may be necessary to reconstruct a financial history of the firm from such records as can be found, often a difficult, time-consuming, and not inexpensive process that will not always produce satisfactory results. Important changes in assets, income, and costs over a given period may reveal hidden financial weaknesses as will changes in liquidity and cash flow. Long and short term debt and possible hidden liabilities have to be identified.

--Any serious potential buyer will want financial information that meets international business standards so as to be able to compare the company's performance with that of the industry as a whole.

--If the price structure for the product has been subject to government regulation, is government prepared to allow market forces to set prices if the firm is privatized?

--Foreign investors will require precise information on official restrictions on repatriation of profits and capital investment. If it is likely that repatriation will be subject to a limited percentage annually (as in the case of investment derived from capitalization of debt in Chile), this will have to be factored into a buyer's estimate of the firm's value.

Apart from the purely financial aspect, an important part of valuing the firm rests on an estimate of the past and present capabilities of management.

--A buyer will need to know how the managers have dealt with budgeting, planning and personnel issues. How well trained are the managers in modern business practice? In many cases, managers of SOEs have in past been seconded civil servants not necessarily attuned to the profit motive. Increasing numbers of younger managers have had appropriate training but they may not have been able to put it the best use if they have had to answer to a board composed of political appointees who have little knowledge of (or interest in) the business or to Ministry representatives who regard board membership as a perquisite of office. Even a well-trained manager cannot function effectively if he is continually being second-guessed by the board of directors.

--If a potential buyer feels it necessary to replace the entire management structure, this may entail undue delay, stemming from local opposition, preventing quick resumption of production with resulting loss of markets.

Cases arise in which the government may feel that for political reasons full privatization may not be practicable regardless of its desirability. Several alternatives are available, each of which figures at least in some degree in the valuation of the company.

--The government may decide to sell a controlling interest in the firm or to retain a majority share, in either case with the help of a private joint venture partner, who may be looked to for management skills, foreign market access and/or capital investment. Any potential joint equity partner will require information on the financial situation of the firm, and its past record to arrive at his estimate of the prospects for future development.

--The government may contract out overall policy direction and day-to-day operation of the firm to a management contractor. By contracting, the government avoids the accusation of surrendering ownership of a state enterprise to a private buyer although it does lose operational control. This may be the only feasible way of putting the firm on a basis that will not require further subsidization. If the government surrenders a minority holding in the firm to the contractor, an evaluation of the firm will be necessary to arrive at an acceptable price for this holding.

--Leasing an SOE to a foreign company or a competing local company is a variation on contracting out. In some situations local privately owned companies have come into being which, because of more efficient management, have been able to compete successfully with the state-owned firm without subsidization. A case in point is the iron foundry in Mogadiscio, Somalia. The government was unwilling to divest completely. After a thorough business analysis, the consultant's recommendation was that the failing SOE be rescued by permitting a Somali privately owned and operated competing foundry to lease the property, making use of such working equipment as the state's firm possessed and integrating its production into that of the ongoing successful enterprise. It was also suggested that the range of products theoretically offered by the state foundry (many of which it could not, in fact, manufacture) be reduced to those which could be efficiently produced to meet local market demand.

--Leasing, as a technique for hotel operation is common in many LDCs. In most cases an international hotel corporation takes over full control of the management of the property but only after complete valuation of the possibilities for profitability.

D. Financing the Sale of a State Owned Enterprise

Privatization is not without cost to any government. Many LDC governments feel that they must turn to donor agencies for technical assistance costs as well as guidance and for help in arranging the financing of the sale of large SOEs. Among possible sources of financing are:

--Private local capital. Smaller privatizations in a few LDCs can be financed by local capital sources where an organized capital market exists. The private sector buyer may be able to pay the full cost from his own resources or with the help of local lending sources. A problem arises when the only groups with available capital may be unacceptable buyers for political reasons. If the government is chiefly concerned with divesting to local buyers, it may be prepared to grant easier or extended financial terms to them that would not be available to foreign purchasers.

Private Lending Institutions. Loans for the purchase of an SOE are unlikely to be easily available from local commercial banks. They are frequently more interested in short term loans (preferably one year or less; at most three years) with greater security than a recently privatized SOE could provide. In most cases, rehabilitation of an SOE would require a longer period to produce a profit. Donor agencies do not customarily provide guarantees for commercial bank lending. In many LDCs commercial banks may find their loaning opportunities are restricted by government-imposed interest ceilings, making loans to the Treasury more profitable than those to private entrepreneurs. Unless the local buyers of the divested firm have established a previous credit rating, commercial bankers may require full collateral or government guarantee for any business loan.

Private or semi-private intermediate financial institutions such as development banks may be possible sources of loans. Such banks are able to make longer term loans, often with government or donor guaranties and on more accessible terms. These loans are not always in the government's interest, however, if it is to be the guarantor. In case of default, the government may find itself the unwilling participant in a reverse privatization if it becomes necessary to repossess the divested firm, as the Philippines government discovered.

--International and bilateral donor financing. Agencies such as the IBRD and the IFC are increasingly becoming engaged in both technical and financial assistance to privatization. IBRD Structural Adjustment Loans contain provisions for such assistance (as, for example, in the case of privatization of an oil refinery in Thailand). Conditions of the loans may require rehabilitation and ultimate privatization of subsidized SOEs or direct efforts to institute a privatization plan. The IFC has investigated the privatization potential in a number of countries and individual transactions have been identified. In its policy dialogue, the World Bank has encouraged privatization to promote economic efficiency and growth of the private sector.

Assistance has been provided to governments to make policy and regulatory changes to improve the environment in which the private sector operates. Using its LDC investment expertise, the IFC can provide both technical assistance in preparing for privatization and in the search for buyers.

In selected cases, the IFC may become a participating investor or a source of loans for the privatized firm. Its participation may encourage private sector investment or the mobilization of other financial sources. The two institutions have embarked on a cooperative program to coordinate their responses to privatization requests.

The Multilateral Development Banks(MDBs) are a potential source of financing privatization. The MDBs have become more concerned with expansion of the private sector in their member states but they have hesitated to depart from the traditional practice of lending to the private sector only with government guaranty. The Asian Development Bank has embarked on a program of direct lending to the private sector without government guarantee but, as yet, there has not been sufficient experience to judge its success. If the Banks can be encouraged to embark on more direct lending ventures of this kind, they could become a major factor in financing long term privatization programs.

As a bilateral donor, A.I.D. has directly assisted in the financing of privatization. In the case of Costa Rica, for example, the Mission used local currency funds to establish a trust which acquired SOEs the government sought to privatize. The acquisitions were accomplished by repayment of central bank loans to the firms. The trust will, in turn, maintain a revolving fund by sale of the firms to foreign or domestic private investors. In such an arrangement, care must be taken to establish mutual agreement between the government and the trust on the true valuation of the firms being privatized prior to their acquisition.

<u>Debt-Equity Swapping (Debt Capitalization)</u>. The swapping of debts for equity or, more elegantly, a debt capitalization program is a relatively new concept in its application to developing countries. It is gaining momentum in a number of countries, particularly in Latin America, and an active market has been created. While its major application has hitherto been in the field of new investment, it has potential application to privatization in selected situations. The first formal announcement of a swapping program came from Chile in 1985 and similar programs have been used in Mexico, Argentina, Brazil and the Philippines.

Debt-equity swapping is unlikely to become the panacea that will solve the international debt problem; in 1986 it probably amounted to about $5 billion (a doubling from the previous year). It is admittedly only a small part of the

$242 billion in foreign debt held by U.S. banks. Nevertheless, there is growing incentive for countries to create value by repurchasing their debt at lower than face value. There is now a secondary market in the debt of certain countries; daily quotations are available and put and call options are being used.

The process of swapping is essentially not complicated but it may become so depending on local country procedures. It can be outlined in the following form:

> A foreign firm seeking to make an investment presents the proposal to the Finance Ministry describing the project and the financing by debt capitalization.
>
> After coordination and review by the Ministry and other parts of government, the purchase of debt is approved with the percent of face value being clearly stipulated.
>
> The investing company then arranges to purchase debt at a deep discount. The total to be purchased equals the actual amount to be invested divided by the face value that the Ministry has agreed to pay out in local currency. The total of purchased debt is then canceled by the Ministry by payment of local currency to the investing company.
>
> This currency is then used by the investor to purchase the capital stock of a newly organized or an existing company. This second company then uses the local currency to make the desired investment (new plant, new equipment, or financial restructuring by repayment of debt to local banks.)
>
> The swapping process allows the Finance Ministry and/or the Planning Ministry to exert some control over new investment coming into the country in that the discount rate can be made more or less favorable depending on the type of investment being made or the location of facilities to be constructed or extended.

Swapping can be used, then, by firms needing to make new investment or to recapitalize an existing subsidiary. In the latter case, this represents a reduction in local currency debt and an increase in equity. Attracting investment in the first instance may require certain modifications of local tax laws. If the spread between purchase price of the debt and the local currency payout is treated as taxable gain, the investor may be less interested.

The possibilities for swapping depend, of course, on investment opportunities within the country. If there is little or nothing worth investing in or if the political climate is regarded as too risky, no amount of discounting of debt will attract new foreign investors.

Not all debt is susceptible to swapping. Depending on the conditions of the original syndicated loan agreement, specific limitations may apply. Penalties for prepayment may be laid down; partial payments may be prohibited or all syndicate members may have to share in any payments received on a loan. Repurchase of debt with these limitations at a discount may be impossible.

The sellers of the debt being purchased are normally banks with relatively low exposure in the country concerned or those which have already written down the loans they hold (by increasing their loan reserves) to an amount below the face value of the loan--American regional banks are among this latter group. Selling of debt by U.S. holders may be limited by American "mark to market" banking regulations (U.S. banking regulations require that when any portion of a loan is sold at a discount, the face amount of the loan outstanding must be discounted to reflect this discounted market value of the loan.) Many of the sellers of LDC debt are European banks where such regulations are not an impediment.

The process of bringing together the three parties to the swap (the purchaser, the seller and the government) is normally done by an intermediary who performs a number of functions:

--Advises and educates governments on the advantages of debt equity swapping as a tool inducing foreign investment.

--Assists prospective purchasers in the process and mechanics of debt capitalization and in the preparation and negotiation of the investment project.

--Purchases the debt on behalf of the investor.

--Prepares the documentation for the debt cancellation, transfer of local currency and issuance of new stock. In some countries, such as Chile, this process requires several complicated steps, a knowledge of bureaucratic procedures, and a wide knowledge of the debt structure.

The intermediary is usually recompensed for his services by the arbitrage arranged in the course of the purchase of the debt.

Gains and Losses in Swapping for Governments and Investors. The most obvious gain is overall reduction of international debt owed. Even though the amount may be small in comparison to the total debt, it nevertheless reduces debt service charges and continuing demands on foreign exchange devoted to debt servicing.

It produces productive investment in the country which might not otherwise have been made had not the opportunity existed to acquire local currency at a reduced rate.

It is of help in developing local capital and securities markets if the government is prepared to require that all equity obtained by capitalization is listed on a local stock exchange.

For the government, foreign exchange requirements for later repatriation of capital and profits connected to the investment can be minimized either by prohibiting repatriation for a period of years or restricting the percentage of dividends that can be repatriated annually. This has already been done in some Latin American countries. While this may be a deterrent for some investors, it may be overcome by the advantage of securing local currency at a discounted rate.

Capitalization programs have also been used to encourage portfolio investments in some of the more developed LDCs to capitalize closed end mutual funds which, in some degree, helps to overcome the reluctance of investors to enter overseas markets by making more shares available, thereby increasing the depth of the market.

The advantage of debt-equity swapping has been questioned because it may result in higher inflation rates. The government will simply print up new money to meet the local currency needs resulting from the swaps. This is not necessarily true; methods exist to avoid greater monetary impact, such as:

--The amount of capitalized debt converted can be limited to a fixed figure per month or the rate at which the local currency funds are disbursed may be spread out over an extended period.

--Instead of printing money, the government can issue debt paper on the local market or redenominate the debt in local currency which the investor then sells on the local capital market for cash, use it to pay existing local debts, or to purchase assets from local companies. This could result in upward pressure on interest rates but not if the government regulates carefully the rate at which paper becomes available.

The government's domestic debt will be increased by the amounts made available in local currency and the interest on these (possibly at higher rates than that formerly paid on the original loan). However, this may be offset by the fact that the new investment made as the result of a swap should produce tax returns, both business and personal, that will be net additions to overall government revenue in the long term.

Despite the gains to be derived from debt-equity swapping, some governments may feel that it is undesirable from a political point of view in that it opens the way to greater foreign control of industrial production and thereby exposes the government to opposition criticism. Where strict limits are imposed on foreign ownership, a capitalization program may not be possible, although this does not rule out swapping by citizens of the country using returning flight capital.

It can be argued also that, from the government's point of view, there is no great advantage to swapping since, from a long-term point of view, it is always possible to go on rescheduling debt, so long as interest payments are kept up. Indeed, it may never become necessary to repay the principal at all, if current third-world pressures for debt forgiveness are successful.

Experience with Debt-Equity Swapping. Swapping has thus far been carried on largely in Latin America. Chile converted $121 million in the first nine months of the program despite restrictions of a four-year grace period on dividend repatriation, after which repatriation is limited to 25% of net profits annually. The largest Chilean conversion thus far has been carried out by Bankers Trust of New York which converted $60 million of debt into a 51% holding in a major pension management company. Brazil has converted over $1 billion of debt thus far, but conversion ceased in early 1987 as a result of mounting internal financial problems.

Argentina has engaged in relatively minor swapping thus far, partially because of lack of outside investor interest. The new Philippine government has expressed interest in a large scale capitalization program but only a few minor deals have been completed. Outside Latin America, Nigeria has expressed interest and Morocco would appear to be a good candidate.

Applying Debt-Equity Swapping to Privatization. Swapping may, in selected cases, have direct applicability to A.I.D's policy concerns with both privatization and with capital market development. Where a government is interested in privatizing an SOE and is prepared to seek a foreign joint partner, it may provide an inducement to a buyer who might not otherwise be interested.

The price sought by the government for an enterprise may be unrealistically high, if payment were required in dollars, discouraging potential investors. If, however, payment could be made in local currency through a discounted swap, the price may become more attractive. Matching buyers to swapping opportunities can be handled by investment or commercial bankers. Missions would not normally be directly involved in the debt swapping process, but they should be aware of its possibilities in planning privatization programs and capital market expansion.

Swapping is designed to increase the rate of economic development by new productive investment as well to provide a positive environment for private sector growth. Technical advice supplied at the request of governments might include basic explanation of capitalization programs as part of privatization strategy discussions.

Convertible Bonds. Convertible bonds are instruments which may be converted into shares of stock in a company at market rates. Even in those countries where capital markets have developed to a point where there is a nascent stock market, a problem continues to be the lack of offerings on the market. The concept that money can be made from stock holdings is still too new for many investors to understand. There remains an underlying suspicion of the private sector and its possible manipulation of the small stockholders for the benefit of a few larger families or groups which control the majority of the shares. On the other hand, small investors have been more comfortable with the notion of a government guaranteed investment.

One way to bridge this gap is by use of convertible bonds which are issued with a government guarantee. Buyers of these bonds may convert them into shares of stock which may rise in price, as will the bonds. So long as the buyer remains comfortable with the price of his shares, he can retain them for market trading. Should prices fall or become too volatile, he can dispose of the shares, relying on the government guarantee of the underlying bond. If the sale of SOEs can be financed by bond issues of this type, it may both encourage the small investor to come into the market and at the same time diversify the offerings available for sale.

E. Mixed Ownership as a Problem in Privatization

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 on the part of shareholders as to whether the enterprise will be operated on strictly commercial lines so long as the 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.

Although the government may be prepared to accept the idea of full divestiture, in some countries there may not be enough small shareholders capable of buying into the firm and no single indigenous buyer with sufficient resources to buy the enterprise outright. If one of the government's objectives in privatizing is to expand the capital market by increasing the numbers of small shareholders in the private sector (as is the case in Malaysia, for example), mixed ownership may be desirable for a temporary period while the process of educating the public to the advantages of profits from shareholdings goes on. Some form of intermediary ownership (such as an IFI or a Development Fund) may be desirable under these circumstances so that share purchase can be made as easy as possible.

Divestment of an SOE that involves continuing mixed ownership by the private sector and government creates a number of policy considerations for donor agencies assisting in privatization efforts. A major question turns on whether such a divestment should be considered part of a privatization plan that qualifies for technical or other support. The decision on this point may involve an estimate of what a government's ultimate intentions for the SOE may be.

(1) Reasons Advanced by LDC Governments for Retaining Participation in a Divested SOE.

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

a. Political considerations (chiefly accusations that the government is inappropriately selling off the national goods to private individuals, or ideological dispute 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 (an example can be seen in national oil companies such as Petro-Canada).

c. For public policy reasons, the government may wish to maintain some voice in decision making in the firm because the firm's products are perceived as vital to national security, or because they concern exhaustible natural resources (minerals or petroleum). There may also be a long standing *dirigiste* tradition in the government (as for example, in Mexico) that makes the government disinclined to surrender full control to the private sector.

d. The entity may be too large to be privatized at once to a single buyer, domestic or foreign, even if the government is willing. The alternative may be to spin off viable parts of it or to sell as large a share as the market will bear, particularly if the government's secondary objective is to increase popular acceptance of private sector activities.

However, it is not always easy to convince the government that, in sharing 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 some of which may not be compatible with the commercial objectives of a private sector firm.

(2) <u>The Impact of Mixed Ownership</u>

(a) <u>Perceived Gains</u>

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

--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.

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

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

--The private sector shareholders may feel reassured that the government will regard the firm with special favor because it has a continuing interest in it (although this perception represents practices that are not conducive to free and open market competition).

(b). <u>Real Losses</u>

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. Additional losses from, the government's point of view, may be:

--<u>Reduction of selling price or share value</u>. 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 reasonable 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.

--<u>Increased autonomy of management under mixed ownership</u>. The normal commitment of managers in private firms is to work in the commercial interests of the shareholders. Any reduction in governmental control of a corporation through privatization creates a corresponding rise in the autonomy of the managers and in their ability to resist government demands. 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. Thus, the government's position as a shareholder is weakened because it becomes subject to the forces of public opinion.

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 number of private shareholders may not be strong enough to effect management changes and, if the government tries to do so, it exposes itself to charges of interference.

(c) <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:

--<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 entirely divorced from government participation and subjected 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 the firm 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 might be the case of a capital intensive mining operation 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.

--<u>The Arm's-Length Holding Company</u>. 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; this, however, may leave the relationship too close between the firms and the political level.

(d) <u>Protecting the Government's Interest in the Case of a Partial Privatization</u>

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. Several points may be emphasized:

--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 to 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.

--It may be possible to persuade the government that its regulatory 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).

--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.

--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, government may apply unusual pressure on the firm by threatening to remove its main supply contract. This may ensure that the privatized firm will produce according to government requirements but it may also mean that it will have to accept lower profit margins.

--The government may have recourse to a "golden share" provision either to protect what it views as a vital policy interest or, in the case of more developed economies, to forestall a takeover 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 (ir effect, a veto) over some majority decisions by the board or the stockholders. Its inclusion has a chilling effect on potential buyers, however, unless its use is clearly restricted before the sale is consummated (by legislation or preferably by contract which, if breached, can be enforced by the courts) 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. The "golden share" arrangement may prove particularly useful in LDCs where the government is exposed to political attack for selling the national goods. It permits effective privatization while making the government's vote effective at critical points. Some major privatizations in the United Kingdom have included this feature.

--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 or must operate under special limitations.

The focussed instrument, which is a variant on the general instrument, can be applied to a regional development objective to promote industrial concentration in a localized area.

--The government can always preserve the ultimate right to require a mixed ownership firm to undertake activities which would clearly not be in its best commercial interests. Requiring the firm to hire excess numbers of employees during periods of high unemployment or regulating prices or production levels for public policy reasons are examples. 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.

Whatever mechanism is used to protect the government's interests, machinery for performance evaluation and accountability to the appropriate level of government should be in place before a partial sale is completed. Mixed ownership will clearly never be as satisfactory as outright and complete privatization. In those cases 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 being served by it. If this is found to be true, the firm should be sold 100% to the private sector.

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.

It is desirable that government become at most 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, private shareholders will be reassured if the government's objectives are made clear.

It is to the advantage of both the government and the private shareholders that the government demonstrate its arm's-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. This serves to increase investor confidence and therefore the price of the shares.

Technical Assistance for Mixed Ownership Privatization

Depending on the policy makers' interpretation of the meaning of the term, achieving partial privatization through mixed ownership may be considered for technical or other assistance. Among the policy options available are:

1. Mixed ownership or partial sale does not qualify as a privatization and no help, either in the form of technical or financial assistance, can be extended to assist in such a sale.

2. Mixed ownership qualifies 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,

designed to eliminate ultimately all government participation in the firm. Provided this schedule is adhered to, technical assistance could be provided.

3. Mixed ownership would qualify for assistance as a privatization without formal commitment to eventual full private ownership provided safeguards 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.

4. Mixed ownership would qualify as privatization for the purpose of technical 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 would not qualify for assistance since the foreign venture partner should be expected to provide needed technical assistance.

F. Management Contracting as a Prelude to Privatization

Management contracting as a means of rescuing SOEs which are chronic money losers has come into increasing use in the developing world as the pressures to reduce subsidy costs grow stronger. In its simplest form, it is an agreement to provide management control and operating functions of a company in return for a fee. The goal of a management contract is to produce an efficient, cost-effective, and profitable operation. Where the government is committed to a privatization program, the ultimate goal may be to make the firm attractive to potential private sector buyers either domestic or, in joint enterprise form, with foreign investors. In any case, management contracting -- putting management in private hands -- is a first step in the process of transferring ownership to the private sector. A long-term leasing arrangement may accomplish the same ends, particularly if political considerations make outright sale undesirable or if it is desired to avoid sale at a bargain price in the face of unfavorable economic conditions.

Management contracts may take a wide variety of forms; in fact one of their great attractions is that they are almost infinitely flexible. They may contain virtually any terms on which both parties agree. But a management contract must be clearly distinguished from a situation in which an outside executive is brought in for a temporary period to assume management direction as an employee of the firm. Management contracts universally have three elements--the owner, the managing firm, and the personnel who are assigned as employees of that firm to carry out the responsibilities required under the contract. The contracting firm usually requires full guarantee of operational autonomy and decision making with complete freedom from interference by government ministries during the term of the contract. This autonomy normally includes hiring and firing and control over wage rates -- powers which governments as owners are often reluctant to concede. It is important to distinguish here between a management consulting contract (under which management advice is given, but not necessarily taken), and a contract in which ful management authority is granted.

For the owner (i.e. the government), a management contract provides efficient and independent direction including the transfer of modern management technology and knowledge of production methods and permits the government to retain ownership of the firm to counter political charges of selling state-owned facilities to (possibly foreign) private owners. It may, in the case of a foreign management contractor, be able to provide access for the firm to external markets and international capital sources.

For the Managing Contractor, a contract provides compensation for services throughout the term of the contract, in many cases with no equity risk involved; additional compensation which can be negotiated through procurement or product marketing arrangements written into the contract, and experience for employees in management under difficult operating conditions.

But there are disadvantages on both sides. The owner loses effective operating control over the firm and the ability to use board and management positions for political purposes, as well as the expenses involved in the contract fees.

Disadvantages to the contractor include the risk that the government may renege on the agreed fees. The legal costs and the time involved in forcing payment may not be cost-effective even if a unilateral termination clause in case of failure by the government to pay agreed costs is written into the contract. The possibility exists, moreover, that the government may be unable to resist the temptation to interfere in operational decisions properly within the agreed upon prerogatives of the managing contractor.

Structuring the Management Contract. It is imperative that the owner and the manager be clear at the outset on the objectives the contract is designed to achieve and that these be spelled out in detail in the contract language. There must also be a clear division of responsibility between the parties with delineation of the precise role (if any) the government's representative on the board is expected to play. Both parties will need "escape clauses." In the case of the government, the right to intervene, for example, may be desirable in case of mass political discontent where the industry is a producer of crucial necessities, such as bread or beer.

The question of equity participation by the management contractor is a matter of negotiation. Some contractors (especially U.S. firms) will not undertake a contract without equity in the firm, arguing that, without this, there is less incentive to provide profitable management.

Where the government retains majority control, the management contractor will normally insist on full operational control to protect its equity. In the case of hotel leasing and in franchise and lease-back arrangements, the contractor may undertake management alone either in return for a fixed fee or fee plus share of the profits. Both public and private sector firms under management contract have to work within the overall context of the government's macro-economic policy. Prospective managers may insist that certain changes in commercial and labor codes be made before they will consider undertaking a contract. For management contracting to be effective in rehabilitating a failing SOE, its problems must derive from an evident lack of certain skills or capabilities in current management which, if brought in, would provide some prospect of improving the firm's profitability. It is always possible that the firm cannot be rescued by any management change and should either be sold outright if a buyer can be found, or liquidated.

The owner (especially in the case of government) must have a realistic expectation of what a management contract can accomplish. If the government is chiefly concerned with immediate returns in the form of profits at the expense of building a solid base for expansion of the business, it is likely to be disappointed.

Management contractors do not perform miracles; a firm in need of such services is probably going to require a long turn-around time not only to achieve internal efficiency but to create new markets for its product. Management contracting has often been regarded as applicable chiefly to the industrial sector. However, some of the most successful contracts have dealt with agriculture -- an example is the Kenana sugar plantation in Sudan where 125,000 acres have for some years been under the management of an American firm. Apart from the growing and marketing of the plantation's main product, the firm has branched out into production of electricity from sugar biomass which supplies the needs of the operation and feeds surplus power into the national grid. Modern large scale agro-business is capital-intensive and requires management, technical, and marketing capabilities which make it peculiarly adaptable to contracting.

Service industries such as transportation (particularly at the municipal level), air lines, hotels, port facilities, and, less frequently, railroads, have been the subject of contracts. Since these state-owned facilities do not usually provide opportunity for the manager to take equity, the contracts are somewhat simpler to draw up. This applies equally to contracting for public utility management.

Paying the Management Contractor. In any discussion of the financial arrangements under the contract it is important to remember that the government, as owner, is paying for services for which there may not be a pre-determined market value. The owner needs the skills, experience, and contacts the manager's personnel can provide; depending on the specialized nature of the firm's product, the choice of potential candidates may be very restricted and hence the price will be high. For political reasons the government will seek to keep the cost as low as possible. The negotiations will be affected by the owner's perceived need to rehabilitate the firm on the one hand and by the manager's calculations as to the indirect benefits that may be derived in business experience, separate material supply contracts, and marketing arrangements.

If no equity in the firm is taken, the manager's risk is reduced; on the other hand, the chances of substantial profit will be foregone if the enterprise can be made highly successful. Ultimately, the management company can only take a limited degree of commercial risk and the government can only make limited tax or foreign exchange concessions as levers to bargain for a reduction in management fees. Some contracting firms argue that the cost of their fees for a long-term contract may well be less than the cumulative cost to the government of the subsidies that would be required to keep an inefficient firm in business.

U.S. firms have an additional incentive to engage in long-term contracts because of domestic tax-breaks available to them for work outside the country. If these can be combined with additional tax incentives offered by the owner, or the prospect of substantial profit sharing, they will be inclined to assume greater risks in the the type or condition of the firm they are prepared to manage. In the final analysis, the cost of the contract will represent a saw-off between all these conflicting interests.

Two types of financial agreements under which contracts have been undertaken include:

(a) Annual Fixed Fee without Equity Participation

--This is one of the more attractive arrangements from the point of view of the managing company but much less attractive from the owner's point of view. The manager receives a guaranteed fixed sum (which usually includes an inflation protection clause) in addition to any other indirect benefits. From the owner's viewpoint, this may be unacceptably high in terms of political risk and it may be difficult to find comparative figures to determine whether the proposed fee is fair. Moreover, the fixed fee arrangement lacks the critical factor of guaranteed performance. Without equity incentive, the contractor has no reason except professional reputation to get results; fee payment is to be made in any case. It is not surprising, then, that this arrangement is relatively rare; however, in those countries where the risk of political upheaval and consequent harm to the manager's personnel or damage to the managing firm's reputation is perceived to be high, the government may find no alternative.

(b) Fixed Fee plus Incentive

--A reimbursable cost-plus arrangement may be made but this has the disadvantage, from the owner's point of view, that there is no certainty as to the ultimate cost of the contract.

A combination of payments may include the base fee plus an incentive addition, fees based on production, or a percentage fee on gross revenue with a minimum floor. The manager normally seeks an incentive related to sales (preferably calculated on a quarterly basis) while the owner finds one linked to profits more advantageous.

Finally, if special services beyond purely management are desired, the contractor may insist on separate payments; it is preferable, however, that these be built into the general payment or at least limited by a total expenditure figure.

On balance, contracting has proved to be a promising solution in cases where effective management can turn around a failing enterprise or provide production and marketing avenues in capital intensive heavy industries such as mining or petroleum production in which LDCs lack technical skills. Not every failing SOE's problems can be cured by improving the management but as a technique leading to private sector interest in acquisition of a state owned enterprise, it deserves serious consideration.

Case Study: Hotel Management Contracting.

The hotel field is particularly suited to management contracting and there has now been a good deal of experience with it in developing countries. Under a typical management contract, an international hotel company will undertake to operate a property for the owner (usually the government) but only with full operating control. Contracting is done on a combination of base fee (e.g. 5% of gross revenues) and incentive (10% of gross operating profit). A set-aside of incentive is frequently provided for if operating profits for the year do not cover debt-servicing, on the understanding that it will be recouped at a later point as revenues grow. The manager may require a market survey and a very close scrutiny of the entire financing package of the hotel before accepting a contract. Full hiring and firing rights are usually reserved and resolution of any outstanding labor severance obligations is frequently needed before contract signing. Specific provisions for access to foreign exchange and repatriation of profits are normally made.

In many developing country capitals, a first class hotel is a major tourist and business attraction as well as being an impressive location for official meetings and diplomatic functions. It is therefore in the interest of the government to have a well-run establishment and the manager of the hotel becomes a person of consequence in the community. Harmonious relations between the contractor and the owner may depend on the manager's diplomatic skills; he may also, because of his contacts, be able to give early warning to his employer of a deteriorating situation.

Hotel management contracts may also take the form a leasing arrangement. Such a lease generally takes one of two forms:

Net Lease: The fee paid for leasing is guaranteed to the owner, irrespective of profitable operation. It is usually a base minimum plus override based on revenue. This can be the most profitable for the lessee but also the most risky.

Operating Lease: This resembles a management contract but the lessee provides working capital and covers any working losses but not debt service. There is no management fee but a provision for a share to the lessee of net operating profits which may be as high as one-third.

In hotel management contracts it is important that both parties understand the meaning of the term "gross operating profit"--i.e. the difference between gross operating revenues and the entire costs of operation, direct and indirect. These include, for example, the cost of international reservation service and an annual addition to a Furnishings, Fixtures and Equipment (FFE) Fund, which may amount to $15,000 to $25,000 per room. The entire management agreement must be very carefully drawn and every effort made to see that all parties concerned are aware of the obligations being incurred. Provision for settlement of disputed points should be included in the agreement.

III. Privatization of Services

The service sector has received increasing attention over the past few years as a fertile field for privatization. This stems, in part, from the competition that has grown up between the provision of services by government and higher quality services that have begun to be provided by a competitive private sector.

A. Municipal Services

Services provided by municipalities are particularly well adapted to privatization. In the case of urban transportation, government services have operated at substantial losses while competing privately run buses have begun to provide better service on a cost-efficient basis. As a result, city governments have become interested in turning over to private firms a service that has long required heavy subsidization . In Bangkok, for example, the municipal administration has for some time been seeking a buyer for its bus services; service has already been successfully privatized in Calcutta and this has been discussed in Dakar.

Divestment of municipal transport faces a major political hurdle, however, in that the private transporter is almost certain to increase user fees. Although there is evidence that the consumer is willing to pay for reliable and frequent service, nevertheless there is a limit to his ability to accept increased fares charged by private operators if they rise too steeply. In consequence, a private buyer is likely to face regulation of his profit margin which discourages investment in new equipment and route extension. A balance must be struck between the consumers' willingness to pay for better service and the perception that they are being exploited by the private sector operator.

It is possible for the government to retain ownership of the system while offering it to the private sector on a competitive leasing or franchise arrangement. By so doing, the administration is relieved of maintenance costs and capital investment in new equipment. The franchise should be open to competitive bidding; otherwise there is a danger of exchanging an official inefficient monopoly for an equally ineffecent private monopoly.

Other municipal services, such as trash collection, road and park maintenance, and even municipal parking can be similarly treated (as in the case of Kualalumpur). In Abidjan, the municipal water supply system has for some time been in private hands, based on the model of French cities. In the case of water, the distribution infrastructure is usually provided by the government while operation is carried out by the private firm. Private tube wells have been successful in Pakistan and Bangladesh.

In some service franchise operations, the government receives a fixed fee, in others a profit-sharing arrangement can be negotiated. In the case of essential services such as water, the government may regulate the price charged to customers, while allowing for reasonable profit after maintenance charges are paid.

Municipal services are particularly suited to this type of privatization arrangement because entry costs are fairly low. Unlike the purchase of a goods-producing firm, a heavy initial investment is not required and capital replacement costs can be spread over a longer period. There is also the incentive of a reasonably secure market for the service provided.

Several countries have tried experiments in contracting for road maintenance with varying success. It is often the case that, when budgets are tight, road maintenance is considered among the expenditures with the lowest priority. To cut the cost of maintaining large amounts of equipment scattered throughout a wide area, to meet the local political demand for frequent maintenance and achieve greater flexibility, national or regional governments have contracted out maintenance to the private sector. Berg points out that in Yugoslavia, Brazil, and Argentina good results have been obtained; in Kenya, small local contractors have developed capacities to undertake full maintenance contracts. In Zaire, the Office des Routes has contracted, with Mission encouragement, for mechanical and manual maintenance and rehabilitation of over 500 kilometers of roads and similar experiments have been tried in Madagascar. Success depends on the capabilities and skills that small contractors can muster; performance is subject to criticism by the local community which leads to uniformly higher level of work.

B. Energy Supply

One impediment to more rapid spread of service privatization has been the popular perception of "entitlement"--i.e. what services do the populace traditionally expect government to supply without user cost? In some countries, user expectation is unexpectedly high; in Kingston, Jamaica, for example, user charge measured by meter for electricity supplied to dwellings is deeply resented and extraordinary efforts are made to evade these charges by bypassing meters. The result is that there is little likelihood that a private buyer can be found at present for the electric plant.

Elsewhere in the world, however, privatization of energy is being actively pursued. In Southeast Asia several firms are producing energy for their own needs from refuse from their main operations (such as bagasse from sugar cane). Energy that is surplus to requirements is fed into local or national distribution grids for which payment is received from the government. Divestment to the private sector of power generating firms has not been widespread, however, in part because the high capital cost both of production and distribution networks makes them unattractive to investors.

Governments are concerned with making electricity available as widely as possible to rural customers as well as to urban concentrations. But the cost of providing service to isolated rural communities is often so high that private firms are discouraged from undertaking it. One way to compensate for this is to have government fund expansion of the grid to meet rural consumer demand while privatizing the generating and maintenance functions of the system as a whole. In some cases, it may be more feasible to encourage creation of privately owned local networks serving limited areas rather than expanding the national grid over long distances to small numbers of users. Imposing a higher user fee on rural areas or requiring new customers to pay connection costs is politically difficult.

C. Telecommunications Systems

Telecommunications is becoming one of the more active candidates in the field of privatization of services. In the LDCs, with expansion of the private sector, a growing need arises for rapid and reliable communications not only overseas but in-country as well. Many LDCs suffer from technologically primitive internal communications systems inherited from the former colonial administrations. These have only sporadically and locally been updated, often with inadequate or incompatible equipment. In many cases it is not only virtually impossible to communicate by telephone with areas outside the main centers but even communication within the major cities is slow and frustrating. Larger foreign companies have installed their own radio communications but local businesses have increasingly chafed under the inadequate telephone systems. In such cases privatization is often being driven more by the forces of technological change than by government intention.

As a result of local pressures, governments have found themselves faced with the dilemma of replacing antiquated systems with modern equipment at a capital cost beyond their reach or finding the business community deserting the national telephone network to establish its own network by private radio or satellite systems. The alternative is to allow the private sector to take over the functions now poorly carried out by a government department. The successful privatization of British Telecommunications and the Japanese system over the past three years have provided examples for at least one country, Malaysia, to begin the process of allowing a private company to assume the responsibility for the internal telephone system. Other countries are following suit. In Hong Kong, the Eastern Caribbean, and Sri Lanka a private British company, Cable and Wireless, has either assumed control or is in process of buying a majority share in internal and external communications. Several other countries, including Sierra Leone in West Africa, are considering similar moves.

Surrendering control of the telephone network is not easy for any government, however. Security considerations play an important role; the armed forces are very reluctant to see communications in private hands and are likely to resist any moves in this direction.

For most LDCs, the phones and the postal service have traditionally been combined in a single Ministry of Posts and Telecommunications which is loath to give up its prerogatives and whose employees foresee a loss of jobs. The problem is how to convert a Ministry into a private company. Technically, the solution is not difficult but its implementation carries with it a number of pitfalls. In the first instance, it may require not only an act of the legislature, but even a constitutional change if the powers of the Ministries are enshrined in the basic document. Decisions must be made regarding employee pension rights, separation allowances and other benefits, since benefit rights provided under the civil service may not apply to state-owned enterprises or to private companies. Once these obstacles have been circumvented, the Ministry can be turned into a publicly owned company as a normal state-owned enterprise.

Once this step has been accomplished, it is envisaged that a period of three to five years will be necessary before the final stage of privatization can be undertaken. During this time the SOE will have an opportunity to establish a track record of performance to give potential investors an indication of the company's operating position and net worth. The SOE can then be privatized either by sale to a single bidder (which is unlikely, given the size of the enterprise) or placed on the market by stock floatation. The shares are expected to find a ready market given the pent-up demand for services and therefore a rapid expansion of business opportunities. Since it is often regarded as not being in the national interest to allow majority control of such a vital service to be held by non-nationals, the government may decide to limit the amount of equity foreign investors will be allowed to hold. It is also likely that the government will retain some degree of minority holding in order to avoid the political criticism that it has allowed such a vital service to disappear entirely into private hands.

An alternative to outright sale of the entire service is to spin off individual functions. In the Malaysian case, building and maintenance of lines and substations had been privately contracted even under the Ministry. To ensure expansion of the network into rural areas, the government may, as in the case of electricity, have to pay the costs as a form of subsidy. This was planned in the case of the sale of telecommunications in Grenada.

Since privatization of services in these fields is both complex and lengthy, it is likely that any government embarking on it will need substantial technical advice. In Malaysia, the same brokerage firm (Kleinwort-Benson) that handled the sale of British Telecommunications was hired as advisor.

IV. Privatizing the Agricultural Sector

A. Returning Agriculture to the Private Sector

The agricultural sector has been the subject of state intervention in most LDCs at least since the colonial period. Marketing services have frequently been government monopolies as have input services, pricing, and overall management of production. Almost universally, state intervention has proved to be a disaster, from the point of view of food supply as well as from the viewpoint of the peasant farmer.

Parastatals in the form of marketing boards have been the major instrument of state control and direction of the agricultural sector. The use of marketing boards derives in part from the experience of the colonial period where they were instituted to maintain export supplies. After independence the system was continued because the new leadership was faced with the political problem of providing supplies of food grains at cheap prices to satisfy the demands of the politically vocal urban population. The peasant producers were expendable because they lacked a unified voice. Agriculture was the predominant economic activity in most LDCs and it therefore was expected to provide the most accessible source of capital for the new industrial base of development dreamed of by the nationalist leaders. Without this, there would be no domestic source of urban employment nor could an import substitution program be created that would free the newly independent country of the economic shackles of colonialism. The marketing boards were designed to maintain the sources of foreign exchange through controlled agricultural exports and to furnish the means of promoting the modernization of the economy. The farmers were consistently the losers from the outset in this new vision, although ultimately the state was an even greater loser since the system provided little or no incentive to the producer to increase the surplus for the export market.

The governments justified the marketing boards as instruments to protect the peasant farmer from exploitation by private traders. But the monopoly exercised by the officially designated agencies more often than not proved more exploitive than market forces while at the same time becoming a wasteful and inefficient use of scarce public resources. As Berg has pointed out, "agricultural marketing, in the conditions normally found in LDCs, is inherently unsuitable for large scale bureaucratic organizations." By its very nature, the buying and selling of agricultural products in a small-holder situation requires decentralized activity, over large areas involving close interpersonal relations. The local trader knew his customers, could be flexible in his transactions, and could respond quickly to changing market conditions. He may have profited at the expense of the farmer but often less so than did the government agent.

Apart from the inevitable inefficiencies of a bureaucracy that sought to centralize control of a process that did not lend itself to close supervision, the marketing boards required costly storage facilities and a large and highly trained staff whose skills and energies might have been better employed in more technical development projects. The boards provided sinecures for the politically unemployed, offered large-scale opportunities for corruption and failed to provide the input services that might have helped to create greater production. The price distortions resulting from conflicting government objectives only added to the deteriorating agricultural situation for which the boards were in large part responsible.

Both bilateral and international donors frequently served to exacerbate the problem. Food grains were provided on concessional terms to meet the governments' requirement to provide adequate food supplies at reasonable cost to the urban concentrations. As a result, the need for fundamental changes in agricultural policy was masked and governments could afford to ignore the increasingly critical shortages in domestic production. Technical assistance to agriculture was provided through government agencies on a project basis which, though beneficial to the immediate recipients, failed to take into account the political environment in which agricultural policy was developed.

In many LDCs, ideological considerations played an important role in the government's view of the role of agriculture after independence. Those leaders who espoused socialism as a model for development placed emphasis on collectivization at the expense of the traditional individual farmer, particularly in Africa. The result was the creation of state farms or collective farming experiments of the type espoused by Nyerere in Tanzania, Kaunda in Zambia, or Toure in Guinea. Invariably, where the African farmer no longer benefitted from the results of increased labor, production declined, marketing facilities failed, and care of the land was neglected.

As a result of two decades of policy mistakes, ineffective administration by the marketing boards as well as factors beyond the control of governments (such as drought and changes in world commodity prices) agricultural production in many LDCs, especially in Africa, declined to a point where countries which had formerly been food self-sufficient became heavy net importers. Reluctant governments were finally forced by circumstances and by donor pressure to consider radical changes in their approaches to agricultural policy. One of the foremost of these was privatization.

Unlike privatization of producing industries, however, in agriculture the problems have been much more complex and in some ways, deep-seated. It was not simply a question of eliminating the marketing boards and turning over their functions to a waiting private sector. In a few countries, such as Turkey, India, and Mexico, which could afford subsidization, the government was able to use the boards to provide new technologies which increased production. The board managers were not always at fault for the failure to produce satisfactory results. In many cases, fundamental government attitudes toward agriculture had to be changed. So long as policy was designed to favor vested interests in official circles or certain limited groups in the population, such as the urban minority, no liberalization allowing for entry by the private sector would succeed in increasing production. Macro-economic factors such as foreign exchange restrictions, over-valued currencies and import restrictions were as much a hindrance to agricultural progress as were the marketing boards. Government taxation of agriculture to provide resources for industrialization had reached a saturation point. The farmer was forced to pay beyond his capacity and in time-honored rural reaction, he either limited production to his own needs or clandestinely smuggled any surplus out of reach of the marketing agency.

As a result, however, of years of restriction of private sector activity, in many countries there is real question as to whether and/or when the private sector in agriculture is capable of taking over the tasks that have been performed, albeit ineffectively, by the boards. The network of local traders that may have existed at independence has atrophied and capital resources at the local level have seriously diminished. Increased centralization of political and financial power in the hands of the national government has weakened local authorities to the point where they have no longer been able to regulate local trading practices as they have in past.

Because governments quite correctly fear the political volatility of the cities, they continue to find it easier to control prices for food grains, subsidize the operating deficits of the marketing boards and acquire needed additional supplies from external sources while selling them to the consumer at a profit above the concessional buying price. Returning agricultural production and marketing to private hands is dependent on the willingness of government to engage in serious policy dialogue on changes which may appear to be only peripherally connected to agriculture. Unless these are made, however, agricultural trading will be less attractive to the private sector than other activities.

Any changes that are made in macro-economic policy will have little effect if they are not accompanied by price incentives to the producer. Peasant farmers are not unaware of world prices and without equitable return on their export crops or fair prices for food grains, they will simply cease production or switch to a barter economy. In Tanzania, for example, a combination of failure by government marketing agencies to provide adequate return or provide means by which commercial crops could be brought to market caused many peasants to revert to subsistence farming. Since 1986, the government has instituted policy changes in food crop marketing aimed at legitimizing the role of private traders. Transportation has been a constraint to agricultural inputs and marketing of domestic and export crops and the government has sought to increase private sector participation in the movement of food crops.

B. Experiments in Agricultural Privatization

Despite the difficulty in replacing the functions of the marketing boards, a number of experiments have been tried, with varying success, in Asia, Africa and Latin America to privatize aspects of the agricultural sector. These include:

--In Bangladesh, privatization of fertilizer distribution has been proceeding slowly over the past three years. This particular commodity lends itself very well to private distribution. The government usually acts as the bulk buyer while distribution can be turned over to private traders who sell directly to the consumer, at officially fixed prices, allowing for reasonable profit.

--In Pakistan, private tube wells in the Indus River Plain now outnumber similar wells constructed by government and it is anticipated that private wells built by individuals or groups of farmers will replace government-owned wells.

--In the Philippines, the Mission is assisting the government to privatize agro-business and agri-marketing firms such as the National Food Authority and commodity firms such as the Philippine Cotton, Dairy and Tobacco Corporations.

--In Sri Lanka and Thailand, controls over rice have been liberalized and the seed industry is being recommended for transfer to the private sector.

--In Mali, a new role for the private sector has been initiated by the government with the coordinated assistance of external donors. In 1980 it was agreed that the marketing of cereal grains would be put in private hands and the operations of the agricultural marketing board, OPAM, would undergo gradual reform over a period of six years. During this time the cereals market would be restructured and the board would function only as a coordinator of sales rather than as a direct buyer from the producer, except that in a food crisis, the board reserved the power to become the buyer and seller of last resort. Subsidies were not entirely eliminated. The donors' collectively pledged to supply food grains at concessional prices and the local currency thus generated would be used for subsidy over the six year period of the agreement. It would appear that the private sector is gaining strength through the trial period and the board has confined itself largely to a coordinating role.

--In Guinea, the military government that succeeded the regime of Sekou Toure made a number of moves to liberalize the agricultural trade which was formerly entirely in government hands. State farms have been eliminated with the land being returned to private farmers. Four SOEs in the field of agricultural inputs and cash crop exports are in process of being closed. However, opportunities for private sector investment in agriculture outside of trade remain limited.

--In Nigeria, the government decided in April 1986 to eliminate by the end of 1986 all six commodity marketing boards and turn their functions over to the private sector. Government intervention in agriculture goes back to 1942, but the present Boards (covering cocoa, groundnuts, cotton, rubber, grain, and palm products) date from 1977. They have had almost complete powers over trading in these commodities and operated with a staff of over 30,000. In addition, the government has announced that eleven government-owned companies concerned directly with agriculture would be privatized because it was considered that "on balance they were costly and inefficient and acted more as a deterrent to agricultural development than as a help."

Given the long period in which government has controlled the agricultural sector, it is questionable whether the private sector has the capacity to take over the Boards' functions immediately. Since no transitional arrangements were provided in the decree abolishing the boards, foreign buyers have already questioned whether the private sector will be able to exert sufficient quality control over export commodities. To ensure the quality of export shipments, the government has recently decided to make export licenses issued to private traders conditional on production of a federal produce inspection certificate. Without close supervision, the licensing system could lead to corrupt practices.

--In Senegal, with A.I.D. Mission assistance, the government has laid plans for reduction of non-productive agencies in agriculture. Fertilizer distribution has been privatized. State control of cereals marketing has been abolished; regional agricultural parastatals are now involved chiefly with the provision of extension services.

--In Zimbabwe, the government has proved conclusively that price incentives can increase agricultural production. By raising farm-gate prices for cereals by 50%, production by African as well as European farmers doubled in one year to the point where existing storage facilities became insufficient.

--In Malawi, the government is in process of divesting two-thirds of its investment holdings in the Agricultural Development and Marketing Corporation (ADMARC) and the remaining assets will be held by a separate holding company which will be operated on a commercial basis. The A.I.D. Mission is providing technical assistance for this and other divestitures.

--In Swaziland, a new firm, Commercial Agricultural Production and Marketing, now being organized, will provide direct and indirect assistance to private sector firms expanding input services to the agricultural sector.

--In Chile, an attempt has been made to privatize agricultural extension services to small holders. Specialists chosen from a government approved list were provided to give advice to farmers. They were paid partly by the farmer and partly by government subsidy, with the work being supervised by government.

--In the Eastern Caribbean states, American companies are interested in taking over citrus juice operations now owned by government and in Belize a banana marketing operation has been privatized with the help of the A.I.D. Mission.

C. Techniques for Encouraging Agricultural Privatization

Agricultural policy has been the subject of intense review by both governments and lending agencies, largely in the context of broader policy dialogue dealing with reduction of the role of the public sector. As the results of these reviews become available, governments are becoming more inclined to adopt reform measures, as the Nigerian and Malian examples prove.

As part of the encouragement to reform agricultural policy, some points that might be kept in mind are:

--A.I.D. Missions can without difficulty demonstrate to LDC governments that marketing boards and other agencies seeking to control agricultural activities have had detrimental effects by reducing producer output and that they have often been the cause of price distortions and misallocation of resources, not only of funds but of trained personnel as well.

--Mission officers should be aware that agricultural privatization is an exceedingly sensitive area of political concern in most LDCs. Vested interests in the bureaucracy and in the political arena are likely to be endangered by any moves to reduce the role of entrenched marketing boards and these can be expected to encounter stubborn resistance, particularly from those whose jobs are threatened. But when it comes to balancing this with the critical question of producing enough food for the urban areas by increasing incentives to the farmers, governments are likely to turn a more receptive ear to reform initiatives. Mission officers will need to concentrate on a full understanding of the political ramifications entailed by drastic reduction of the role of marketing boards or their total elimination.

--Missions may wish to consider putting together an inventory of the capacities of the private sector to replace marketing board functions prior to advancing a privatization plan. If the trading community is not large enough to service the producers of if the transport network cannot be relied upon to get agricultural production to market, privatizing may not be effective. It will be necessary to coordinate the prospective privatization plans for agriculture with other mission projects in this sector, such as rural transportation or provision of rural credit facilities.

--The overall economic environment in which agriculture operates has to be taken into account. Persuading the government to increase producer prices will not produce the desired result if inflation or consumer goods shortages make it impossible for the farmer to buy what he wants with increased income from the incentive of higher prices for his production. Policy dialogue on macro-economic changes should be a part of agricultural privatization.

--Privatization in agriculture can best be approached through the coordinated efforts of all potential donors. It may require specialized forms of technical assistance, particularly if joint agro-business ventures with foreign partners are contemplated.

Privatization of the agricultural sector is just as important and just as possible as it is in the industrial sector. It requires different techniques and a sensitive approach; it may be slower and require even more patience than selling industrial units. Partial privatization may have to be accepted as an initial step. A government agency may have to remain, at least temporarily, the importer of a major agricultural input such as fertilizer while domestic distribution is given over to the private sector. But it may have ultimately more profound effects on the society as a whole than divestment of state-owned enterprises, particularly in those LDCs where agriculture remains the major form of economic activity.

D. Case History: An Agricultural Privatization in Mali -- Operation Haute Vallee

Background. In the 1960s and 1970s, the government created rural development organizations in the southern area of the country, the Upper Valley (Haute Vallee) of the Niger river. The area has substantial cultivable land, sufficient rainfall and the possibility of irrigation.

One of the development organizations, Operation Haute Vallee (OHV) has been the recipient of A.I.D. assistance for almost a decade for a variety of rural development activities. In a further phase of this assistance, the Mission will seek to expand production by increasing access to farmer access to technology, financial resources for investment and marketing outlets. Under this new phase both public and private agencies will be supported but with special emphasis on increasing private sector participation in agricultural growth. It is contemplated that farmer cooperatives based at the village level, private businesses, and rural financial institutions will take part in the development of rural enterprises and institutions. Many of the currently government-operated development functions will be transferred to cooperatives and private firms. It is expected that, as a result of this, the OHV staff will be substantially reduced.

While the Rural Development Organizations (RDOs) created in the 1960s were in theory to be self-supporting, none has been able to function without heavy government subsidy although they have been able to increase production and infrastructure. Wider use of private sector business is designed to reduce this subsidy bill.

Increasing the Role of the Malian Private Sector. Because of its privileged position as a government agency, OHV now operates as the sole deliverer of agricultural inputs and equipment. It has the legal monopoly for marketing cotton and tobacco, two of the major crops. The demand for inputs greatly exceeds OHV's capacity to deliver and it is evident that there is ample room for expansion into private sector contacts, particularly in fertilizers, pesticides, and animal traction equipment. However, private operators have hesitated to invest in marketing operations so long as OHV retains its monopoly.

There is evidence that the private sector is willing to engage in input activity. Village cooperatives have been offered credit for animal traction equipment in exchange for a guaranteed delivery of cereals at a pre-negotiated price as repayment for the credit. One village is considering producing on contract green beans for the off-season European market. Agricultural equipment is now produced by an unreliable state-owned firm. Private importers of this equipment are required to have attestation by the state owned firm that it cannot produce the equipment before it may be imported; this clearly provides a serious block to private initiative.

The Mission's plan is to seek to assist the gradual expansion of private sector marketing activities while at the same time helping OHV to manage a phased withdrawal from these activities. OHV will contract to the private sector the purchase of inputs to be delivered to village cooperatives; at a later stage the cooperatives themselves will become responsible for purchasing inputs and delivering marketing outputs. They will thus become responsible for procuring the needed inputs, rather than being dependent on what OHV can deliver to them.

The process of introducing wider private sector participation in input and output functions will take time. It will be necessary to ensure that private traders' costs will not be unacceptably high to the farmer and that private business can supply what is needed. Special arrangements with a private bank may have to be made to provide the necessary lines of credit to private business men for the import of agricultural machinery for sale to the village cooperatives.

A concomitant feature of the program will be the reduction of OHV functions and activities to concentrate on agricultural extension services and development planning while phasing out its supply and credit activities. Village cooperative associations may be able to take over the marketing functions through contracts with the private sector. The result will be a diminished role of government in the lives of the OHV farmers and greater reliance on locally controlled organizations of farmers to meet their needs.

V. CONCLUSION

The experience with privatization in the developing world is too recent to permit more than generalized guidelines for the creation of privatization plans. Each country is an individual case which may present particular opportunities or involve special problems of internal political and economic tensions that must be resolved before a privatization program can go forward. Nevertheless, A.I.D.'s experience thus far has provided some lessons in assisting privatization planning where the government is committed to reducing the role of the state in economic growth. Among these are:

A. Privatization is essentially a political decision

The decision to privatize is in the first instance essentially political in nature, although it may be prompted by financial pressures. To make outside assistance of real value, it is necessary that those designing assistance have a prior understanding of the local political situation, the power bases of political support in the society, the strength and influence of special interest groups, and a thorough knowledge of the political and internal decision making processes of the government. Without this, there is no way to judge the degree of political risk the government is being asked to face if it embarks on large-scale privatization.

Communication of the government's intentions, both to the general public and to special interest groups at the appropriate time and as fully as possible will serve to reduce the risk factor. A successful privatization that distributes stock broadly to new investors who clearly profit from their purchase serves better than any number of speeches to convince the public that privatization is in the national interest.

B. Various options for privatizing are desirable

Privatization proposals are much more likely to receive serious consideration if they embody a variety of options from which the government may choose, rather than recommending a single course of action. Governments understandably like to feel that they have the freedom of choice, provided the advantages and disadvantages of the alternatives offered are clearly set forth.

C. The Government must have a clear idea of its objectives

Any government contemplating privatization should be encouraged to develop a clear idea of why the step is being undertaken and its objectives for the program. If, for example, there is an expectation of relief from long-term financial pressures through the sale of public assets, there is bound to be disappointment, although there may be more immediate relief from the subsidy burden.

If the objective is redistributing wealth in the society, then the privatization plan should include a broad based public share offering, and/or employee stock ownership plans (otherwise, potential buyers may be individuals who have already accumulated substantial capital.) It is important that the reasons for privatizing be made clear beforehand to the political opposition and to interest groups which may be opposed to it so that a strategy can be planned to meet their arguments. Prior determination of what interests are likely to be harmed and the degree of their political influence may be critical to successful privatization.

D. The employment aspects of privatizing are highly sensitive

Governments tend to be most sensitive to the employment aspects of divestment. If sale to the private sector will mean serious loss of jobs as a result of greater efficiency of operation, it is advisable to include in the early stages of the privatization strategy mechanisms such as early retirement provisions or retraining programs to absorb the impact of substantial unemployment (as the world bank has done in Mali, for example). There appears to be some recent evidence that the employment aspects of privatization (employee displacement, lower salaries and fringe benefits for workers) are overstated as impediments to privatization.

E. Valuation of assets is a difficult but crucial question

Valuation of the assets to be divested and agreement on sale price are the most difficult, and at the same time, a crucial aspect of any privatization. To attract buyers, it is essential that a true financial and operating picture of a firm be given; otherwise there will be a loss of buyer confidence in the sale procedure. Perhaps the most difficult task for outside advisers is to persuade the government to accept the true value of the assets it is seeking to divest.

F. Privatization should be viewed in the light of its beneficial effects on the economy as a whole

It may be necessary to demonstrate to the government that privatization should be seen in the light of its beneficial effects on the economy as a whole, not just in the context of the particular firms being sold or services privatized. It will increase productivity and, ultimately, employment, and provide for better use of available resources. It can also assist in the development of the stock market, if one exists, and can have highly beneficial effects on the development of a capital market. If the financial institutions of the country are sufficiently developed, new forms of "constructive financing" can materially aid in the privatizing process.

G. Privatization is not a quick and easy process

One of the most important lessons governments must learn is that privatization may be a long, slow, difficult, sometimes tedious and often frustrating process. Preparing for a privatization program may take many months of detailed work. Finding buyers and concluding the financial aspects of the sale may take equally long. The task of the outside adviser may become one of encouraging government officials not to lose heart or become impatient before a successful outcome can be brought about. Once having committed itself to a privatization plan, the government should be strongly advised not to abandon it in mid-stream; to do so may defeat any prospect of starting again at a later point.

H. Privatizing does not mean loss of government control

Governments often fear that, by privatizing, they will lose control of the direction of industrial and financial development. But the state will continue to perform certain functions, no matter how broad the scope left to the private sector and, in the ultimate, the power to regulate remains. As Paul Starr has commented in a recent essay:

> "The illusory appeal of privatization is to provide a single solution for many complex problems. But if the idea of privatization has any merit, it is to force us to rediscover the rationale of the public services we need and to remind us . . . that the public-private mix ought not to be considered settled for all time."*

I. Privatization is not a panacea for all financial and development problems

It is essential that the government understand that privatization is not a panacea for all its financial and development problems. Selectively and carefully applied, in the

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* "The limits of privatization" in Steven Hanke (ed.), The Prospects for Privatization, New York, Academy of Political Science, 1987, p. 136.

proper place, and at a suitable time, it is an extremely useful instrument to reduce subsidies, shrink the role of the state in economic activity, and develop a healthier private sector. But unless the government is prepared to accompany it with funadamental macro-economic policy reforms, its effect can be minimal or even negative. If the initiative of the private sector is hampered by over-regulation or other disincentives, no amount of privatizing will increase the pace of economic development.

ANNEXES

A. .A.I.D. Policy Statements on Privatization

1. Excerpt from Private Enterprise Development Policy Paper, March, 1985

2. Excerpt from Trade Development Policy Paper, July, 1986

3. Policy Determination No. 14, June, 1986, Implementing A.I.D. Privatization Objectives

B. Bibliography

1. PPC Supported Studies on Privatization

2. Selected General Works on Privatization

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EXCERPT FROM THE
PRIVATE ENTERPRISE DEVELOPMENT POLICY PAPER
(MARCH 1985)

V.D. 6. Assistance to the LDC's Private Sector

A.I.D. funds provided to financial institutions should avoid introducing government ministries or parastatals into the on-lending approval process where such involvement does not now exist. Furthermore, such projects should seek to extract government ministries and parastatals from the process if they are now so involved.

V.F. Parastatals and Government Authorized Monopolies

1. A.I.D. assistance to or through a parastatal should be given in the context of exposing the parastatal to market forces and scheduled divestiture of the government interest. This objective is more likely to be achieved through an evolutionary process rather than as a result of an A.I.D. insistence on the immediate and complete divestiture by sale to the private sector. A.I.D. resources should start a policy dialogue which initiates the process even if there is no initial commitment from the LDC on eventual divestiture. AID resources should assist the process as LDCs indicate interest in reducing the financial and management burden accompanying state ownership of companies. The experience of a number of LDCs which have divested parastatals suggests that measures to improve the management and operational efficiency of a parastatal has helped the divestiture process. A.I.D. projects designed to improve parastatal performance must have identifiable benchmarks upon which substantive progress towards divestiture can be measured. However, the burden of proof rests squarely with Missions proposing such activities to demonstrate that the proposal can achieve meaningful objectives, and that the selected benchmarks represent substantive evolutionary progress in moving the parastatal towards market-based operations and divestiture.

2. A.I.D. encourages the introduction of employee stock ownership plans (ESOPs) as a method of transferring a parastatal to private ownership.

3. In assisting an LDC through the divestiture process, A.I.D. should explicitly consider the consequences to the parastatal's employees of transferring all or part of the parastatal's activities to the private sector. In this regard A.I.D. resources could be used to assist those employees who may be adversely effected by the firm's transition from state to private ownership by job retraining or job placement assistance.

EXCERPT FROM THE
TRADE DEVELOPMENT POLICY PAPER
(JULY 1986)

VI.D. Trade Monopolies and Parastatals

LDC governments have become heavily involved in their country's international trade by granting special rights to import or export essential or economically important commodities (such as fuel, agricultural inputs, and food) to one or a few firms. In many cases, the firm receiving the sole right to import or export is a parastatal or state-owned enterprise (SOE).

Generally, the granting of special trade privileges results in a separation of the domestic resource allocation decisions from world market signals so that these SOEs concentrate their efforts on production in a secure and protected market, and on the manufacture of products that are below world quality standards and above world price levels.

Over time, the SOE's production or consumption generally requires substantial subsidization and may discourage private enterprise involvement in the import or export of particular commodities. In addition, the country itself becomes locked in a particular pattern of trade and technological dependency that hastens its loss of comparative advantage in key exports. State trading companies also are more likely to seek countertrading arrangements. To the extent that countertrade transactions are less efficient and introduce distortions in trading patterns, the state trading companies themselves can intensify their country's economic problems, especially if the controlled commodities constitute a large portion of a country's exports.

These particular trade restrictions and their ensuing pricing distortions on fundamental economic activity have profound consequences for the entire LDC economy in terms of fostering inequity and suppressing economic growth. A.I.D. strongly encourages and supports efforts to introduce or expand private sector competition in the export or import of essential or economically important commodities. It is recognized, of course, that many LDCs may raise political and social objections to this approach; the dialogue in this area is of great importance.

A.I.D. resources may be programmed to assist LDCs to terminate trade monopolies and oligopolies, dismantle marketing boards, and divest parastatals. When A.I.D. resources are used to start a policy dialogue to initiate the dismantling of a marketing board or the divestiture of an SOE when there is no initial commitment from the LDC, Missions must show that any improvement in the performance of the marketing board or SOE resulting from our assistance will contribute to increased dependence on market forces and the eventual dismantling or divestiture of the state entity. Clear benchmarks of substantial progress toward market-based operations and divestiture must be established and adhered to in the assistance program. If the SOE is providing unfair trade competition to private enterprises, restricting private enterprise development, or is enjoying special trade privileges or preferential treatment, these activities should be phased out before funds are provided to the parastatal in accordance with A.I.D. policy.

PD-14
June 16, 1986

A.I.D.

POLICY DETERMINATION

IMPLEMENTING A.I.D. PRIVATIZATION OBJECTIVES

1. Introduction. The Deputy Administrator, speaking for the Administrator, announced the following Agency objective for privatization at the International Conference on Privatization (February 17 - 19, 1986). He said:

> "... To take advantage of the momentum generated by this conference, the Agency for International Development is setting a goal for itself. We have substantial staff and resources in about 40 countries. We will ask each of those missions to engage in discussions with their countries about privatization. Our goal will be for A.I.D. to be involved in an average of at least two privatization activities in each of these missions by the end of fiscal year 1987. Now I say average because we recognize that not all countries are going to be interested, but, clearly a number of countries are very excited..."

The Agency's privatization objective is based upon the pragmatic realization that the entrepreneur and the private sector are the most appropriate mechanisms for economic growth. A healthy independent private sector and secure individual economic freedoms also serve as a strong base from which to ensure that democratic institutions are brought into existence and remain free from centralized political control. Privatization of functions, activities, or organizations currently in the public sector should contribute to the achievement of these goals..

Implementation of the privatization objective must begin with the determination of which public activities are appropriate for the private sector. The appropriateness of public versus private sector should be determined on the basis of which sector is more likely to produce a higher level of economic efficiency, innovation, and incentive, and, therefore, the greater economic benefit. Experience has demonstrated that a private enterprise (rather than a wholly or partially state-owned enterprise or parastatal), operating in a truly open and competitive environment, is usually the more likely to meet goals of economic efficiency and growth.

The purpose of this Policy Determination is to provide (1) additional policy guidance on implementing A.I.D. privatization objectives and (2) information on sources of technical assistance for Missions undertaking privatization activities. This PD and the revised Private Enterprise Development Policy Paper (March 1985), which discusses the privatization technique of divestiture, should be used as companion documents in developing privatization plans and activities.

2. Definition. For the purposes of Agency policy, privatization is defined as the transfer of a function, activity, or organization from the public to the private sector. (Related activities discussed in Section 4B of this paper, but not falling within this definition, may be justified with reference to the revised Private Enterprise Development Policy Paper.) The major techniques for privatization, for the purpose of complying with this PD, are discussed in section 4A below. The term "privatization" is not synonymous with private enterprise. Privatization is an important and unique aspect of our private sector program in that it brings together policy reform, institutional development, and utilization of the private sector. Our private enterprise goals and program are described in the Private Enterprise Development Policy Paper.

3. Policy Guidance.

A. Existing Agency policy. Previous Agency policy guidance on privatization is contained in sections V.F. ("Parastatals and Government Authorized Monopolies") and V.D. ("Assistance to the LDC's Private Sector") of the revised Policy Paper on Private Enterprise Development (March 1985). The guidance in section V.F. of that policy paper is limited to the privatization technique of divestiture. Briefly stated, that guidance stipulates that "A.I.D. assistance to or through a parastatal should be given in the context of exposing the parastatal to market forces and scheduled divestiture of the government interest ... A.I.D. projects designed to improve parastatal performance must have identifiable benchmarks upon which substantive progress towards divestiture can be measured." The latter sentence is the ultimate condition upon which assistance is to be granted. In other words, the selected benchmarks must represent substantive evolutionary progress in moving the parastatal towards market-based operations and divestiture in order to qualify for A.I.D. assistance.

Missions have, in the past, utilized technical or capital assistance to make state-owned enterprises (SOEs) more efficient, more responsive to market forces, or more attractive for buy-outs. It should be recognized, however, that enormous amounts of donor funds committed to help SOEs meet the goal of greater efficiency have been largely unsuccessful. There is no reason to believe that new A.I.D. resources will be better spent for that first goal unless the process is linked clearly to both making the SOE more responsive to market forces and actual divestiture. Therefore, the use of A.I.D. funds in a manner that only improves the capability of the parastatal to respond to market forces in the absence of true policy reforms (such as improving an SOE's accounting procedures as opposed to revising the tax code for all enterprises in a particular industry) does not comply with this policy.

The guidance in section V.D. deals with parastatal financial institutions and applies the privatization technique of partial divestiture. The guidance states that "A.I.D. funds provided to financial institutions should avoid introducing government ministries or parastatals into the on-lending approval process where such involvement does not now exist. Furthermore, such projects should seek to extract government ministries and parastatals from the process if they are now so involved." Based upon this guidance, the responsibilities of the parastatal financial institution would be separated into its purely public functions, which it would retain, and functions that can be carried out by the private sector, which are divested to the private sector.

B. <u>Coverage and scope of new policy</u>. This PD and its targets apply to the A.I.D. Missions listed below. Each of these Missions is directed to engage in discussions with its host country about privatization, with the objective of having at least two privatization activities in each Mission by the end of fiscal year 1987, and two new privatization activities every year thereafter. Although adherence to the guidance is not mandatory for non-Mission field operations (A.I.D. representatives, A.I.D. affairs offices, sections of embassies, and regional offices), it is hoped that those overseas operations will attempt to implement this guidance.

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Missions Subject to Guidance

AFRICA	ANE	LAC
Botswana*	Bangladesh	Bolivia
Burkina Faso*	Egypt	Costa Rica
Cameroon	India	Dominican Republic
Ghana	Indonesia	Ecuador
Kenya	Jordan	El Salvador
Lesotho*	Morocco	Guatemala
Liberia*	Nepal	Haiti
Malawi	Pakistan	Honduras
Mali	The Philippines	Jamaica
Mauritania*	Sri Lanka	Panama
Niger	Thailand	Peru
Senegal	Tunisia	RDO/C
Somalia	Yemen	
Sudan		
Swaziland*		
Zaire		
Zambia		
Zimbabwe		

* These Missions are exempted from complying with the PD for FY 87. The application of the guidance to these Missions in FY 88 will be reviewed at a later date.

C. Short-term and Long-term reporting requirements. It is expected that privatization will become an integral part of each Mission's programming. Therefore, both short-term and long-term reporting requirements are described below.

(1) Overview. Missions may submit an overview of their plans for meeting the Agency's privatization objective in the 1987/1988 budget submissions due in June 1986. The overview should contain (a) your current privatization activities; and (b) your strategy and schedule to achieve the privatization objectives. Annex L of the ABS has been reserved for the overview. (Submission of an overview is optional.)

(2) Short-term. Missions are requested to submit detailed privatization plans in an amended Annex L by July 1. These plans should identify (a) short- and long-term targets of opportunity for privatization; (b) the Mission's proposed strategy for addressing privatization; and (c) a projected timeframe for achieving the goals of the privatization plan.

Missions may also wish to take this opportunity to develop their medium- or long-range privatization strategies. An essential first step towards framing a privatization program and determining priority actions would be to assess and lay out an overview of the relative role and influence of private and public sector institutions and organizations in individual countries. Some of the considerations listed in section 9 of this guidance would be important elements in these plans.

(3) Long-term. Following submission of the initial privatization plan in the 1988 ABSs, Missions are required to integrate their privatization plans into the regular reporting system for ABSs, CDSSs, and Action Plans.

4. Techniques for privatization.

A. Primary techniques for privatization. The successful privatization process, which depends upon the country strategy for privatization and the reasons privatization is being undertaken, involves selection and implementation of an appropriate privatization technique. Privatization can take a range of forms, some of which involve change of ownership status and transfer of decision-making authority from the public to the private sector (complete and partial divestiture) while others entail only the transfer of decision-making authority (contracting out and partial privatization). The major techniques for privatization, for the purpose of complying with this PD, may be classified as:

(1) complete divestiture - in which an SOE is (a) sold, operationally intact, to a private sector entity (such as another firm, individual investors, the firm's own managers or workers, or the general public through a stock offering or auction); or (b) operationally terminated and liquidated, with its business operations halted and its assets sold off piecemeal. Complete divestiture is the preferred Agency approach to privatization of SOEs.

Liquidation should be considered as a positive form of privatization as it (a) relieves the recurrent cost burden of an unproductive asset on the host country budget; (b) ends the need for special subsidies or incentives for noncompetitive SOEs; and (c) contributes to a greater market allocation of resources.

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(2) partial divestiture - in which (a) the host government enters into a joint venture with private investors (with the government retaining only a minority equity position that allows actual control to pass to private hands and the enterprise to operate as a private entity); or (b) responsibilities of the SOE are separated into purely public functions, which are maintained by or absorbed into the Government (such as setting quality control standards for agricultural products), and functions that can be carried out by the private sector, which are turned over (or "spun off") to the private sector (such as the sale of agricultural inputs that currently may be under the control of a ministry or government-owned or -controlled marketing board).

(3) contracting out of service delivery - in which the responsibility to provide certain public services (and, in some cases, ownership of the assets) is retained by the host government, but the implementation of certain functions (typically operation and maintenance of facilities and equipment) is delivered by private entities through such mechanisms as service contracting, franchise agreements, or lease, or reliance upon such instruments as a voucher system or regulatory and tax incentives.

(4) partial privatization - in which the Mission encourages reduction of the public sector role through privatization of (a) different activities in the SOE such as management (by hiring a private company to conduct management - e.g., in the U.S., many public hospitals have contracted out management to a private company), production (by contracting output and services), and finances (by requiring users to pay the real (unsubsidized) costs associated with provision of the product or service that they receive); or (b) entire subsidiaries of vertically integrated firms (such as fertilizer importation and retail distribution). Partial privatization should be viewed as a short-term or interim approach, and should be utilized as part of a longer-term process leading to complete divestiture within the life of the same particular privatization project or activity.

A variety of factors in the host country influence the country's privatization strategy as well as the privatization techniques chosen. These factors include the: (1) purpose for undertaking privatization;

(2) business climate; (3) commercial viability of public enterprises; (4) availability of capital (locally or internationally); (5) availability of local managerial and technical talent; (6) side effects (such as displaced labor); and (7) sociopolitical environment of the country.

B. Other options. Missions are encouraged to be innovative and realistic in developing their privatization projects. In those instances where the host government has stated that it is unwilling to divest SOEs to the private sector or transfer functions to the private sector, there are still options available to Missions to comply with this PD. One option is to encourage direct competition to the SOE by private firms by deregulation of markets. Another is to seek to change the policy environment to allow for competition by persuading the host government to (1) eliminate all market entry and protectionist barriers, subsidies, and other measures that reduce competition; (2) reduce government monopolies; and (3) force its SOEs to operate more like private entities in a free and competitive market environment.

Where there is no permitted private sector alternative and the SOE or parastatal is not likely to perform competitively or to be privatized, the Mission should seek to remove itself from those sectors of the economy in which such functions are non-competitive and exclusively public. They should shift to other sectors of the economy where A.I.D. may more effectively operate.

5. Policy conditions important for privatization. Commitment to privatization, in any form, must be accompanied by the adoption of a policy environment that allows for competition and the operation of market forces in the sector in which the enterprise exists or an activity is performed. Economic activity must be open to competitive market forces (with no laws, regulations, or subsidies which would deter competition with what was the SOE). Governments must be made aware that if industries are protected from market forces, little will be gained from privatization.

Policy reform is essential for the success of all techniques of privatization. The policy conditions needed for privatization to be successful include (but are not limited to) market-based prices (and the concomitant removal of price controls); low, common tariff levels; prompt and fair enforcement of contracts; equal application of controls (in those cases where elimination of these

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factors is not feasible); equal access by all to credit and to foreign exchange (where exchange market manipulation is practiced); the elimination of protectionism; market-based interest rates; reform of employment or labor codes; and elimination of any other policies that would inhibit the emergence of lower-cost and, therefore, more efficient competitors. Reform of the legal framework, investment code, licensing procedure, and tax code are also critical to the success of privatization.

For example, for Employee Stock Ownership Plans (ESOPs) to be a useful divestiture tool, it is generally necessary to change a country's tax code. Changes in the legislative or administrative laws of a country may be needed to provide incentives for the firm's current owners to distribute stock shares to their workers and for the employees to purchase the stock. (ESOPs are encouraged as a method of transferring parastatals to private ownership in section V.F. of A.I.D.'s revised Private Enterprise Development Policy Paper.)

6. <u>Divestiture and ownership issues</u>. Private ownership and control of a firm are critical issues in privatization of SOEs. In some instances, it is possible for control of an enterprise to be transferred to the private sector without the transfer of ownership. These instances, in which ownership and control are divisible, through establishment of management contracts, should be viewed as short-term or interim approaches, and should be utilized as part of a longer-term process leading to complete divestiture. In that interim, the management of the SOE should be expected to exercise the same type of authority as the management of a privately-held firm. However, it is preferable for ownership and control to be transferred together whenever possible.

The new owners of a former state entity, and the managers employed by them, must have the right or freedom to undertake actions they deem important to respond to competitive conditions in a timely manner, including restructuring of the firm, altering the firm's product and its price, changing lines of activity, using subcontractors, and expanding some activities while closing down others. Other areas in which the owners should not be restrained are employment and compensation decisions, sourcing, production engineering, cost structure, financing, investment, and innovation. Such flexibility comes with private sector ownership and control. It is rare under public ownership.

Preference for simultaneous transfer of both ownership and control is based on other considerations as well, including: (1) the tendency, where ownership remains with the public sector, or when clear title is ill-defined, for property assets to be undervalued by the private sector; (2) the possibility that the motivations of the firm's owners (the state) may still be more socially-oriented than profit-oriented and that this may lead to less efficient allocation of resources; and (3) the fact that public ownership might affect or distort the judgments made by the firm's managers on such critical issues as assessing political risk.

A critical issue associated with divestiture in LDCs is who is allowed to buy the SOEs. For a variety of political and social reasons many LDCs exclude certain groups from purchasing SOEs (especially foreign businesses, multinational corporations, and some local entrepreneurs of certain minority or ethnic groups). These people are often excluded by the political process, explicitly or implicitly, from the purchase of state enterprises. This issue is largely irrelevant in industrial countries, where the major issues are building a constituency for privatization and utilizing the appropriate sale mechanism.

There is some concern that these foreign-owned enterprises or local individuals or firms (who may already own or control a large share of the LDC's economy) will, in fact, purchase the parastatals and increase their control of the LDC economy. Their predominant role in the LDC economy and potential participation in the privatization process is, in the view of some LDCs, contrary to public policy.

Missions should encourage LDC governments to accept all potential buyers into the privatization process and not exclude any potential buyers on the basis of race, nationality, or economic position.

7. <u>Private delivery of services</u>. The conventional approach to providing many services is for government to collect the revenues needed to support the service and to deliver the service as well. The implicit premise in this view is that local public services are all "public goods" (i.e., goods or services that can only be produced and paid for collectively). Yet, most local public services have few attributes of true public goods. Most of them (including garbage collection, transit, and aspects of police and fire protection) have specific, identifiable users, who are the services' principal beneficiaries. To

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the extent that discrete beneficiaries or users can be identified, these services are viable targets for privatization. Moreover, even for services that are closer to being pure public goods, it is not at all clear that government must be the deliverer of the service.

Many national, state, and municipal governments are discovering that public services do not necessarily have to be delivered by government or paid for by taxes. Many studies have found that the services provided via privatization are generally produced more cost-effectively than services provided by tax-funded local monopolies. Privatization of public services offers governments a way to decrease the cost and improve the quality of services.

8. A.I.D. instruments and resources for implementing privatizations. Missions should encourage, where possible, the private sector (indigenous and other) to undertake the entire range of activities related to privatization without A.I.D. assistance. In those instances where that is not possible, A.I.D. has a variety of instruments available for privatization. These instruments are technical assistance that prepares an SOE for divestiture or assists a public organization in achieving private delivery of its services, and financial assistance in the form of loans and grants.

A. Technical assistance. Preparing a country privatization strategy (and, therefore, preparing SOEs for divestiture and public organizations to privatize their services) is a complex task. Therefore, the technical assistance needs associated with privatization may cover a wide range of topics. Some of these include: (1) sector- or industry-specific analyses, including financial, agricultural, industrial, transport, service industries, etc; (2) enterprise-specific analyses, including organization, production processes, finance, audit, marketing, personnel, restructuring, etc; (3) policy/legal/ regulatory analyses; (4) project design, implementation, and evaluation related to privatization; or (5) determining the appropriate brokerage mechanism for the sale of SOEs.

B. Financial assistance. A great deal of risk and expense are involved in financing privatizations, and Missions should proceed with care. A.I.D.'s financial assistance for privatization is limited to loan and grant activities (as described below). Consistent with A.I.D.'s revised Private Enterprise Development Policy Paper and the Foreign Assistance Act, A.I.D. will not take an equity position in a private enterprise.

Missions should encourage the private sector to undertake the entire privatization financing package without A.I.D. assistance. If a Mission decides to participate in providing loan funds for privatizations, it should: (1) maximize its catalytic role in stimulating private capital by minimizing the percentage of loan funds it contributes to financing the privatization; and (2) direct the bulk of its capital assistance towards assisting the private sector purchaser, as opposed to the government seller, in the transaction. A.I.D.'s involvement in this type of privatization financing should be designed to maximize private sector participation in this activity.

There may be instances when some grant assistance could be provided to a buyer to cushion a burdensome covenant imposed upon him by the seller for political purposes (such as a requirement to continue all current employees for a limited time). As execution of the covenant may be considered a grant from the buyer to the seller, an off-setting A.I.D. grant to the purchaser may be appropriate. In such instances, A.I.D. should first encourage the seller to accept a lower sale price as a condition for acceptance of the covenant and only as a last resort provide a one-time, directed grant to the purchaser. (For example, if the purchaser must provide job retraining to X number of employees as a condition of the sale, and the privatization depends upon the acceptance of that requirement, A.I.D. may consider providing the funds for the training.) Missions should investigate such cases as they arise and identify these issues when they submit their privatization activities to AID/W for approval. Missions should not develop a broad-based project that provides for grant assistance in anticipation of instances such as those described above. The availability of such funds may distort market forces and private sector decisions in privatization.

C. Resources for privatization. Sources of technical assistance is found in the Annex to this PD. Resources additional to OYB levels will not be made available for privatization. We recognize, therefore, that some Missions will have to adjust or amend existing priorities and programs to meet the new Agency privatization objective. (This should not present an obstacle to Missions that have already initiated privatization efforts.) It is assumed that Missions will make funds available to support privatization from all appropriate accounts.

9. Conclusion. All too often governments have tended to see divestment as a simple process of announcing a willingness to sell and finding a suitable buyer at the price the government was willing to accept. One of the more difficult tasks facing Missions will be to convince governments that privatization is not a process in which only one side sets the terms, and it may be a long, slow and often frustrating activity.

In formulating and implementing privatization plans and activities, Missions should be aware of the following considerations:

- The process of privatization is essentially political although economic forces may prompt it. Prior understanding of the local political situation, the power bases, and the sources of influence must be achieved before explicit proposals for privatization are laid before the government. Missions should develop a conceptual dialogue with the host government, be understanding of the political risks the host government will be taking on when it embarks upon privatization, and be able to suggest ways of mitigating these risks.

- Privatization plans are more likely to be seriously considered by political decision makers if they contain a variety of options rather than a single course of action.

- Before embarking on privatization a government must have a clear idea of its objectives for the program and why it is being undertaken. Countries may engage in privatization for a variety of reasons, such as to generate immediate cash income, immediate foreign exchange, or future cash income; settle foreign debt; encourage industrial development; encourage foreign investment; improve or create efficiency of operations; develop capital markets; or pursue a free market philosophy.

- Governments tend to be most sensitive to the fiscal and employment aspects of privatization. It becomes important, therefore, to design options which will reduce the subsidy burden without seriously undermining current levels of employment.

- Any strategy for privatization must take into account the groups whose interests may be harmed if divestment is successful. These may include labor groups and current managers of the firm, bureaucrats whose positions and power may be eliminated, political groups that favor public enterprises, local private enterprises that will suffer competition if the sale is to non-nationals, and enterprises which are protected from competition through their relationship with the public institution. A divestment program must include strategies to deal with these opposing groups.

ANNEX

AID/W offers a variety of services to provide USAIDs with the technical assistance and information needed for achieving successful privatizations. These include privatization services available in PPC, PRE, S&T, and Africa bureaus, as discussed below; the briefing book and background papers prepared for the International Conference on Privatization, which have been pouched to all Missions; and the report on the conference, which will be made available to Missions later this year.

A. Agency-wide Resources - PPC. In addition to providing policy guidance on privatization and working with PRE, PPC offers a variety of independent assistance to Missions in their efforts to assist with country divestment and privatization plans. PPC has available a privatization specialist who will respond to requests from Missions for advice on proposed privatization projects. He will apply the experience of other countries to the specific problems faced by the requesting Mission. Missions in Honduras, Indonesia, Jamaica, Mauritania, the Philippines, R/DOC, and Thailand are among those that have received assistance. PPC assistance was discussed in 1985 STATE 224591. For additional information, please contact L. Gray Cowan, PPC/PDPR.

PPC also has several studies on privatization and divestment available for distribution to Missions upon request. These include "Divestment and Privatization of the Public Sector, Case Studies of Five Countries" L. Gray Cowan (December 1983), "The Private Provision of Public Services and Infrastructure" by Steven H. Hanke (May 1984), and "Privatization of Municipal Services in Sub-Saharan Africa" by Dr. Ian Marceau (October 1985).

Shorter studies are also available to Missions on specific aspects of the privatization and rationalization process such as management contracting, business analysis, problems faced by LDC governments in privatization planning and the contract plan, as well as case studies of individual country plans (such as Tunisia, Malaysia, Thailand, and the Philippines).

PPC is having prepared a technical assessment on privatization and divestment techniques which will be completed later this year.

B. Agency-wide Resources - PRE. PRE is currently contracting for assistance to Missions in policy dialogue with host governments, strategy development for divestiture and privatization, and technical assistance for the beginning stages of privatizing specific organizations. The PRE contract with Analysis Group, Inc. and its Center for Privatization will provide assistance over a two year period primarily through short-term consultancies in a wide range of specialties. This contract is discussed in 1985 STATE 386291. For additional information, please contact Paul Haire, PRE/PPR.

That PRE contract is designed to provide assistance in developing and implementing strategies and projects for the divestiture and privatization of state-controlled enterprises. This assistance may include sector or industry specific analyses in the agricultural, industrial, and financial sectors or in service industries. Enterprise specific analyses including organization, production processes, finance, audit, marketing, personnel, and restructuring may also be provided, as can general analyses of the policy, legal or regulatory environment. Help with policy dialogue on utilizing private sector alternatives to state ownership and strategy development for divestiture and privatization plans can be supplied.

PRE will also manage the Agency's Privatization Fund, which is currently being developed. Additional information on the Fund will be made available when its operating guidelines are established.

C. Agency-wide Resources - S&T. S&T has available a variety of technical resources that can be used to assist Missions in developing different aspects of their privatization plans. A few of these are summarized below. Please contact Mike Farbman, S&T/RD/EED, for additional information.

The Employment and Enterprise Policy Analysis project (Harvard, Michigan State Univ. and Development Alternatives, Inc., contractors) has a buy-in provision under which short- and long-term TA is available to analyze sectoral and macro-policies that may affect privatization efforts.

An S&T/RD cooperator, the Industry Council for Development, has substantial experience working with USAIDs in designing action plans, assisting in political and interest group consensus-building, and assisting directly the process of privatization/commercialization of LDC seed industries.

S&T/RD supports RSSAs and PASAs with the U.S. Department of Labor (DOL) through which assistance in analyzing labor markets and/or strengthening labor market institutions may be obtained. The array of labor redundancy, ESOP, retraining, and similar employment issues that accompany some privatization efforts may be addressed through DOL assistance.

The Local Revenue Administration Project (LRAP) has supported national tax reform programs aimed at improving the environment for the private sector in several countries over the past four years. It has a buy-in mechanism under which Mission funds can be used to support tax reform programs and carry out applied research through September 1987. (Please contact Ken Kornher, S&T/RD, for more information on this project.)

A new FY 1987 activity will provide mission support and applied research in government reforms to foster private sector development. S&T/RD is especially interested in working with missions on feasibility and implementation of "contracting out" of construction, maintenance, or other public services to increase the role of the private sector and improve economic efficiency. Pending an FY 87 RFP, S&T/RD can accommodate some mission-funded TA requirements under an existing project (Performance Management).

D. <u>Additional Resources for Africa Missions</u>. In addition to accessing agency-wide sources of assistance, Missions in Africa have available several sources to obtain technical and financial support for privatization. A major source for East Africa Missions is the IQC set up in 1985 by REDSO/East with a group of companies led by Coopers and Lybrand in Nairobi. Others in the IQC group are Morgan Grenfell Bank, Arthur D. Little, and Technoserve. There

PPC-Supported Studies on Privatization

1. _Divestment and Privatization of the Public Sector, Case Studies of Five Countries_ by L. Gray Cowan (December 1983).

2. _The Private Provision of Public Services and Infrastructure_ by Steve Hanke (May 1984).

3. _Agricultural Parastatals_ by Keene, Monk & Associates, Inc. (September 1984).

4. _Community Self-Help: A New Strategy_ by Free Zone Authority Ltd. (May 1985).

5. _Privatization of Municipal Services in Sub-Saharan Africa_ by Ian Marceau (October 1985).

6. _Financing Privatization Under Limited Capital Conditions_ by Arthur Young & Company (November 1986).

7. _Political-Economic Dynamics of Marketing Boards in Latin America_ by L. Michael Lynch and L. Francis Bouchey, Inter-American Security Educational Institute (December 1986).

8. _Capital Markets and Privatization_ by The MAC Group (May 1987).

9. _Privatization and Employment Policy_ by The Hay Group (June 1987).

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