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INNOVATIVE USES OF A.I.D. FUNDS IN FINANCING PRIVATIZATION

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Office of Policy Development and Program Review
Bureau for Program and Policy Coordination
U.S. Agency for International Development

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by

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A. Introduction

It is clear that A.I.D. resources can only be stretched to meet a very small part of the overall needs to provide the private sector with an environment in which it can demonstrate fully its ability to be an integral part of development. In contrast to the large multilateral donors that have substantially greater resources in funding and staff that enable them to undertake programs of greater scope, duration, and complexity, A.I.D. Missions must find those niches where the flexibility and expertise A.I.D. can offer will be most effectively used.

There is ample room for the smaller, more narrowly focussed programs in privatization, in which the larger donors are unlikely to be interested. Finding these opportunities puts a premium on donor coordination in order to avoid duplication of effort and confusion on the part of the host government. In some cases, governments are more inclined to turn to A.I.D. than to the World Bank because of the closer attention that Mission and consultant personnel can give to a program. It may require more time and effort for mission officers to find these special niches where A.I.D. funds can be best used but the results can be highly rewarding.

B. Past Uses of A.I.D. Funding in Privatization

A.I.D. support for privatization has hitherto been confined principally to provision of technical assistance (TA). Funding of privatization strategy development and of assistance in achieving the disposal of SOEs has taken a wide variety of forms. Each Mission privatization program has been tailored to the specific requirements of the host country, depending on the government's objectives, the degree of political risk the government was prepared to take to gain them, and local capacities to undertake the sale of firms being divested.

1. Providing TA to Improve the Environment for Privatization

The government's macroeconomic policies exerts a strong influence on the success of privatization efforts. A.I.D. has undertaken studies and activities in several fields designed to improve the macroeconomic environment in which the private sector operates. On the surface these studies and activities may not appear to be directly related to privatization activities but their effect will be to promote and eventually institutionalize the privatization process. In a broad sense, much of the TA directed toward policy dialogue at various levels ultimately assists in privatization. Changes in foreign exchange regulations; banking laws that make credit more accessible to the private sector; and revision of commercial, investment, labor and tax codes are all conducive to market liberalization and to greater opportunities for both domestic and foreign private sector investment. The new investment code adopted in Guinea in 1986 and a new Senegalese code in 1987 are illustrative of this trend.

TA designed to encourage tax law reform can be particularly effective in expanding capital market activity and in promoting the growth of joint ventures. Tax codes developed in many LDCs over the past three decades have tended to favor state control of the economy at the expense of the private sector. Private firms have been subject to high taxation, reducing the resources left for expansion or renewal of outdated equipment. Double taxation of equities and excessive taxation of capital gains further discourages new investment. TA to assist in standardizing and improving accounting systems to bring government and private systems into line will help to simplify corporate accounting and tax collection.

Overall tax policy in an LDC has to take into account social as well as economic goals. TA can play a role in a comprehensive review of the tax structure to ensure that it is consistent with the government's overall macroeconomic and microeconomic goals. In the review, recommendations may be made, for example, on incentives to increase external investment by lowering corporate tax rates and reduction or elimination, for a stated period, of taxation on expatriated dividends.

TA has been used, and could be employed more extensively, in restructuring investment and commercial codes to facilitate external and joint venture investment. In several LDCs, assistance in code revision has been supplied by the World Bank as well as A.I.D. The new Zimbabwean code announced early in 1989, for example, is designed to attract new investment by relaxing profit controls and moving toward a market-oriented economy. The process of liberalization of trade and the introduction of investment guarantees is expected to take five to seven years. It is hoped that the resulting new investment will reduce Zimbabwe's current high unemployment rate. State ownership of important parts of the economy will gradually be eliminated under the new code.

2. Providing TA to Facilitate the Privatization Process

The initial steps toward a decision to privatize have in some instances required TA, as a way of providing information to a government on the advantages of privatizing, on the results that might be expected from it, and advice on the basic elements of a privatization strategy. Once the government has fully considered its objectives (as well as the risks involved), and the decision has been taken, an even greater TA effort has been required in deciding on what assets should be privatized, in what order, and over what period of time. In many cases, expert advice has been needed to discourage the government from unrealistic expectations as to the immediate financial gains to be realized. Missions have, for example, provided experts to make industry or sector specific analyses of existing or potential markets as well as enterprise specific analyses of management, financial strength, and organization. These analyses can provide the basis for the next step for which TA is required.

In the case of Malawi, the TA team proceeded, after thorough analysis, to categorize the assets to be offered for sale into five tiers:

- Full divestiture through negotiated sale or competitive bid
- Divestiture through negotiated sale or public share offer
- Partial divestiture through negotiated sale
- Restructuring prior to sale
- Retention by the government owned grain marketing agency

This categorization proved extremely useful in prioritizing asset sales by the government and in the ensuing search for suitable buyers.

In other cases, TA has been used to provide specialists in the valuation of firms, for auditing to prepare financial statements for the use of prospective buyers, and in marketing of assets being put up for sale. TA at this latter point is essential since, in most cases, product specialists who know the world market are required to advise on finding possible bidders. The more specialized the asset being sold, the greater the need for expert advice.

TA has been provided to develop public education campaigns on the meaning of privatization, to develop programs to answer the concerns of special interest groups (such as labor), and to inform the public on stock offerings. Funds have also been used to support the holding of regional and national conferences on privatization as a means of promoting wider government and private sector knowledge of the process.

In the financial field, TA has been made available to study the feasibility of new financial instruments, for the development of stock markets (as in Tunisia), and for technical procedures in the marketing of a stock offering. Even where facilities for a public offering are available, the question of pricing the shares requires substantial technical skill and experience. The government, as seller, wants to to realize the maximum return; the buyer wants as low a price as possible. Too high a price may discourage potential buyers; too low a price means losses for the government. In Jamaica, for example, a British investment banking firm was called in by the government with TA help from A.I.D. to advise on the critical question of correct pricing for the market offering of National Bank of Jamaica shares.

C. Possible Future Uses of A.I.D. Funds in Privatization

The tendency to apply mission privatization funds to assist in planning privatization and in providing expert consultation on the sale of specific assets has obscured the intimate connection between reducing the role of the state in economic activity and overall private sector development. Privatizing is more than just selling discrete industrial enterprises. It is not an end in itself but a tool to create greater reliance on market forces in the economy as a whole. This broader view of the place of privatization raises the question of more sophisticated uses of TA and other A.I.D. resources to finance the growth of capital markets in the context of the privatization exercise, as described below.

1. Improving the Image of the Private Sector

One of the major deterrents to privatization in many LDCs is the lingering suspicion of the motivation of the private sector. Governments are hesitant to permit private sector control over sectors of the economy that are regarded as crucial to the national interest, such as food supply in Malawi, or electric power generation in Southeast Asia. Technical assistance by expert consultants can assist in designing a regulative structure that will satisfy national security concerns by giving the government ultimate decision-making power over actions (such as export of high quality seed) taken by a privatized company. At the same time, day-to-day management operations remain fully in private hands.

2. Developing New Financial Instruments

The method of sale in a privatization scheme is in large degree dependent on the financial mechanisms available to the government. These depend in turn on the degree of sophistication of the local capital market. Public share offerings are the most desirable form for spreading ownership as broadly as possible, but they are at the same time the most difficult to bring about because they require an established and popularly understood and accepted mechanism (a stock market).

Beyond public offering, the alternatives for financing privatization in LDCs are:

- ESOPs as a partial public offering, if sufficient leverage is available through companies' cash flow.

- Private placements, if there are holders of capital available. The danger with these is that they sometimes subject the government to the suspicion that cronyism or ethnic distinction is the determinant of who may buy.

- Sales to domestic competing firms, although this may give rise to the charge that a private monopoly is being substituted for a public one.

- Sales to overseas buyers who may be able to bring capital and management skills. These sales may not only create political difficulties for the government but may, at the same time, create new problems of foreign exchange regulation if agreements are required on repatriation of profits.

Each of these alternatives represents a lesser stage of development in domestic capital market capabilities and hence a limitation on the methods open to the government for financing privatization. Whatever methods are employed, the great bulk of developing country governments lack the technical expertise within the civil service (or in the local financial community) to carry out sales, especially if they are dealing with overseas buyers. They have had to turn to outside assistance for technical advice on the form of offering, valuation, the search for buyers, the mechanics of sale and financing, and new financial instruments. Among the latter are:

--Formation of Unit Trusts: Studies are being carried out of new financial instruments in support of capital market expansion that will permit greater numbers of small investors to enter the market. One of the more important of these is the Unit Trust (the British term for what is essentially, in the U.S., a Mutual Fund). It would play the same role in a developing country as it does in the U.S., that of allowing the small investor to buy shares in the trust, the assets of which are made up of the trust's holdings of a wide variety of stock issues. The trust is owned and operated by a group of investors who supply the capital necessary to permit the trust to buy its initial basket of shares. From the profits of dividends and trading, the trust pays a return to the investors on a per share owned basis.

The advantage of a trust is that it permits individual small investors with little available capital to participate in the market while providing a shared risk. In a developing country this is an important feature in that it enables the small investor to become accustomed to holding stocks as an investment, while it provides at the same time a broader market for shares being issued by large industries. The success of a trust in attracting small investors depends on its ability to pay higher returns than can be obtained from savings banks and government securities with as little risk as is compatible with investment in stocks. Particularly in countries with nascent stock markets where investor confidence is not yet fully established, this new instrument must rely for its success on the quality and number of issues that form its initial capitalization.

The structuring and operation of a trust at the outset requires highly specialized skills and experience in finance and stock market operations. For most developing countries these skills would have to be drawn initially from overseas investment banks that could provide the necessary management personnel during the period needed for training of local employees. TA is required for the initial studies on the feasibility of a trust in the light of local capital market conditions. Successful trusts have been in operation in Malaysia for some time and, more recently, they have been established in Zimbabwe and Botswana.

The A.I.D. mission in Malawi is being asked to finance a detailed study looking toward the creation of a unit trust. Preliminary studies have already been undertaken by a British investment banking firm as part of the preparation for divestment of assets belonging to the Agricultural Development and Marketing Corporation (ADMARC).

In this case, the trust would have as part of its base the minority shareholdings retained by ADMARC from assets that have been privatized, and, in addition, shares of major banks and insurance companies and possibly in future those of the country's largest industrial conglomerate, the Press Trust. As further assets are divested, these issues would also be included in the trust as would those of other private firms.

--Formation of Holding Companies: TA may also be sought to advise on the formation of a holding company that would be the repository of the government's retained minority shares in privatized companies. These would provide additional share offerings to broaden the scope of the stock market. The trust would then purchase its shares from this arm's-length holding company. The use of such an arm's-length company is designed to reassure investors that the government will not interfere in the activities of privatized firms even though it remains a minority shareholder.

--Creation of New Stock Markets and Improvement of Existing Markets: Many developing country governments are eager to embark on creating a stock market; however, a successful market requires more than just a building and an official announcement of its existence. A sufficient number of issues must be available to provide investor choice and the issues themselves must be based on evidence of the profitability of the underlying companies. A lengthy public education campaign may be required to acquaint small investors with the process and advantages of stock purchases. Without the necessary skills to operate a stock market, the attempt may be abortive, resulting in a severe set-back in public confidence and in capital market development.

Nevertheless, TA requests from host countries to study the feasibility of a stock market and new financial instruments meant to increase investor participation are becoming more frequent. Where a weak market already exists, studies can be directed toward methods of creating new issues through the use of, for example, convertible bonds, as has been suggested in Morocco.

A.I.D. funds have also been utilized, as in the case of Tunisia, to increase the skills of stock market personnel through local training in transaction operations and market rules and procedures. Requests have been received to meet the cost of training new stock brokers and to finance public education campaigns on the advantages of purchasing stocks. This type of technical assistance is important not only for capital market development in general but, in the longer term, for facilitating the sale of SOEs.

--Employee stock purchases: Where there is little prospect of developing a stock market in the near future, one alternative is to promote with TA the expansion of employee purchase of stock in the firm, leveraged management buy-outs, or even full scale Employee Stock Ownership Plans involving complete employee ownership of the firm. TA is being provided in Egypt, for example, on the creation of an ESOP for a firm to be privatized. In Tunis the Mission is providing funds for the holding of a conference on techniques of leveraged buy-out by management.

--Incentive Funds: In at least one case, Economic Support Funds (ESF) have been used to provide an incentive for the government to proceed rapidly with divestment of state-owned assets. To relieve hard currency shortages, the Malawi mission provided $15 million to be paid out on a ratio of $U.S.1 for every 3 units of local currency realized by sale to the private sector of ADMARC assets. The entire amount was allocated for payment within 18 months when roughly one half of the priva ization program had been completed. The effect of the arrangement was to focus the government's attention on rapid decision-making regarding sales proposals. Some buyers have indicated that they would not have proceeded with the purchase had it not been facilitated by the encouragement provided by the A.I.D. grant.

The use of any A.I.D. funds for encouragement of more rapid privatization should, however, be thought through carefully at the outset to determine the figure which applies to the commitment of A.I.D. funds. In the Malawi case, the amount of ESF funds to be paid for each privatization sale was based on the greater of the book value or the sale price of the asset.

Valuation was never a critical question; the normal political objection to selling national assets at less than book value did not arise. Target prices for the assets were set at very low levels; in some cases they were exceeded by purchase offers. The government was content with this lower rate of return because the conservative sale price was, in effect, nearly doubled by the subsequent ESF payment. This may not have been the intent of the agreement but it served to make the assets much more attractive to buyers and to push the government into speedy sale decisions.

--Debt-Equity Swaps: Debt equity swapping has hitherto been undertaken, chiefly in Latin America, between governments and private sector firms with intermediation by investment banks. The process of debt-equity swapping has by now become relatively well known at least in Latin America and has produced good results for all parties concerned--reduction of government debt, increased equity investment by both foreign firms and local investors, and commissions for the facilitating banks. In the case of SOEs, privatization can be made easier by the use of swaps. Local development banks or central banks are anxious to convert dollar loans from international commercial banks thus avoiding continued foreign exchange drain for debt servicing. Holders of the loans are equally anxious to be rid of the loans because of doubts about repayment.

The privatization of a steel foundry in Honduras provides an example of the use of the swap in completing a sale. The idle plant was sold to a group of U.S. investors after a number of other investors failed to express interest. The transaction was effected by means of a $2 million swap of debt of the Honduran National Investment Corporation. Of this, $1 million was for the firm's assets and the remainder was converted to local currency to be used by the investors as working capital. The innovative use of debt-swapping in this case was perhaps the most attractive aspect of the deal in that both the government and the investors benefitted. The investor exchanged debt for equity in a non-performing asset which was expected subsequently to earn hard currency from its export sales. The government sold some of its hard currency debt; the investor paid a lower price for the local currency needed which reinforced the viability of the firm and compensated in part for the risk involved.

3. Privatizing Land

--Agricultural Estates: With the changing attitudes of many LDC governments toward the agricultural sector, particularly in farm gate prices paid to producers, the question of privatizing agricultural estates owned and operated by government agencies has taken on new importance. Private sector operators now see greater possibility of profits from export and domestic crops with the liberalization of controlled prices formerly paid by marketing boards. Governments have begun to realize that private sector operation is more productive and the crops are often of higher quality than was the case under state control. In some countries marketing of staple grain crops is being put into the hands of private traders, with the marketing board retaining only the function of buyer of last resort.

Sales to private owners of large-scale government agricultural holdings is not easy because of the limited availability of local capital, even if the necessary operational skills can be found. An effort was made to broaden ownership when Malawi set out to market large tea and macadamia nut estates but it soon became apparent that few individuals were able to finance the purchase of the largest estates (particularly since Indian buyers were excluded). The only alternative to local buyers was large external purchasers such as the Commonwealth Development Corporation.

The A.I.D. mission agreed to provide, out of the local currency equivalent of the balance of payments credit to the government, a co-financing facility for estates up to 1000 acres. The facility is operated through a local commercial bank. Loans up to 90% of the purchase price were made available (as opposed to the normal bank limit of 50%). The co-financing fund took up to 60% and the bank the remaining 30%, with a 10% down payment by the purchaser. Loan terms were extended from the usual commercial bank limit of 3 to 5 years to 8 years; interest was set at a blended rate between the bank rate of 16% and the co-financing rate of 11%. Knowledge of the availability of the facility was not widely spread; initially, buyers were informed of it only after they had expressed interest in bidding. As a result, very few applications have been received; had notification of the facility been more broadly disseminated, more potential buyers would have been encouraged to bid.

This use of A.I.D. loan funds could be replicated in other countries where the government plans to divest large agricultural ventures. The marketing board, or any other government agency for that matter, cannot devote sufficient management time in addition to its other functions to close management of large farm holdings. If the government can be encouraged to privatize such holdings, it benefits not only from the sale but from higher production from the land. But little is accomplished if the sale benefits only large absentee landowners. Properly administered, A.I.D. loan funds can not only broaden private ownership possibilities but may influence the commercial banks to liberalize their loan practices in the agricultural sector.

--Land Ownership: There is a possibility of using A.I.D. TA assistance to achieve greater privatization of land ownership and use in cases where traditional land tenure practices have been an obstacle to the most effective utilization of land. Particularly in African countries attitudes toward possession of land are undergoing fundamental change. Hitherto the value of land has been its usufruct, but ownership of the land itself had little or no intrinsic economic worth. Traditionally, ownership of land was vested in tribal authorities who possessed the power to grant use of parcels of land to individuals for subsistence production of food. With independence, overall ownership of land was often vested in the state. As the price of food crops has increased with greater emphasis on the rural sector and liberalization of marketing practices, land is rapidly becoming a source of profit and hence is being seen in an entirely new light as a source of personal wealth.

As a result, legal recognition of private ownership of land and judicial delineation of boundaries are becoming matters of critical importance. As larger mining and agro-business projects are developed, determination of the ownership or leasehold rights of the land to be used and its precise boundaries is necessary if the project is to go forward. In most African countries, no registry of land ownership exists in rural areas. In urban areas where extended families may be able to exert prior ownership rights, land development for industrial purposes may be subject to indefinite delay until all the claims can be sorted out in the courts.

Traditional law did permitted neither private sale of land nor its rental for profit; the land had to used for the direct benefit of those living on it. Now that land is beginning to have growing monetary value to its owners, governments are becoming more concerned with the question of regulating exchange of land and recognition of the rights of those already in possession. Debate is arising between those who believe in the statist theory of land ownership -- that is, protection of the land for the ultimate use of the people in the face of the threat of alienation of large tracts to foreign control for exploitation of mineral or other resources, or for industrial construction. The other side argues that private individuals should be free to acquire and sell land for profit as part the liberalization of all economic activity.

Governments are now approaching donors for assistance in developing land law and overall land ownership registration procedures. In Guinea, for example, the World Bank and the Food and Agricultural Organization are considering cooperative assistance to create a system by which current ownership can be at least identified and a limited registration scheme set up. Full land registration is beyond the administrative capabilities of most African governments and would be prohibitively costly to maintain at the local government level.

The Uganda government has already requested help in identifying the Indian owners of lands and businesses nationalized in 1972 when the Indians were expelled. Although the government's expressed intention is to repay the original owners for their losses, the more important point is that without clear title the present African occupiers of these properties are not prepared to invest in improvements.

In the Senegal River valley, the complex land tenure system is seen as a constraint to private sector development by large land owners. Recent dam construction has made newly irrigated land more attractive and substantial numbers of requests are being made to local authorities for additional allocations. These are, however, running into resistance from traditional elites who seek to continue their control over land rather than distribute it to the landless. Land cannot be mortgaged to finance new acquisition, nor can it be sold, purchased or leased. It has been recommended that the government adopt a system of land registration according to standardized recording and mapping practices. Pressure for development of leasing arrangements and means to facilitate land transfers are increasing as the price of paddy rice becomes more attractive.

Use of TA funds to assist host country governments to create formal land registration agencies and develop laws for the sale and lease of land would be welcomed in several countries. These would meet a growing need and would support private sector growth as well as emphasizing the advantages of privatization.

4. Privatizing Social Services

There is a growing inclination to explore the privatization of social services, particularly in the health and population fields. Substantially different problems, requiring new forms of TA, will have to be solved with the entry of the private sector into service delivery since large sections of the population will be directly affected. Missions will be able to find opportunities for new application of A.I.D. funds depending on the special circumstances and needs of each host country.

D. Conclusion

A.I.D. TA for privatization of industrial assets has already proved to be of great utility in several countries. In many cases it is doubtful whether privatizing would have gotten under way at all without it. Other donors have either been disinclined to assist in this field or have been slow to recognize the need to reduce public sector inroads into areas of economic activity where the private sector could achieve better results.

It is becoming increasingly important to integrate TA for privatization with other aspects of a mission's overall program. Privatization is not an isolated activity; it goes hand in hand with policy dialogue designed to produce macroeconomic policy change, programs for assistance to the private sector directly, and capital markets development. It can become part of a broader approach to increased private sector involvement in large scale agricultural development.

TA will remain the basis of assistance to privatization, given the legal and financial restraints under which Missions can operate. But the expert advice that is offered can lead to more rapid privatization and to paving the way for increased foreign investment through a more favorable climate for private sector activity