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# SUCCESSFUL APPROACH TO PRIVATIZATION

A CONFERENCE PAPER

BY

Howard W. Edwards

CENTER FOR PRIVATIZATION
1750 New York Avenue, N.W. - Washington, D.C. 20006

Project No. 49 July 1987

Prepared for the
BUREAU FOR PRIVATE ENTERPRISE
U.S. AGENCY FOR INTERNATIONAL DEVELOPMENT

# CENTER FOR PRIVATIZATION

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# INTRODUCTION

Privatization is becoming one of the most promising approaches for developed and less developed countries to use in responding to the crushing debt servicing, deficit reduction, and economic restructuring requirements that countries are facing now and in the immediate future. Carrying out privatization programs and activities, however, remains a formidable task (particularly for developing country leadership) and involves making hard choices among numerous alternative strategies. As there are "many paths to Rome," so are there many ways to effect privatization, including some or all of the following:

- o Fundamental policy reform.
- o Market deregulation.
- o Restructuring parastatal organization and financial management.
- o "Contracting-out" total or partial areas or specific functions of an enterprise.
- o Leasing assets.
- o Partial "spin off" or divestiture.
- o Total divestiture.

At this moment there are those who are probably working on new and innovative ways of approaching privatization that will eventually occupy this list. These new approaches will be the result of imaginative and daring responses to the critical issues and problems with which these individuals are confronted.

Numerous factors must be taken into consideration in the selection of the appropriate mix of strategies and their timing, including the sociopolitical environment of the country, the business investment climate, the size and composition of the work force in the public enterprise, the commercial viability of the public enterprise, and the availability of required capital, management, and technical staff to carry out the functions and activities of the enterprise.

To help clarify and elucidate the nature of such choices and the framework in which they occur, it is extremely useful to present some examples of pragmatic, hands-on cases of successful privatization efforts. Following are brief illustrations of a few successful programs.

## General Trends in Privatization

Before discussing specifics, it should be pointed out first that major privatization efforts are being undertaken throughout the world in the following areas:

- State-owned telephone and telegraph companies, airlines, and banks are being sold to the private sector.

- Bus and other transportation systems and related services, including entire railway systems, highways, shipping and ship building facilities, and automobile manufacturing are being privatized;

- Public housing is being sold to tenants. Surprisingly, in countries such as China and Cuba.

- Natural gas utilities, oil, and petrochemical companies are being sold to the private sector.

- State-owned hotels are being sold or leased.

- Sugar refining and other agricultural industries are being privatized.

- Even social security systems are being privatized.

Every conceivable sector of industry in which governments are involved seems to be "fair game" for a privatization initiative somewhere in the world.

## The British Experience

One cannot speak of privatization successes without discussing those of the British. Although privatization is occurring all over the world, the one country that is way ahead of all others in implementing it is Britain. While other countries have dabbled in privatization, the British have developed it into a science. A privatization revolution of enormous proportion has taken place in Britain and is transforming the entire British economy. The policy has been so extensive that virtually every aspect of British economic life has been touched and changed.

- British Telecom, a huge government-owned telephone and telegraph company, was sold to the public last November. It was the largest public offering of stock in history. About two million Britons bought shares; half of which were first-time investors.

- Jaguar, Britain's state-owned car company, was sold to the public. Nearly 190 million shares were placed on the market in 1983. There were traffic jams and fights in the street as potential buyers rushed to purchase stock.

- The government sold all of its stock in British Sugar and 51 percent of its stock in Britoil (North Sea oil exploration) and in British Aerospace. It has sold almost 40 percent of its stock in British Petroleum and has sold off subsidiary operations of British Steel, British Rail, and British Airways.

- The government has sold 873,000 public housing units--13 percent of all British housing--to the tenants.

- Every municipality in Britain has contracted at least one service out to private firms, and most are contracting out several.

The platform on which the Conservative Party won the 1979 election did not mention the word privatization. Instead, the emphasis was on reducing the size of government by cutting out waste and imposing budget limits on government programs. Only when it became clear that this approach was not working did privatization begin to take on importance as a major policy initiative. Since then, the scope of the policy has been increasing and the pace has accelerated. It was through privatization, that the Thatcher government finally succeeded in making real reductions in the size of government.

A recent Background Briefing released by John Moore, Financial Secretary of the British Treasury, says that privatization "ranks among the most radical reforms of the UK's econcmic and industrial structure since 1945."

- When Margaret Thatcher assumed office, nationalized industries accounted for 10.5 percent of Britain's Gross Domestic Product and one-seventh of total investment in the economy.

- Nationalized industries employed 1.5 million people and dominated the transport, energy, communications, steel, and ship building sectors of the economy.

- Under privatization, the government has sold $28 billion of public sector assets and is currently selling assets at the rate of about $5 billion a year.

- To date, over 400,000 jobs--almost one-third of the total--have been transferred to the private sector.

Privatization in Britain has not been limited to the selling off of state industries. Privatization also has meant having public services provided by the private sector. It has developed into a campaign to turn over whatever is done by the state to private enterprise as part of a systematic effort to replace the public sector. This includes not only industries, but utilities, human services (such as health, social security, and education), and even certain regulatory functions of government.

Progress is being made on all of these fronts. Conservative Party Chairman Norman Tebbit has said that in 1979 Britain had the largest public sector of any country in the western world but, by 1990, it will have the smallest. He may well be right.

- If the government's privatization program is achieved in full, the proportion of gross domestic product in the hands of state industries will have dropped from 10.5 percent to around 6.5 percent.

- More than 600,000 jobs will have been transferred to the private sector.

Surprisingly, enthusiasm for privatization is now emerging in parts of the public sector itself. The management of the government-owned English Industrial Estates Corporation, which builds and manages factory developments in depressed areas, has proposed a management-led buy-out. The corporation's 320-person staff in 16 offices would be offered individual shares in the new company. Lord Marshall, Chairman of the Central Electricity Generating Board, has announced his support for privatization of the electricity industry and a number of state water board chief executives also have endorsed privatization.

Why is privatization so popular in Britain? One reason is that the British government has made sure that management and employees of targeted enterprises gain from privatization.

For example, the Thatcher government has made a special effort to encourage employees of nationalized companies to purchase stock in the companies as they are privatized. Methods include (1) offering free shares to employees, (2) offering free shares in proportion to shares bought by the employees, and (3) giving employees priority in the allocation of shares sold to the public.

The British have even gone so far as to privatize partially their social security system. Employers can contract their workers out of the second tier of the social security system by providing them with private pensions which provide retirement benefits as good as or better than those promised by social security. To date, more than half of all British workers have been contracted out, and the Thatcher government recently announced its intention to completely privatize all second-tier pensions.

The British privatization experiment has provided an example for other nations to follow. It appears that is what other nations are doing. Particularly in less developed countries.

I'd like to take a moment now and share with you briefly some of the personal experiences from which I draw in moving toward the development of a "prescription for (a) privatization (strategy)."

## The Jamaica Experience

Public Administration Service, while working for the Ministry of Planning, Government of Jamaica, had the opportunity to monitor privatization planning and related implementation activities in that country. We have seen a number of World Bank and International Monetary Fund officials come and go shaking their heads in disbelief at the financial problems with which the Government of Jamaica is beset as a result of the debt-ridden and "life blood" draining state of Jamaican parastatals. This situation has been labeled, by some, as the "Jamaica disease." In light of this situation, Jamaica has been "encouraged" by donor and lending agencies to divest itself of these "albatrosses." Consequently, some action has been taken (albeit slowly and painfully for the government) to eliminate government holdings in the sugar and hotel and tourism industries. The effect of these actions is that Jamaica has sold or leased most of its sugar refining and hotel interests.

The big success story, however, is the handling of the national hotels and properties project and the eventual revitalization of Jamaica's tourism industry. The story goes something like this. Following the devastating declines in tourism during the '70s and '80s, the Government of Jamaica became the owner of all but one of the hotels on the Island in an attempt to "bail out" the tourism industry. Although the Government of Jamaica was successful in keeping alive (barely) what was left of the hotel and tourism industry, the properties declined to depths which precluded their revitalization through use of government funds or supported loans. It was decided that the time had come to "privatize" the industry.

The unique aspect of this effort is that the Government privatized but retained ownership of the properties. This was accomplished through initiation of "tight, long-term lease agreements" with the private sector for an undisclosed share of the profits. The Government made things attractive to the private sector by providing the following:

- Tax write offs for refurbishing costs.
- Waived duties on furniture/equipment needed to refurbish facilities.
- Certain other tax incentives.
- Tourism ministry support in tourism marketing/promotions at little or no cost to the industry.
- Government involvement is limited to foreign currency regulations and licensing; there is no government involvement or interference in management of the enterprises.

Results: Most government hotels have already been refurbished; occupancy rates are up; and tourism is increasing. The lone hotel not previously owned by the Government (and which previously was cited as the premier hotel in Jamaica) is losing business. Its facilities will have to be refurbished and its rates reduced if it is to have a chance at competing with the leased government properties.

This is a prime example of what can be done to privatize while working under existing government laws and structures. Privatization was, in fact, accomplished without divestiture.

## The Malaysia Experience

Public Administration Service has had a continuous presence as a contractor in Malaysia for over two decades. Our work has been with a number of parastatals: FELDA, RISDA, MISC, and Port Klang, to name but a few. In 1985, while engaged by Port Klang to conduct an organization and management study and improvement program, the Port was advised by the Government that it would be the first of its parastatals to be privatized. Consequently, the scope of work under which PAS was working was modified to include assistance to the Port in addressing the issues of privatization of its container operation and identifying the impact privatization would have on the structure.

Under this project, the valuation and legal aspects of privatization were the purview of commercial banks and government attorneys, respectively. Several interesting problems surfaced, however, for which counsel was provided by Public Administration Service. These included the questions of how to handle the disposition of some 2,500 employees, who were by law to retain equal treatment under the transfer and guaranteed nonretrenchment, and how to dispose of several million ringitts (Malaysia dollars) worth of computer equipment, the use of which the "spin off" corporation accounted for approximately 65 percent. The new corporation, however, had no interest in acquiring the equipment and the attendant additional financial liability.

The solutions were long in coming, but finally it was agreed that the "new corporation" would "absorb" the 2,500 employees and not "retrench any for a two-year period." The Government "cashed out" all outstanding obligations to the affected employees: obligated leave was paid; retirement funds were frozen in the employees' provident fund until employees are eligible for retirement. The solution to the disposition of the computer equipment involved creating another new corporation which now sells services to both the Port and the privatized container operation.

Results: The Privatized container operation agreements were finalized and transfer of ownership made in the spring of this year (1986). Other privatization activities in which I have been involved, (including those in Liberia, Ghana, and, most recently, in Pakistan) also have interesting stories to be told. But these will have to wait for another time and place when the topics of limited successes and failures are the subject of discussion.

## Toward a "Prescribed Privatization Strategy"

From experience, we have found that one thing common to all successful privatization projects is the recognition that the privatization effort or program of activities must be organized and well planned: policies and issues articulated, forecasts and assessments conducted, goals and objectives set, strategies and action plans developed, programs implemented, and results monitored. What I've just described is a basic strategic planning process. Strategic in the sense that, privatization is something that requires time and, therefore, cannot be accomplished through "tactical" or short-term planning; even though tactical planning is an inherent part of the various stages of the strategic planning process.

Most importantly, it must be recognized that privatization is a political process and must be handled accordingly.

## Prescription for Privatization

The model or "prescribed privatization approach" that follows incorporates the basic principles of the strategic planning process. In essence, the prescribed approach, is merely a micro-definition of the process.

In the interest of time, I will merely walk through the process with some commentary on each phase of what we recognize at the Center for Privatization as the basic privatization process. The Process consists of five phases. These include:

1. Phase One--Assessing privatization climate.

2. Phase Two--Examining privatization approaches and selecting SOE targets.

3. Phase Three--preparing for investors/ marketing.

4. Phase Four--negotiating the transfer.

5. Phase Five--The role of government after divestiture: establishing regulatory and oversight agency and monitoring performance.

### Phase I. Assessing Privatization Climate

To conduct a privatization program successfully, there must exist a healthy supportive environment for private sector development and investment through structural adjustment and macroeconomic policies. In addition, an important key to success is a clearly defined set of policy objectives and goals together with a firm commitment from key government officials and related government organization(s) responsible for program implementation.

The steps involved in this phase include the following:

1. Determine Overall Goals and Objectives.

   a. Define policies program objectives. The Government may have many reasons for privatizing state-owned enterprises. Among which are to:

      - Reduce losses of SOEs, reduce government budget deficits and subsidies.

      - Promote private sector development.

      - Satisfy multilateral lending groups.

      - Stimulate economic growth and development by making SOEs more efficient.

      - Convert frozen assets into liquid

funds for use in reducing debt and establishing or expanding other development programs

b. Determine need for additional TA. Preparing a country privatization strategy is complex task. The kinds and level of technical assistance must cover a wide range of subjects. Some of these areas include:

- Sector or industry specific analyses.
- Enterprise specific analyses.
- Review and analyses of policy, legal, regulatory provisions.
- Project design, implementation, and evaluation activities related to privatization.
- Methods of conducting valuation assessments, sales, and transfer of enterprises.

c. Define issues. This item relates to clarifying why the enterprise is controlled by the state, whether or not those reasons/conditions still exist; determining the appropriate intervention, if any; and outlining how it carried out.

d. Determine program roles. This item involves clarifying the roles of key actors and decision-makers in a country's privatization program.

- Role of government officials and agencies.
- Role of private sector.
- Role of donor and lending organizations.

e. Create mechanism/organization to implement/monitor program.

f. Create awareness of the consequences of privatization.

2. Assess Legal, Economic, and Political Environment. In order to determine the likelihood of a successful privatization campaign, a thorough analysis of legal, social, economic, and political issues and indicators must be undertaken. A local capacity to perform assessments must exist. Qualified people with expertise in finance, contracting, legal issues, macroeconomic policy, organization and management systems are needed to perform these assessments.

a. Determine degree of private ownership presently allowed; desired; local business interest.

b. Determine degree of foreign ownership desired.

c. Determine availability of local capital and capitalization burdens on government and private sector.

d. Assess affect on supply of public services and goods.

e. Assess affect on changes in employment levels; job displacement.

f. Determine impact on government regulations, subsidies, protectionist measures, and possible affect on socioeconomic issues (i.e., food subsidies).

g. Review legal barriers; economic constraints; political costs-/benefits; economic costs/benefits.

h. Present report of findings.

3. Educate Public--Foster Public Support. It is important to involve the general public in the privatization process and to educate them on the benefits which can be derived therefrom. It is also important to clarify the issues and objectives of the program. To the extent possible, these clarifications should include the perspectives of business and community leaders as well as other groups which are or potentially affected by privatization.

   a. Develop dialogue with business and community leaders.

      - Create private sector coalitions.

      - Demonstrate economic benefits (rate-of-return analysis) from sale of firm.

        (1) Impact on national budgets.

        (2) Financial impact on economy.

        (3) Describe considerations necessary for impacts.

   b. Communicate with groups possibly threatened by privatization (union/SOE employees).

      - Assure that worker rights are protected.

      - Demonstrate benefits.

      - Market/promote other possible offshoot programs, i.e., retraining, job placement, compensation.

   c. Assure that national rights are protected. The initial promotion of the privatization program should emphasize that process will be "even handed;" that there will be know special deals or such things as "fire sales" to foreign investors or political cronies; and, that privatization is intended to strengthen political, economic, and social institutions through reducing national debt, capital flight, and employment generation.

d. Continue to foster support and monitor results through the entire privatization process.

4. Develop Strategies and Guidelines

a. Determine privatization approach--selected areas vs. total enterprise.

b. Determine criteria for selection of targets.

- "Basket cases" vs. profitable ones.
- Manufacturing vs. service-oriented.

c. Develop system for preparing SOE's for privatization.

d. Formulate recommendations re: market deregulation, restructuring, and other private sector incentives; tax relief; loans; deregulation; social/economic policy changes; etc.

e. Recommend programs for other related areas:

- Management development.
- Micro-enterprise development.
- Capital markets development.
- Rural/cottage industries development.
- Investment=promotion--freezone/freeport promotion.

**Phase II. Examining Privatization Approaches and Selecting State-Owned Enterprise Targets**

This activity involves the following steps:

1. Conduct Comprehensive Review of SOEs

a. Analyze SOEs in the following areas:

- statutory/legal framework--constraints.
- Organizational and administrative arrangements.
- Financial administration; accounting systems.
- Operations.
- Strategic planning.

- Political environment.

2. Determine those SOEs which lend themselves to privatization. This must be done in light of government objectives and benefits to be derived for all parties affected by privatization. Basic questions such as, "Can output of state-owned enterprise be better and more economically provided by private sector?" "Will small investor involvement be increased?" "Will employment be generated?"

3. What are the Privatization Options? This step involves reviewing the various options and selecting a course of action appropriate for the privatization program at hand. These options are likely to include, but are not limited to, the following:

   a. Partial Divestiture

      1. Government sells part--retains some control to influence management decisions/policy issues.

         (a) Constraints:

         Reduces attractiveness to private investor; rather see government as just a regulator/"watchdog."

         (b) Advantages:

         Limits political risks; may be too much of a risk to transfer entirely to private sector.

   b. Complete Divestiture

      1. Direct sale--depends on:

         (a) Size of investment required.

         (b) Local capital availability.

         (c) Degree of outside control government willing to accept.

         Constraints:

         -- Single buyer may negotiate lower price.

         -- Buyers may liquidate firm.

         -- May result in reduced employment opportunities.

         Advantages:

         -- Potential for lower market costs for goods and services.

         -- Infusion of capital for government.

2. Public offering--depends on:

(a) Capabilities of local capital markets.

(b) Existence of local stock market.

Constraints:

- Possible nonexistence of a + b.
- Problems re: valuation of SOE; determining initial offering price.
- Potential need for technical assistance.

Advantages:

- Provides wide distribution of ownership.
- Encourages public participation.
- Politically sound endeavor.

c. Sale to Employees--(ESOPs--Employee Stock Ownership Programs). The use of ESOPs is gaining popularity as a privatization option. It is supported often by employees and is viewed as a politically viable way of getting around the problem of retrenchment.

(1) Selling stock to the enterprise's employees depends on:

- Availability of employees' resources.
- Possible availability of long-term, low interest loans from Government or other financial institutions for purchase.

Constraints:

- Point "b" would be indirect subsidy by government; no immediate cash advantage to government.

Advantages:

- Sociopolitically, program would be positive.
- Good for productivity; perhaps, due to incentive for employees.

d. Contracting Out Services

Country remains in control of function by issuing contracts to qualified, experienced firms to provide and manage the delivery of goods and services.

Constraints:

Process contains dangers of mismanagement and political favoritism. governments should take special care to establish a competitive tendering process managed by an independent board of respected and qualified individuals. Additionally, technical assistance may needed in drafting contracts, bid documents, scopes of work, etc.

Advantages:

Saves money, allows government resources to be allocated elsewhere. Firms tend to hire indigenous managers, which helps to develop indigenous expertise in the provision of services. Overall, country may gain management skills, a more efficient industry and, perhaps, easier access to foreign credits and technology.

e. Liberalization: Encouraging Private Sector Development. Measures are instituted that encourage the development of private sector competition by removing or relaxing legal barriers that inhibit or prohibit it. Government can offer attractive incentives to new business through:

(1) Reduction of tax barriers; tax relief.

(2) Deregulation.

(3) Promotion of free zones, freeports.

(4) Reduction of import restrictions/tariff barriers.

(5) Freer movement of currency, in and out country.

**Phase III. Preparing for Investors and Marketing the State-Owned Enterprise**

Depending on the state-owned enterprise selected for privatization and the particular approach decided on in carrying out the privatization program, one of the set of activities would be carried out. These are summarized as follows:

1. Enterprise to be sold outright or sale of equity shares.

a. Determine interest in purchasing enterprise in total or part.

o Develop prospectus.

- o Conduct valuation assessments.

b. Identify investors/purchasers.

- o Domestic private investors?
- o International private investors? Limitation on foreign investments?
- o Employee group purchasers?

c. Prepare for transfer of ownership.

2. Loss of monopoly position (same procedures as above).

3. Enterprise to be leased.

   a. Prepare SOW.

   b. Prepare draft contracts and bid documents.

   c. Identify lessors.

   d. Negotiate and execute lease agreements.

4. Contracting out (same procedures as above).

5. Sale of enterprise assets.

   a. Determine interest in purchasing assets.

   b. Assess valuation of assets.

   c. Prepare for sale of assets.

   d. Conduct sale and dismantle SOE.

## Phase IV. Negotiating the Transfer

Phase IV activities include the various actions to be taken in consummating the transference of the enterprise based on the approach decided:

1. Sell to local and/or foreign investors.

2. Sell equity shares.

3. Sell to ESOPs.

4. Allow entry of competitive enterprises into industry with government divestiture of SOE.

5. Lease the enterprise to private concern.

6. Contract all or part of enterprise.

7. Sell assets.

8. Dismantle (or reconstruct enterprise for future divestiture).

### Phase V. The Role of Government After Divestiture

A function that is frequently overlooked in most privatization projects is the role of government after divestiture of SOE or deregulation, Government's oversight of industry following divestiture, and its role in monitoring performance of privatization program results and safeguarding public interests. The key steps of this phase include:

1. Fixing responsibility for privatization monitoring and evaluation with a single government agency.

2. This agency in performing its mandate would:

   - Assess and report on privatization trends, issues, and developments.

   - Formulate recommendations regarding complementary activities, i.e., management training, investment promotion, capital markets development, and the like.

   - Coordinate activities and findings with appropriate government legislative committees, etc.

   - Modify (or assist in modifying) national privatization policies and guidelines as appropriate. Through this agency, the government would plan and coordinate privatization efforts with the country's overall economic development plans and programs.

### Conclusion

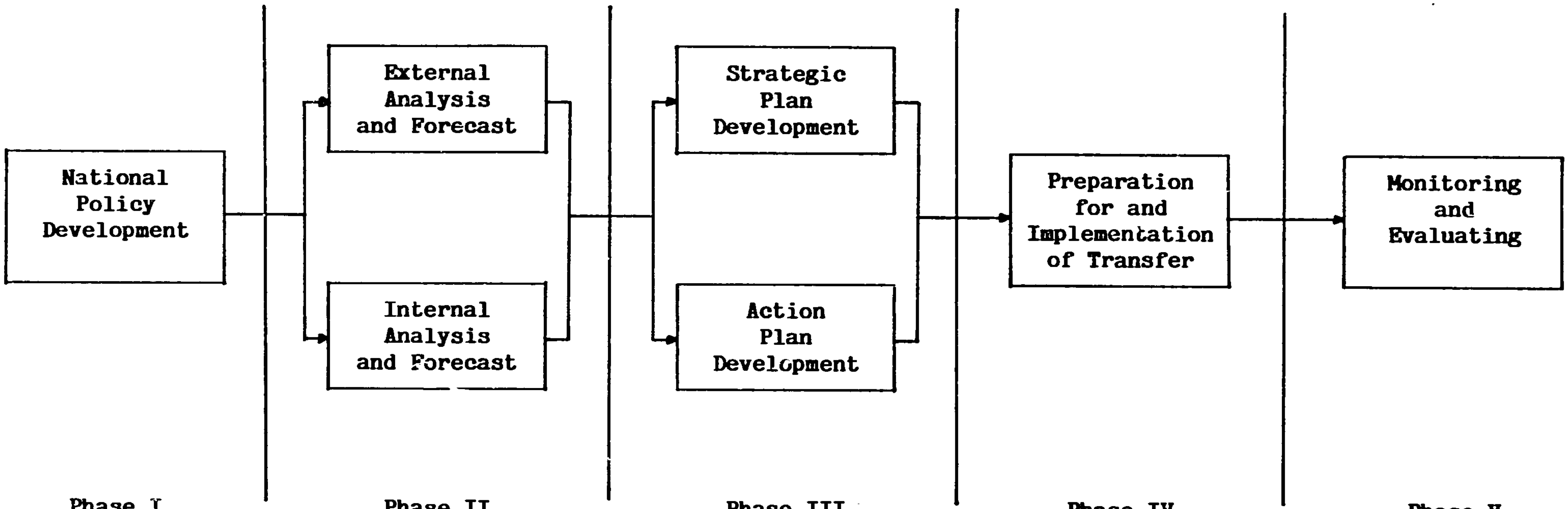
By way of conclusion, let me point out that there is no standard approach (nor can there be) for carrying out a "perfect" privatization project. Every project has its own special set of circumstances: environment, politics, socioeconomic characteristics, etc., that must be considered when initiating a privatization project. It is even unlikely that projects undertaken within the same country environment but in different sectors can be executed successfully from use of a "standard approach."

What we do know is that there are factors and processes that, when properly observed, can minimize the risks and maximize the potential of privatization. Systematic planning, evaluation, monitoring, good common sense, and effective decision-making as "prescribed" in this presentation has worked for many; it can also work for you.

ATTACHMENT A.

**PRESENTATION SLIDES**

STRATEGIC PLANNING PROCESS




Phase I

Assessing Privatization Climate and Preparing for Privatization Effort

Phase II

Examining Privatization Approaches and Selecting State Owned Enterprise Targets

Phase III

Preparing for Investors and Marketing the State Owned Enterprise

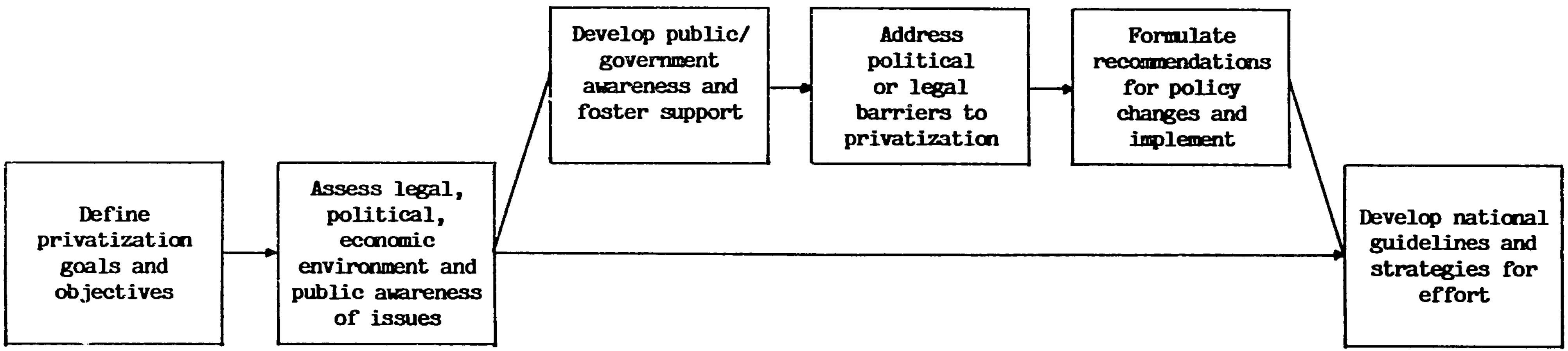
Phase IV

Negotiating the Transfer

Phase V

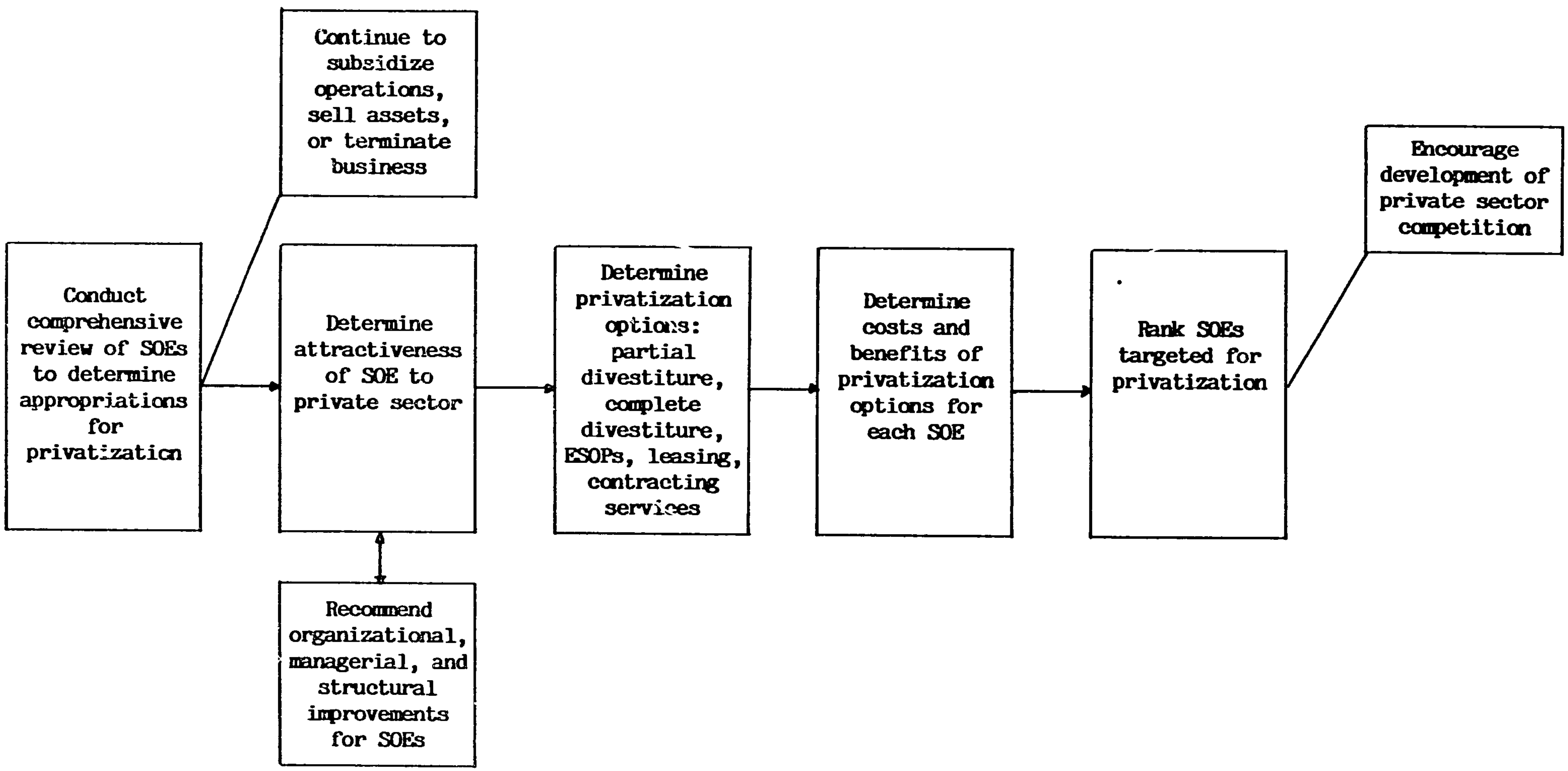
The Role of Government After Divestiture

## PHASE ONE: ASSESSING PRIVATIZATION CLIMATE AND PREPARING FOR PRIVATIZATION EFFORT

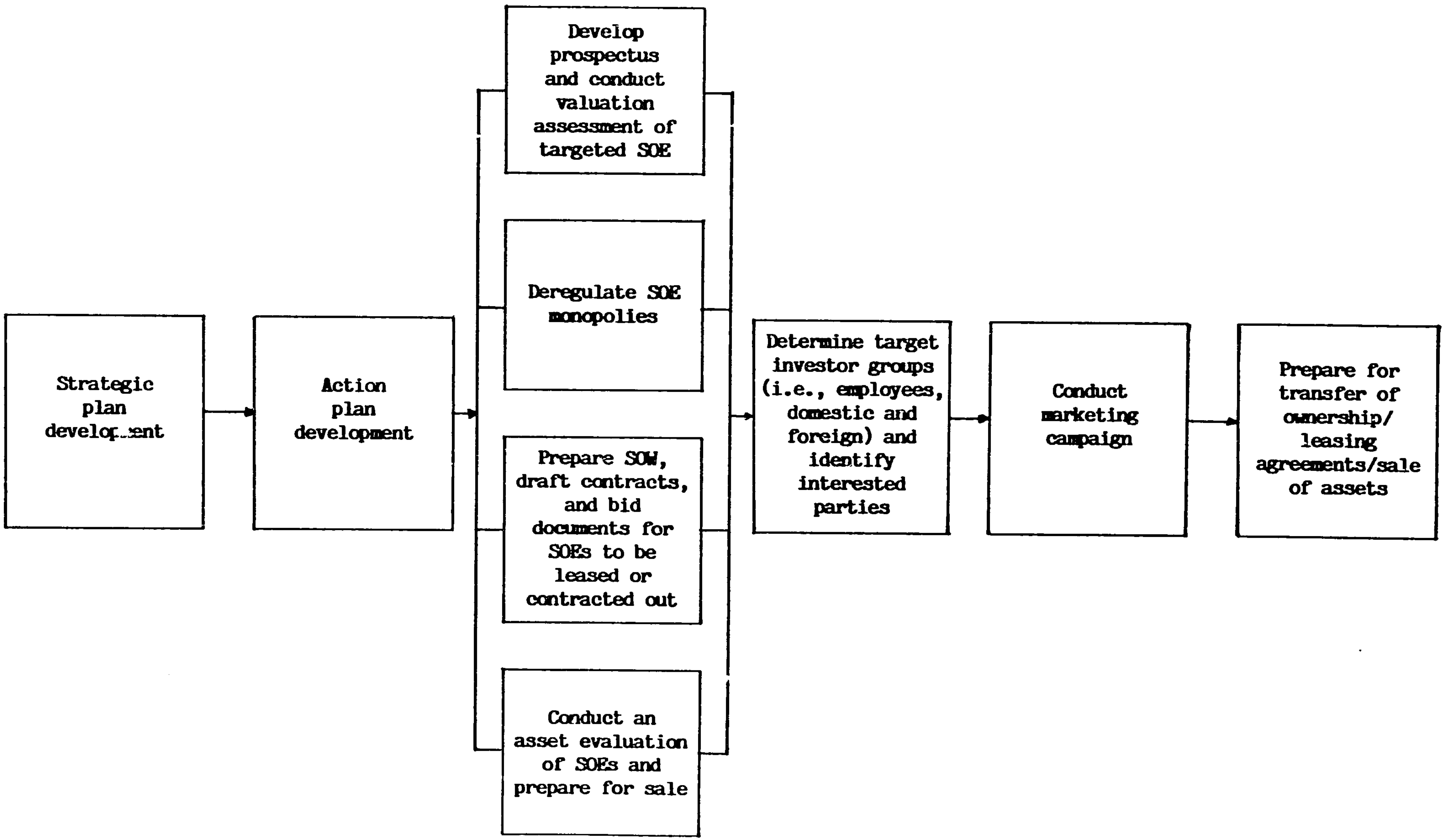



Diagonal line indicates alternative action may be required.

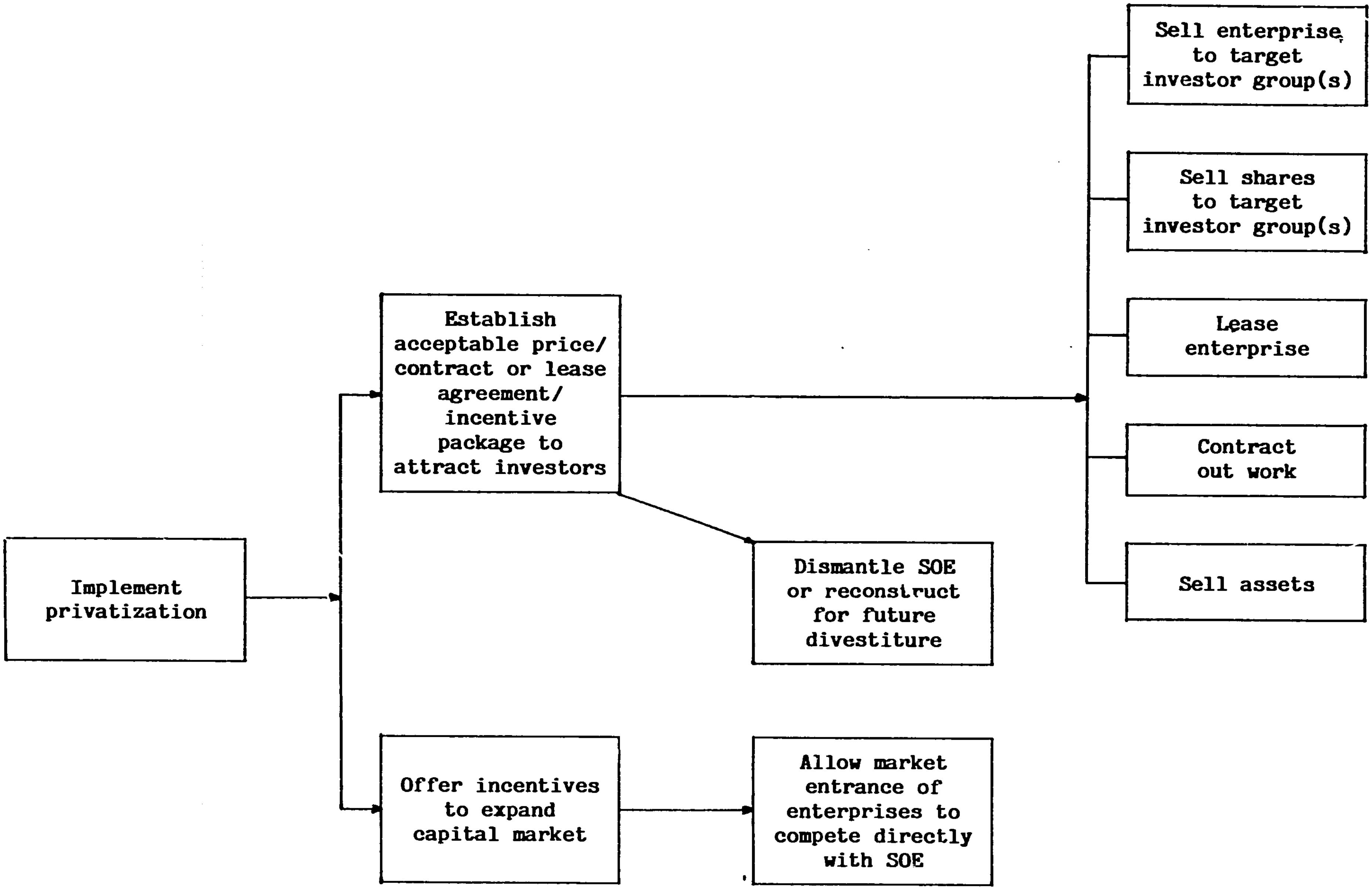
## PHASE TWO: EXAMINING PRIVATIZATION APPROACHES AND SELECTING STATE OWNED ENTERPRISE TARGETS



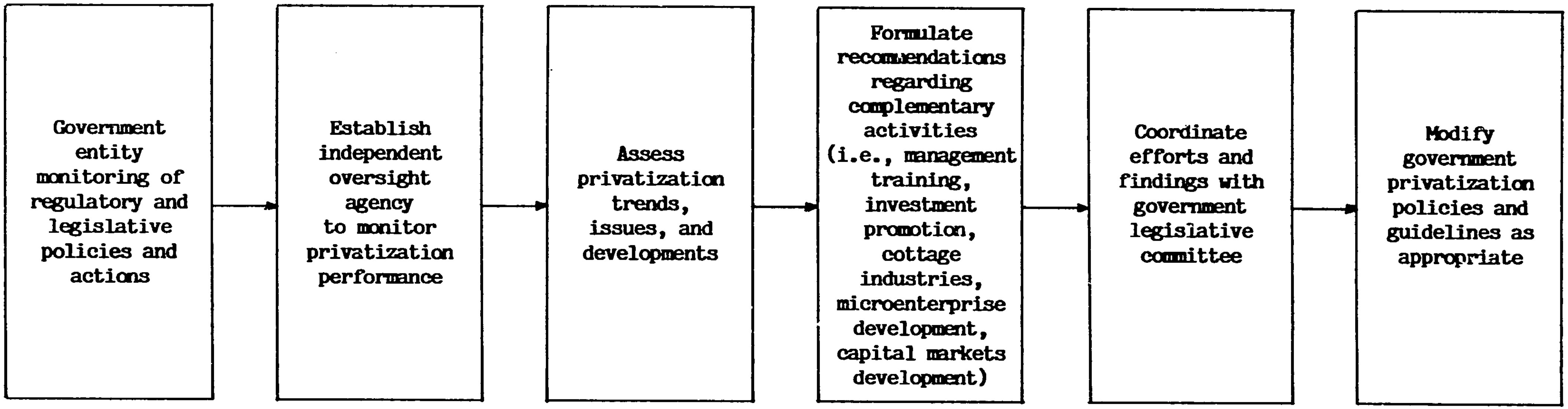
## PHASE THREE: PREPARING FOR INVESTORS AND MARKETING THE STATE OWNED ENTERPRISE



## PHASE FOUR: NEGOTIATING THE TRANSFER



## PHASE FIVE: THE ROLE OF GOVERNMENT AFTER DIVESTITURE



ATTACHMENT B

**PRIVATIZATION VIGNETTES**

## Issue Number 1: How to Reform a State-Owned Enterprise Targeted for Privatization

Problem: It is determined that policy reform is necessary for the SOEs to either become a viable operation or to make the operation attractive to potential investors. However, bottlenecks have slowed SOE reforms and no clear approach has been identified.

Solution:

- An effective approach to this problem is to begin by broadening the dialogue for reform of the public sector so that top government echelon gets truly committed to reform and conveys its commitment to the working staff. The most effective manner to pursue this dialogue is to approach the problem systematically for all SOEs. A coordinative approach to the reform of SOE's relies heavily on the formulation and definition of common guidelines pertaining to management by objectives. Legislation to this effect provides for the implementation of management accountability. At the end of each FY, meaningful and impartial comparisons between targeted and actual results will facilitate establishment of performance contracts and will lead to appropriate rewards and sanctions. This systematic approach was adopted with great success rate in Korea in 1984 for the control of government invested enterprises. Similar recommendations were made to the Government of Gambia in 1986 and results are still pending.

## Issue Number 2: How to Deal with a Lack of Qualified Managers

Problem: The Government has made a commitment to privatize an SOE but the Country suffers from a lack of managerial and technical expertise which is desperately needed to turn the enterprise around.

Solution:

- Foreign management contract. The Government can award a contract for a specified time period in which the contracting firm will manage the enterprise and train host nationals in efficient operation and management practices. In return, the foreign managers are given some level of equity as incentive. One example is: the Kenya Meat Commission, a habitual money loser due to ineffective and inefficient management. The Kenya Government contracted the operations out to expatriate management and the industry was turned around. The KMC, under new direction, tapped into the lucrative market for meat products in the Middle East, resulting in the restoration of its profitability.

- Contract, lease, or sell enterprise to foreign investors. These options are attractive for non-strategic enterprises targeted for privatization as stipulations can be made to involve a certain percentage of indigenous expertise in the provision of services. Overall, the country may gain management skills, a more efficient industry, and perhaps, easier access to foreign credit and technology.

## Issue Number 3: How to Increase Capital Availability

Problem: An SOE is targeted for privatization but there is limited local/international capital availability.

Solution:

- The Government may want to offer schemes for capital generation. For instance, the Pakistani Government devised a method for businessmen to cleanse black money by issuing bearer bonds at 17 percent interest. Although a high risk venture, it was successful in expanding the pool of capital resources as it raised approximately 200 million dollars from first sale of bearer bonds. The second sale is expected in early summer 1987.

## Issue Number 4: How to Deal with Groups Threatened by Privatization

Problem: Groups which feel threatened by privatization (unions, SOE employees) are becoming increasingly vocal about the proposed government action and are turning it into a political/social/economic issue. The Government fears a backlash.

Solution:

- As soon as the Government targets a SOE for privatization, open communication should begin immediately to curtail dissent. The Government needs to assure that worker rights and interests will be protected and that benefits can be derived for the individual as a result of the privatization. If it has been determined (or if there is a legitimate possibility) that privatization will result in streamlining the workforce, the government should begin to market and actively promote other possible off-shoot programs, such as retraining, job placement, compensation, early retirement programs, scholarship funds established for children, etc.

## Issue Number 5: How to Attract Investors

Problem: An enterprise is targeted for divestiture and potential investors have been identified but all investors have some reservations about short- and long-term profitability. What incentives can the Government provide the investors to "sweeten the pot"?

Solution:

- The Government may offer a host of attractive incentives to entice investors and enhance short- and long-term profitability of a given enterprise. These incentives may include:

  - Reduction of tax barriers.
  - Tax holidays.
  - Reduction of import restrictions/tariff barriers.
  - Promotion of free zones, free ports.
  - Deregulation.
  - Debt write off.
  - High rates of return on bearer bonds.
  - Freer movement of currency, in and out of County.

In Togo, the Government was able to attract private investors by offering: a 41 percent duty and regulated domestic prices; the investor would be compensated by Togo at book value on all improvements and assets if the lease was not renewed after 10 years; assurances of stable legal conditions; and, the right to transfer capital, dividends, and other funds for the duration of the lease. The result of Togo's privatization efforts was that it attracted its investors, resulting in the effectual demolition of its debt arrears, reduction from its domestic budget from 14 percent of GNP to 2 percent, and was able to decline another IMF rescheduling.

## Issue Number 6: How to Handle Resistance to Privatization from Middle-Level Bureaucrats

Problem: Privatization efforts in a Country have continually met resistance from middle-level government officials who have a legitimate or illegitimate vested interest in a targeted SOE.

Solution:

- For middle-level managers who have a legitimate vested interest (i.e., they serve in an official capacity with the management and function of the SOE; their power base in derived from the SOE's existence, etc.) it is important to give them early involvement in the privatization decision making process. Furthermore, how the privatization will affect middle-level managers should be openly communicated and decisions reached on how their services will be redeployed.

- For middle-level managers who have illegitimate vested interest (i.e., they have supplemented personal incomes with kickbacks, graft, extortion, and other corrupt practices relating to the SOE). Stronger controls are needed to curtail those activities and identify participating parties. Stronger controls may involve tighter financial reporting standards, periodic unannounced audits, or an independent firm contracted to check the inventory, contract award procedures, and SOE financial statements.

## Issue Number 7: How to Deal with Unacceptable Buyers

Problem: The Government of an ethnically segmented/divisive country is concerned about losing economic control of key industries to its ethnic rival(s). How can their interests by safeguarded?

Solution:

- The Government may wish to restrict the level of equity by ethnic group. Such a consideration must carefully weigh potential political/social backlash of this decision although it may be important to note that similar plans have been adopted in several countries, such as Malaysia and Kenya. In Kenya, for instance, restricting the level of equity by ethnic group has become a stumbling block for privatization. The Commission on Privatization identified three principal potential buyers for these targeted SOEs: (1) native-born Asians (Indians); (2) Kikuyus; and (3) foreign multinationals. It was decided that none of these candidates were "acceptable," and the program has been stalled on this issue for two years.

- Develop affirmative action and employment generation programs to safeguard the economic, social, and political interest of protected classes.

## Issue Number 8: Options Available for SOEs with Limited Commercial Viability

Problem: The targeted SOE has questionable commercial viability and has failed to attract investors. What options are available?

Solution:

- Liquidate. The Government may find that it needs to sell its assets at a loss to unleash its white elephants. This will allow other firms to enter the market or substitute industries to evolve if demand is recognized.

- Reorganize for later divestiture. If the enterprise is considered strategic, such as a transportation system, the impact of liquidating the enterprise may be more detrimental and costly than continued subsidies. Or, if the enterprise is worth more than the value of the assets, liquidation may not be the best alternative. The Government may wish to reorganize the enterprise (i.e., established clear performance objectives, develop new management practices and structure, award foreign management contracts, restructure board of directors, establish performance criteria, streamline activities, etc.) with the objective of enhancing its viability for future divestiture.

## Issue Number 9: What to Do if There is Resistance to Sell to Foreigners and No Local Capital

Problem: There is resistance on the part of some government officials to sell shares to private foreign investors as this may lead to loss of national control over industrial development. However, lack of either local managerial skills, financial resources, or interest precludes sale to domestic investors.

Solution:

- Many countries have legal restrictions on the percentage of equity holdings foreign investors can own. However, joint ventures between foreign investors and the Government or between foreign investors and local investors have been accomplished with successful results (providing the Government doesn't interfere with managing the operations). For instance, a joint venture arrangement is now being considered by the Government of Grenada in which SOE's will be owned by a conglomerate of foreign investors, employees of the SOE, and residential and nonresidential nationals. As most investors are wary of government interference in the management of the divested enterprise, there are a number of steps which can be taken to protect investor interest. Successful examples, such as Mali's divested SOE's, have safeguarded against government interference by restructuring the organization, restructuring the board of directors, and securing professional management.

## Issue Number 10: Excess Employees

Problem: Governments sympathetic to labor and the labor unions themselves fear higher unemployment if SOE's are sold since private owners usually want to reduce the number of employees to increase efficiency.

Solution:

- The Government can determine the impact of the sale of an SOE on employment levels or income distribution then the social prices can be computed to find the Social Internal Rate of Return (SIRR). The SOE with the highest SIRR should be selected. Municipalities of West Germany were concerned about rising unemployment rates if public enterprises were privatized and selected enterprises based on the projects impact on employment. Germany's League of Cities (Deutscher Staedtetag) conducted a nationwide survey of the 48 types of public functions contracted out by municipalities and found that the loss of jobs was, in fact, minimal.

Alternative Solutions:

- Some Governments have stipulated that the contractor or buyer retain a certain percentage of the employees and that the firm retrain those retained to occupy new positions.
- Governments can provide attractive early retirement compensatory programs.
- Stipulate that retirement plans are frozen when transferring from public to private sector.
- Provide alternative compensatory benefits for those whose positions are to be terminated, such as educational scholarships for employee's children.
- Transfer employees to other public sector enterprises for specified time period (a la Malaysia)
- Termination.

In a particular privatization study conducted by Public Administration Service for the Malaysian Government, the question was raised as to how to dispose of some 2,500 employees. The employees were, by law, to retain equal treatment under the transfer and guaranteed non-retrenchment. The new corporation, however, had no interest in retaining the employees.

The solution was long in coming, but finally it was agreed that the new corporation would "absorb" the 2,500 employees and not retrench any for a two year period. The Government of Malaysia paid in cash all outstanding obligations to the affected employees (i.e., obligated leave was paid and retirement funds were frozen in the employee's provident fund until the employees were eligible for retirement.

The result was successful--the privatization operation agreements were finalized and transfer of ownership was made in the spring of 1986.

## Issue Number 11: How to Sell Shares Without a Viable Stock Exchange

Problem: The Government would like to sell shares in the enterprise targeted for sale but the country lacks a viable stock exchange. How can this be accomplished without buyers misinterpreting the government offering as a distress sale?

Solution:

- One solution is to retain the help of a multilateral or bilateral lending institution to make available local currency to establish a trust fund to buy the shares of the SOE. The fund, a private entity, will take possession of the subsidiary(ies) and offer them for sale to private investors. Proceeds of the sales will be used to replenish the fund. A similar arrangement was worked out by the Costa Rican Government and the AID mission with its privatization of the Cost Rica Development Corporation. Although the divestment program has been in existence only a short time, successful results are expected within this year. Another divestment assistance program is currently being developed by the Honduras Government and the AID mission in that Country.

## Issue Number 12: How to Privatize Without Losing Control

Problem: The Government is concerned about losing control over a public enterprise for political, security, or national prestige reasons. How can the SOE be made more efficient and more profitable bearing these concerns in mind?

Solution:

- Establish a regulation commission. The Government need not own the industry to maintain nominal control (vis-a-vis standards for quality, health, and safety regulations) over it. Control can be exercised through regulatory commissions without the burden of day-to-day management, as was experienced in the privatization of select SOEs in Papua New Guinea.

- Foreign management contracts. Drawn up for a specified period of time, indigenous managers and technicians are trained to replace expatriates. This allows the LDC to gain management skills/easier access to foreign credits and technology. In addition, foreign managers are more insulated from political and labor pressures which would hamper performance objectives. Successful foreign management efforts are evident in Somalia as Hooker International turned around the Juba sugar project, in the Sudan where Arbel International had similar successes with the Kanena sugar project, and in Kuala Lumpur, Malaysia, waste management services have a foreign management contract with a British firm, GIS Waste Services.

- Leasing arrangements. The Government can lease enterprises in return for a share of profits. By offering attractive incentives to the lease holder, the Government provides the inducement to maximize profits. The Government can "privatize" without losing ownership of the enterprise.

- The Government of Jamaica initiated a tight long-term lease agreement with investors to turn around its hotel/ tourism industry. This resulted in the refurbishing of all four government hotels, higher occupancy rates, and increased tourism. Government offered incentives of tax write offs, waived duties on refurbishing materials, promotional campaigns, other tax incentives, government laissez-faire policy toward management of the enterprises, provided attractive incentives for the leaseholders to maximize profits. Similar leasing agreements have proved to be successful in Niger, with the leasing of three hotels, and in Kuala Lumpur with the leasing of a bypass road.

- Encourage market entrance of enterprises to compete directly with an SOE, or break up the SOE monopoly de facto. The expectation is that market forces will lead to cost cutting and greater efficiency. The Government can improve the climate for private sector market entry through structural adjustments in macro economic policies (i.e., reduce legal barriers to entry, decrease certain tariffs, provide tax incentives, etc.). This approach has resulted in numerous successes. In Zimbabwe, for instance, the relaxation of government price controls substantially increased grain supplies in one year.

- The elimination of certain select departments/division within the SOE and consequent contracting out or leasing of those divisions, particularly if they have proven unprofitable. Or, partially divest SOEs without relinquishing majority holdings. In Japan, partial sale of public sector enterprises in the telecommunications, national airline, railways, and tobacco industries has made these operations more efficient and profitable. In Malaysia, the Government has already relinquished a minority interest in the Malaysian Airlines System (and was so pleased with results that it anticipates relinquishing majority control by 1988).

## Issue Number 13: Safeguards Against Favoritism

roblem: The opposition to the Government has been charging that privatization will lead to the sale of valuable state enterprises to political cronies. What measures should be taken to ensure this doesn't occur?

olution:

- To avoid favoritism, the recommended procedure would be to have merchant banks and securities dealers handle the solicitation of proposals. The proposals should contain the suggested market(s) that will be approached. An approximate value of the proceeds to be received, documents required to effect the sale, and a timetable. The intermediary's fee for services should be on a "success fee" basis from the proceeds of the sale. By conducting the sale of the entities through a third party, the Government cannot be charged with selling on a less-than-arms-length basis for selling low. Privatization consultants have recommended the use of these tactics especially for politically charged countries like Papua New Guinea and the Philippines.

## Issue Number 14: Monitoring Contracted Performance Levels

Problem: Concern exists that once a contract is awarded the Government has no control over the level of service or quality of product produced from the divested enterprise.

Solution:

- Performance Criteria Contracts. A contract that is established without some means of objectively evaluating the performance of a contracted enterprise could result in considerable risk. Once the Government examines and identifies service areas that can be quantified, standards which must be adhered and/or acceptable levels of production, these measurements can be used to establish specific performance levels. These performance levels should be clearly stated in the contract. Contracts should include meaningful payment penalties when the defined level of acceptability is not met and, where possible, include incentives for service levels surpassing expectations.

  Performance contracts which penalize for overruns and reward for services or projects completed ahead of schedule, have been successful. One scheme pioneered by Britain's DOT required that construction contractors pay a daily rental charge for overruns of the stipulated construction time and are rewarded by bonuses for each day the project is completed ahead of time. A major repair job on the nation's largest motor way, the M1, recently netted the contractor a $400,000 bonus for completion six days ahead of time. If there had been a time overrun, the contractor would have been fined the equivalent of $65,000 a day.

- Trial Contracts. An alternative solution would be to establish trial contracts for pilot projects. Under these terms, a three to six month test period could be conducted of a portion of the total service areas under consideration for contracting. A pilot project allows experimentation in a new contracting area with little long-term risk. Pilot projects provide opportunities for head-to-head competition between public and private employees performing the same tasks during the period.

## ATTACHMENT C

### BENEFITS OF PRIVATIZATION

- Privatization has the effect of reducing Government's overall financial commitments in the forms of subsidies, subventions, and loans to state-owned parastatals.

- Higher real economic growth can be achieved with wider impact on living standards through greater efficiency.

- Proceeds from the sale of government interest in the privatized concerns will raise Government's revenue. Tax base will also widen.

- Making enterprises available for sale encourages wider share ownership and helps to develop a local capital market.

- Removing SOE obligations for key government policy makers will reduce management diversion and distractions.

- Privatization efforts serve as a signal to both domestic and foreign investors and banks that Government wants an improved investment climate--a prerequisite to reversing capital flight.

- Privatization provides a non-inflationary vehicle for debt/equity swaps would avoid monetizing the Government's foreign indebtedness.

- Expanding capital markets eliminates supply constraints which often exist when an SOE has a virtual monopoly position.

- Private ownership induces significant cost efficiencies by changing incentive structures to encourage and reward productivity.

- By shifting employment from involuntary taxpayer supported jobs to voluntary customer supported jobs, the market economy can better respond to consumer needs.

## ATTACHMENT D

## PUBLIC AND PRIVATE SECTOR ROLES AND RESPONSIBILITIES

The purpose of this paper is to examine the roles, responsibilities, and relationships of the public and private sectors with respect to establishing and carrying out privatization programs.

What I hope to accomplish with this paper is to share some ideas and experiences as they relate to the topic of discussion and hopefully provide some insights, possible solutions, and/or answers to those key problems, issues, and questions associated with the topic.

The central issues to be addressed include the following:

1. What is or what should be the respective roles of both the private and public sector in the privatization process?

2. How are the basic differences in purpose and mission of the two sectors reconciled in establishing and carrying out a privatization strategy? Or, program?

3. Where does (or where should) the responsibility of the public sector end and the private sector begin in the provision of public or "collective" goods and services?

I would like to begin by pointing out two things. First, the basic differences in mission or purpose of the public and private sectors often serve as impediments to privatization. Second, there is no set formula or prescribed level of involvement for either sector in providing public services and goods in those areas normally believed to be reserved for the private sector--that which, in terms of appropriate roles and responsibilities, is determined by the body politic or through an assessment of legal, social, and financial conditions.

The basic mission of the public sector, more specifically government, is first and foremost to "safeguard the public interest." Government must protect society by providing those public or collective goods and services that cannot (and should not) be denied any individual. On the other hand, the purpose or mission of the private sector is to supply goods and services in an open market with the intent of making a reasonable rate of return on investment. The mission of the public sector when broadly interpreted is or can be all encompassing. The mission of the private sector is more narrow by omission of certain services based on limited markets or non-profitability.

The broad interpretation of Government's responsibility to safeguard the public interest frequently results in its going beyond the basic provision of public or collective goods and services and ultimately delving more and more into those areas normally believed to be reserved for the private sector.

The rationale given for this encroachment is that Government believes that if the responsibility is left to the private sector, the quality and quantity of the supply of goods and services would not be adequate. Among the reasons frequently cited for this belief are:

1. That there are too few entrepreneurs available to provide the requisite level of services.

2. That most businesses are small and unsophisticated. Therefore, they are unable to meet the level of demand.

3. That the private sector is unable to raise sufficient capital.

4. That most businesses wish only to promote a specific product or service, frequently overlooking the several needs of the poor and rural areas.

5. Not to mention Government's desire to command the economy; its fear that certain activities will be dominated by expatriates and or local ethnic groups; and, its need to justify bloated bureaucracies in order to maintain power and prestige.

This leads us to the question, "How are the basic differences in purpose and mission of the two sectors and other significant issues reconciled in establishing and carrying out a privatization strategy or program?" Following are a few examples of the kinds of things that could be done.

1. Develop dialogue with business and community leaders.

    - Create private sector coalitions.

    - Demonstrate economic benefits (rate-of-return analysis) from sale of firm.

        a. Impact on national budgets.

        b. Financial impact on economy.

        c. Describe considerations necessary for impacts.

2. Communicate with groups possibly threatened by privatization (union/SOE employees).

   - Assure that worker rights are protected.

   - Demonstrate benefits.

   - Market/promote other possible offshoot programs, i.e., retraining, job placement, compensation.

3. Assure that national rights are protected.

   - No "fire sales" to foreign interests or political cronies.

4. Continue to foster support and monitor results through the entire privatization process.

5. Develop mechanisms for disposing of equity.

   - Subsidize sale of stock (British Telecom).

   - Free distribution of stock (placement in holding company).

   - Employee ownership (takeover/buy outs).

   - Use of debt write-off to attract investors.

6. Establish policy for dispensing with government employees and minimizing social welfare trauma.

7. Establish the role of government during and following divestiture.

   - Monitor results.

   - Formulate recommendations regarding complementary activities, i.e., management training, investment promotion, capital markets development, etc.

   - Formulate recommendations for modifying national privatization policies and guidelines as appropriate.

## ATTACHMENT E

## SUGGESTED ROLES & RESPONSIBILITIES OF THE PUBLIC & PRIVATE SECTOR

Following are suggested roles and responsibilities of the public and private sectors in carrying out privatization projects.

Role of the Public Sector

1. To develop a programmatic privatization policy which is cognizant of legislative, political, social, and financial barriers (capitalization, tax structures, trade barriers, etc.)

2. To foster private sector activities:

   - Deregulate government monopolies.

   - Provide tax incentives to encourage entry of private sector.

   - Strengthen privatization coalitions; government/private sector partnerships.

   - Allow development of free zones for foreign private sector development; broaden pool of investors; allow indigenous participants of "free zones" to develop means for equity purchases.

Role of the Private Sector

1. Involvement in initial stages of public policy formulation.

   - Support privatization coalitions. The private sector is in the best position to assess barriers and structural or technical weaknesses in policies. Should assist government in developing a reasonable approach to dismantling barriers (i.e., work with legislators for tax reforms, modified tariff structures, etc.)

   - Should support the use of incrementalism as opposed to "revolutionary" tactics to ensure smooth transition in implementing programs.

2. Provide technical resources to assist government assess privatization policy and in actual implementation of privatization.

3. Must respond favorably to and support government initiative.

   - Confidence factor is major issue.

   - Government must be willing to take risk and private sector should be fully prepared to work at accomplishing the initiative.

## SUMMARY

- Privatization cannot succeed unless the political leadership is committed to it.

- Public services to be provided by the private sector must be specific and have a measurable outcome.

- The importance of educating the consumer and disseminating information to the public cannot be overemphasized.

- Equity is an important consideration. The benefits can accrue to the capital owner who supplies the service; to the consumer who receives more efficient service; and, to the public at large through the reduction of public deficits.

If privatization is to succeed, Government must redefine its role to:

- Search for ways to increase competition in the supply of public services.

- Disseminate information so that the public will support privatization and become more rational and discriminating consumers.

- Monitor and evaluate the delivery of public services.

## CONCLUSIONS

It is very likely due to country circumstances that many services will remain the responsibility of the public sector. In this eventuality, the public must be able to exercise control, directly or indirectly, over the efficiency and effectiveness of the institutional arrangements for such services.