

SOME POLITICAL ASPECTS OF PRIVATIZATION

BY

**Paul H. Elicker
Executive Director**

CENTER FOR PRIVATIZATION

**2000 Pennsylvania Avenue, N.W., Suite 2500
Washington, D.C. 20006**

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CENTER FOR PRIVATIZATION

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**Paul H. Elicker is the Executive
Director of the Center for
Privatization since January 1986. He
served as management consultant with
McKinsey & Company prior to joining
SCM Corporation where he was CEO and
Chairman for 15 years.**

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Paul H. Elicker
Executive Director
Center for Privatization
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The purpose of my talk to you here today is to share with you what we at the Center for Privatization, from our experience in 47 countries over more than three years, have come to feel are some of the most universal political questions that relate to privatization in any developing country, and to discuss with you possible ways to deal with them.

You may agree, as I do, with the view that privatization is a political process that operates in the field of economics, not the reverse. From what we have seen, the key questions that arise in any country's privatization program are political ones. The key decisions we have seen made have been made on political grounds. And the problems that arise and the ways found to solve them, again from what we have seen, are also in the political arena.

Before going any further, I have two "caveats" which might be useful to keep in mind:

1. Privatization is not a "cure all" for all economic ills. It is a tool and a very powerful tool. But tools usually come in sets and are more effective when they do. Policy reform, for example, is another tool best used concurrently.
2. This paper emphasizes the vital political component of privatization. But privatization is not exclusively political; it has economic aspects, technical components and requires a range of consulting, investment banking and country-familiar skills.

QUESTION 1: DOES THE POLITICAL WILL EXIST?

1. The key question.
We consider this the key question; it is the first thing we want to know when considering a country's privatization profile and outlook. If power-possessing political will is there, the odds are that privatization will proceed. If not, we are very alert

to not wasting any government's money. In the absence of political will, a waste of money is a strong possibility.

2. How does one know if the political will is there?
The problem is that the mere statement by government officials that they have the political will and a forthcoming program does not always mean that political will is always really there. How do you tell? There are some indicators.

The first indication would be the existence of a clear statement by government endorsing privatization. This is much more credible if this statement comes from the very top level and is in writing.

In most cases, for countries starting to consider privatization, there is already some implementing legislation and some form of organization, however tentative and rudimentary. The existence of these preliminary steps does not prove political will, but their absence may well prove the presence of the absence of political will.

But the most important indicator of political will is whether privatization has a powerful active champion.

3. Who are the champions likely to be?
From the point of view of prospects for effective privatization, the higher up the champion of privatization is in the political hierarchy, the better. The Chief of State or the Prime Minister is the best candidate. However, depending on the particular governmental organization, while a champion at too low a level does not establish political will, a champion at the very top level probably also requires somebody further down who also has the political power and ability to implement.

At this next level, the most likely candidate is more frequently than anyone else the Minister of Finance or someone under his jurisdiction. This is because the origins of a privatization program are always pragmatic and more often than not in response to financial need. It is usually the case that the losses and cash drain of state owned enterprises are unsustainable and the government has exhausted alternative sources of funding to maintain them.

However, a frequent pattern is one in which the champion is from an area seemingly not directly related to privatization. I am not at all diminishing his importance when I call him a "front man". Again, there are political reasons for this. As we will discuss, there is plenty of political heat to be generated in privatization and this type of champion is usually a person able to take the political heat and triumph over it.

4. Rate of Progress

Even with the most powerful political will possible, we should always recognize that the rate of progress in privatization is going to be slow. It is also by its nature going to be "two steps forward and one step back". Political resolution takes a long time. At the Center for Privatization, our experience tells us that a privatization program sufficiently definite to be programmed, usually has a time sequence mapped out for it of about two years, but in actual practice the time required to get from here to there is just about double that.

QUESTION 2: HOW IS A RECEPTIVE POLITICAL CLIMATE CREATED?

1. Special fears of developing countries

Most countries approach privatization with apprehension and intense concern as to both the political and the economic outcome. But developing countries have certain special fears. Many in the country view privatization as a possible return to the bad old days. They fear neo-colonialism. Neo-colonialism is an emotional issue and privatization's opponents therefore start with an emotional advantage.

2. Being clear about objectives

One of the initial ways to create a receptive political climate is for the government to be clear almost from the outset about its objectives. This is particularly so since much of the fear of neo-colonialism is fear of an uncertain future. Setting objectives is also important because privatization is not an end in itself. It is only worthwhile if economically "good things happen" as a result.

It is also important practically speaking. How the country constructs its program obviously depends very

much on where it hopes to go. If, for example, the primary object is to raise revenues, then the privatization targets selected, their asking prices and their offering programs will be very different than if, also for example, the object is a program of broadened popular capitalism or becoming more competitive in export markets.

Being clear about objectives at least substitutes some knowledge for fear of the unknown. It is, for example, a key element in reassuring and attracting potential foreign investment.

3. Who are the opponents and why do they oppose?

One cannot effectively deal with opponents unless you know who they are and what motivates them. This is important in privatization. Privatization is inevitably going to have opponents. It does in every country we have observed. In most cases, these opponents represent distinct interest groups which have, or perceive they have, more to lose to privatization than they have to gain from it. Typically, who are some of these interest groups and what are their typical attitudes?

The first is the bureaucracy itself. All state-owned enterprises have a sizable body of civil servants administering them. In many cases, there are a large number of people excess to the needs of the enterprise. In such cases, this bureaucracy is at risk in what many of the individuals see as a risk to their jobs. Under the present arrangement they have certain powers; they have certain perquisites. They do not on the face of it see why they should put these at risk for an uncertain future.

For much the same reasons, the military, especially when it has political power, is typically opposed. It is interesting to note that when the Pinochet regime in Chile first started its privatization programs in the 1970's it was estimated that 95% of the military politicians were opposed. By the 1980's, the military saw that this was, come what may, the will of the president, and that to get ahead in their careers a knowledge of economics and personal endorsement of the government's programs was necessary. As a result, by the 1980's, it is estimated that 95% of military officials with political power had been drawn from the

ranks of those economically sophisticated and that same 95% was in favor of the program.

Labor is traditionally opposed, particularly union officials. Their fears are somewhat different. Not without some reason, they fear loss of jobs. They of course also fear a similar decline in union membership. All of this is aggravated in many countries by the fact that the government has used state owned enterprises as a disguised welfare system, where excessive employment masks what would otherwise be the true unemployment rate. Labor fears dismantling of this system that, while often an increasing national disaster, is personally comfortable for them.

Surprisingly, an interest group that one would think was an automatic natural ally, sometimes is not: this is the private sector itself. Especially in countries with a wealthy private oligarchy, these individuals have privileged industrial, economic and social positions that, in their opinion, could only deteriorate with change.

4. How to deal with opponents

The first essential is to access all those who have a major stake in the outcome of a privatization program and to bring them into a dialogue. Negotiation is possible and can take place in dialogue. I once talked to an individual who had done a two week survey of privatization possibilities in Argentina who told me that he had not talked to any labor leader during that period of time. I cannot imagine a privatization program in Argentina that did not seek support in a compact with the concerns of the labor unions.

One of the most powerful ways to neutralize and even make converts of the opposition is to bring them into the program with something to gain. This is why employee ownership participation programs are now becoming so important and such a powerful tool. If one has something to fear, one is likely to be an opponent; if one has something to gain, one is likely to be an advocate. In one country, 96% of the employees subscribed to a stock offering of their company against the expressed and vigorous opposition of their union.

It is interesting to note also that various non-employee groups are sometimes given favorable

subscription rights along with employees when a company is privatizing. Usually this is an attempt to make converts of interest groups in the opposition and it can be a successful maneuver. Broadened stock ownership plans should have a bright future for a variety of these political reasons.

A dialogue with the private sector is advisable beyond the fact that it is one of the interest groups with something at risk. The private sector, after all, is the one element in the country that has had the most direct experience with operations in privatized surroundings. It can provide helpful guidelines.

Experience shows that one of the most effective means of dealing with opposition from those interest groups that are somewhat under the control of the government is the use of a very simple tool: steady, insistent pressure on the part of top officials of the government, backed by illustrations that the government is determined. This is especially effective in bringing the bureaucrats around.

An important component in creating a receptive political climate is instituting of a public awareness program. This is being done increasingly by privatizing countries. Whereas three years ago a public awareness program was a rare thing, it is now the rule for countries starting such programs.

There are some do's and dont's to public awareness programs, of which I will mention four:

- a. They should be related to the culture in which they operate. This suggests that if and when firms are engaged to conduct such programs they should be local or regional. This is sometimes hard because the necessary skills, at a sophisticated level and backed by experience, are often lacking in developing countries.
- b. Public awareness programs should identify the interest groups--such as those mentioned above--their relative strengths, and especially their attitudes and the attitudes of the general public. In other words, a public awareness program suggests being preceded by a public opinion survey.

- c. If they are to gain acceptance, public awareness programs should not be flashy, should not be high-profile, and should not be too expensive.
- d. To be convincing and not full of "hot air", they should be backed up by sound research, accurate statistics and understandable financial projections. As we will see a little later, it is also very important to cite a few concrete "success stories."

5. Areas of political attack

Opponents will mount a political attack if they think this has political appeal and can be successful. It is well to take note of the kinds of attack that have been most prevalent. By far the most prevalent kind is an attack on the price of enterprises offered for sale. If sales prices can be perceived as low, the government can be portrayed as either naive or corrupt. More about this when we come to QUESTION 6.

Similar, although slightly different, is the charge that the government is "giving away the national patrimony" in selling to foreigners. Other frequent charges are that the government is selecting the wrong buyers; selling to its cronies; or selecting buyers based on "excess payments" of one kind or another.

6. Political Postures

It is probable that privatization is more difficult in a democratic than an authoritarian regime, especially if that democracy is economically and socially divided. Political opponents will seize on privatization almost as a matter of course so that the opponents we are dealing with are not just interest groups but interest groups that are the constituents of political parties. Nevertheless, in a surprising number of cases, the ruling party has been able to avoid major political confrontation and instead been able to negotiate either an explicit or tacit political standoff. Whether or not they are able to do this probably depends on how urgent the economic damage being done by state-owned enterprises is perceived to be. Under such circumstances, the attitude of the opposition in accepting a political standoff is likely to be: "We are going to oppose you where we can take political advantage. If, in privatization, you take inflammatory

actions, we will respond to them and if you make mistakes we will take advantage of them. But we agree that if you will impose limits on yourself, we will limit ourselves at least to the point where we do not drag the country down economically by over politicizing this issue."

7. Election Visibility

We should also take note of a phenomenon that almost inevitably occurs. No matter how strong or weak the political party implementing privatization may be, and no matter how much the government has political will, as an election approaches the government will try to reduce the visibility of its privatization program or intentions so it does not become an explosive issue. This is a fact of life for the practitioner of privatization. The de-emphasis usually begins as early as a year and a half before an election.

QUESTION 3: HOW SHOULD THE STRUCTURE FOR PRIVATIZATION BE ORGANIZED?

1. Existence of preliminary steps

Almost no country gives serious consideration to privatization without having already taken some preliminary steps. There is usually a phase of early experimenting with privatization during which some form of loose organization, often no more than a committee, is put in place and some legal scaffolding erected. I indicated earlier that in fact the existence of these preliminary steps can be the indicator that political will exists. Why is this preliminary groundwork usually present?

Adoption of a privatization program is taken primarily for pragmatic reasons. This alternative arouses serious fears. Therefore, usually the government has tried other programs. It has tried to make state-owned enterprises more efficient, to "restructure" them or tried to set them up as if they were independent entities even though they are not, i.e. "commercialize" them. Usually this does not work for a very simple reason: Privatization means exposing an enterprise to market forces, and the other hoped-for remedial alternatives do not do this. So governments usually turn to privatization almost as a last resort, having tried other approaches. In the initial phases they take hesitant steps, still hoping that perhaps some of

the other alternatives will work. One of the characteristics of privatization however, is that much more than other alternatives, privatization tends to be irreversible.

2. Should the government create a privatization "director general"? There are two basic ways in which a government can organize for privatization. Both methods have had successes; both have had failures. The government can create a privatization "director general" who, at least below the ultimate policy level, has all operational responsibility. Or it can conduct the program on a decentralized basis: each ministry "does its own thing" with privatization of those state owned enterprises under its jurisdiction.

The problem with the decentralized method is that it does not really employ the "champion" previously identified as so essential to privatization. Also, privatization is a long process. Under these circumstances, if the Minister of Agriculture, for example, is the champion and gets a program started in his ministry, and if he is replaced at some point a program mounted with some difficulty is likely to founder in midstream for lack of successor enthusiasm.

Privatization requires a principal who is dedicated. It is this need for dedication that has the trend running in the direction of creating a director general, increasingly the more popular method.

The problem with creating a director general is the possibility that the government bureaucracy being dismantled is merely succeeded by a new bureaucracy to accomplish privatization which then proceeds to develop its own vested interests and institutionalize itself. It is interesting to note that in Great Britain the director general of privatization, insofar as regulation of public utilities goes, says he asks himself two questions. The first is, "How do I administer and regulate the forthcoming privatization?" But the immediate second question must be, "How do I do it effectively with the least amount of administrative expenditure?"

3. Role of Committees

Any review of governmental organizations to accomplish privatization will come up with a surprising pattern: the existence of commissions or committees, with usually a fairly large number of them. For example, in Honduras there are three separate governmental committees exclusively devoted to one or more aspects of the subject of privatization.

Why is this? Again we look to politics for the answer. The existence of multiple committees shares the burden of political heat. It is not infrequent for the privatization organization itself to report to a committee which in turn may report to another committee. Again, the reason is sharing of the burden of political heat.

Look at the structure of these committees and look at the steps legislatively required and often in both you will see a common theme. This theme is in response to a critical need of a successful privatization program. The process should have transparency; it should be subject at every stage to public scrutiny. A transparent program says to the politician: "We give you no guarantees, but if you will abide by this organization and follow these procedures, this is the best way to stay out of political trouble or at least share the burden if it arises."

The creation of committees is often designed to further this objective.

QUESTION 4: WHICH COMES FIRST, POLICY REFORM OR PRIVATIZATION?

1. The first "which comes first" issue
Whether privatization is best preceded by extensive policy reform, so that it does not operate in an antagonistic climate full of obstacles, or whether privatization can lead the way and get the country started with specific instances where policy reform can evolve out of these events, is a "which comes first" question.
2. Both are needed
The answer of course is that the country is going to have a much better program if policy reform and privatization go hand in hand. This is not unnatural

because, particularly where alternate political parties exist, the party adopting privatization often takes office with a broad economic mandate within which privatization is only one element. In passing, it should be noted that the combination of the two is the mixture most likely to attract foreign investors. In country after country that has started a privatization program, but has yet to have much to show for it, the principal inhibition at the stage where buyers are being attracted is the absence of policy reform.

QUESTION 5: WHAT ARE THE POLITICAL ASPECTS OF PRIORITIZATION?

Prioritization is that step in the privatization process that prepares a list of state-owned enterprises in order of which should be privatized first. It occurs after the state-owned enterprises have been identified, but usually before they have been valued as to the appropriate price for them.

1. Setting priorities is a political process
In this step as with so many others we are reminded that the key decisions are made on political grounds. There is a practical reason to this because out of context there can be no one abstract "right" order of priority.
2. What are the goals of the program?
Once again, where the country starts and in what order it proceeds is related to where it is trying to end up. But there are other issues that will require decisions, whatever the goals and whatever the country.
3. "Easy" versus "Difficult"
Some privatizations can be seen in advance as relatively easy to accomplish, others are more difficult. Following are some of the aspects of this that experience shows are important:
 - a. Regardless of the experience of others, and regardless of the care with which the privatization program is constructed, privatization is uncharted territory for each government newly approaching it, and it is full of unexpected turns. This practically guarantees, especially initially, that government is going to make some mistakes. In fact, often each

successive country makes many of the same mistakes.

- b. It is very important to avoid initial failure. Nothing will harden and strengthen the opposition like a failure, and nothing will sink the program in public esteem more than early failure.
- c. It is important to produce an early success. Not only is success the opposite of failure, but being able to introduce a concrete example of success into the continuing political debate arms proponents with a powerful argument.
- d. The question of whether privatization will be by public offering is important. The riskier privatizations are likely to be private sales; only the more promising ones with profits are good candidates for sale to the public. Often we encounter the objection that local markets are too thin to be able to absorb a large new stock offering, but experience shows that if the price is right to make it an attractive investment compared to other alternatives, the money should be there to take up the offering.
- e. In any case, it seems wise to have as the first priorities not a single company but a manageable small number, perhaps three. Something unexpected is going to come up. Priorities are going to change for a number of unknown reasons, and under these circumstances it is wise to have more than one horse in the first race.

All these considerations suggest that on balance it is probably better to start off a privatization program with some "easy" privatizations. The deck should even be stacked so that the country is pretty sure an initial success will ensue. This approach does not mean, however, that a government should postpone addressing the "difficult" privatizations, which are more likely to be the important ones. The danger does exist that a government could ring up a stack of "easy" privatizations but not accomplish as much economically as it could with a broad approach which includes both easy and difficult cases in its initial planning program.

4. "Grand design" or "Ad-hoc"?

A "grand design" mode is one where the country does not proceed with specific privatizations until it has studied and mapped out a program in considerable detail. "Ad-hoc" is the other extreme. In this case, the country privatizes what happens to come up at the moment without regard to where it is trying to go in the longer term. "Grand design" programs are more likely to occur in highly centralized economies, "ad-hoc" programs where the privatization effort has been set up under a decentralized organization.

There are pitfalls to both approaches, particularly if they are adopted in the extreme. The "grand design" may draw up a master plan but, given the inevitable slowness of privatization, not much may happen for many years. This danger is probably particularly the case for complex economies with a large proportion of the economy under state-ownership. I can well imagine that insistence on putting all the pieces in place in a program for Brazil, for example, could in itself take many years. The "ad-hoc" approach in the extreme has some of the same pitfalls spoken of earlier concerning a decentralized privatization organization. Such a program can operate in fits and starts and, in the absence of a consistently dedicated champion, specific privatizations can get started but fall by the wayside.

This is probably a good time to refer to the concept of the "strategic sector". The question of the strategic sector often comes up in connection with setting goals. Most countries considering privatization seriously can easily agree that there are certain routine enterprises, usually those that manufacture and sell a product, that are not the natural business of government. On the other hand, when we come to those areas that serve public need, more often than not government adopts a very different attitude. This "strategic sector" often includes utilities, transportation, communications, natural resources and sometimes public services. It is not unusual for a government to forbid their privatization or at least give it a low priority.

The answer to this is that privatization, being a process, is always an evolving program. Given a successful program, there will be a growing acceptance of privatization. What is not doable at all in terms

of public acceptance today may be doable in small pieces tomorrow, and quite acceptable thereafter.

5. Liquidations

It is reasonable to estimate that if we listed the names of each separate state-owned enterprise in the third world we would find that at least a third were not in operation but represented non-operating assets, in many cases almost abandoned. Without denying that some of these, transferred to the right hands, could be revived as going enterprises, we would still expect that if we took a world wide count of the number of "privatizations", we would find that a good number of them were in fact liquidation candidates and that the liquidation had been accomplished.

While liquidation may make economic sense in a large number of cases, it often does not make political sense and it obviously does not have political appeal to the public. Accomplishment of liquidations that are otherwise economically rational are therefore always going to lag.

6. The leasing alternative

It is important to recognize that divestiture, which is what we have principally been talking about, is not the only form of privatization. Liquidation is really another form of privatization. Hiving off operations that are parts of companies, i.e., partial divestiture, is another form. Leasing or contracting out to private management, while less complete than divestiture, is sometimes a practical or preferable alternative to begin the privatization process. Leasing, particularly to politically acceptable parties, is one way of easing political confrontation. This, and the fact that contracting out is relatively easy to do with hotels, is one reason why privatization of hotels is often an early step.

QUESTION 6: WHAT ARE THE POLITICAL ASPECTS OF VALUATION?

Put in political terms, the key question is: Who will the public hold responsible when the book value of a state-owned enterprise is overvalued or it is proven to be economically not viable?

1. True worth of state-owned enterprises

There are more state-owned enterprises that lose money than there are that are profitable. It follows, therefore, that in most countries the portfolio of state-owned enterprises is a mixture of profitable and unprofitable companies. The "value" if any, of an unprofitable company is very difficult to determine, compared to a profitable company, and will be subject to a wide variety of opinions.

Valuation is a key political ingredient in the privatization process that answers the question: What is each state-owned enterprise currently worth? What would a willing buyer pay in a free market place for the enterprise?

The difference in value between profitable and unprofitable companies is that almost by definition a company that has been consistently losing money is probably not worth the accumulated net investment that has been put into it. Let's add the fact that the investment cost, or "book value" of the enterprise has sometimes been consistently inflated by excess payments which further increase the discrepancy between investment and true value.

This makes valuation a very critical matter, probably the first big political hurdle a privatization program has to overcome.

The case of Alunasa, a government-owned aluminum mill in Costa Rica that was an early part of that country's privatization program, is a good case example. The book accrued value of Alunasa when it was being prepared for divestiture was \$52 million. Investigation showed that a similar, and slightly newer, aluminum mill in Venezuela had recently been built for \$8 million. This and other computations resulted in an estimated market valuation of like amount. This unexpected difference between book value and estimated market value caused a tremendous furor. In the end, more than a year later, the mill was sold for \$7 million following a period of unsuccessful search at higher prices for a satisfactory buyer.

There are two principal lessons from this example. First, a big difference between net worth and apparent market price can become an intense political issue.

Second, this kind of political issue, like many political issues, can cause substantial delay. The question of valuation discrepancy probably accounted for at least a year's delay in Costa Rica's privatization program.

3. A line of opposition attack

Under these circumstances, it is not surprising that valuation can be one of the main lines of opposition attack on privatization. It is easy to see the party responsible being charged with all the alleged ills of privatization: selling at too low prices, selling to the wrong people, and virtually giving the nation's treasures away to undesirables. Thus valuation, which on the face of it seems to be an accounting procedure with relatively well defined technical aspects, can quickly become a major political issue. It is understandable that those politicians involved in privatization programs view valuation with apprehension and primarily in political terms.

QUESTION 7: WHO WILL THE BUYERS BE?

As with all steps in privatization, identification and selection of buyers has its difficulties.

1. Preparation time

Getting ready to attract buyers in a systematic way should be recognized as a lengthy process. I estimate that getting up and running in this area can take as much as a year. The principal consumer of time is prospectuses. In a privatization context, I should not really refer to the documents we are talking about here as prospectuses. They are really information kits. While they do not usually have the same strict legal requirements as a prospectus, they do have to be accurate, systematic and attractive, a training period in their preparation, sometimes a lengthy one, is often required.

2. Acceptable Buyers

A key political question is: What buyers are going to be acceptable to the government? There are three groups that are prime candidates for being discriminated against or at least having limitations placed on them. These are foreigners, ethnic groups, and former owners, particularly those from the "bad old

days." Somewhat to my surprise, the unacceptability of these groups in most developing countries is stronger for the latter two domestic groups than for foreigners. As often as not, the economic logic of including foreigners among those to whom sales may be made is powerful enough to override political objections. Buyer exclusions, taken in the extreme, can seriously inhibit a country's potential privatization program, Finding the "right" buyers with genuine plans and capabilities to build a healthy and competitive enterprise is critical to the success of any privatization program, but artificial barriers may serve as a screen to protect the "silent opposition."

3. Method of Sale

The method of sale adopted, terms that are acceptable, limitations on share of ownership and various other controls and conditions are often importantly conditioned by these questions of who is an acceptable buyer.

4. Controls and Conditions

Depending on what the goals of the country's privatization program are, controls and conditions can be used to favor certain groups or discriminate against others. In a positive sense, they may, for example, provide reassurances to attract flight capital back.

The point here is that, while the government does impose practical constraints on itself, it is usually under no absolute obligation to sell to the highest bidder. It can in fact exercise considerable freedom, providing it conforms with the law and is willing to take the political consequences of its selection of buyers and terms of sale. As noted above, it is well advised to be transparent in this process. See the discussion below of "popular capitalism" which is an area where governments frequently grant preferences in ownership acquisition to various sections of the public whom they want to become owners. Recognition of the fact that there are no absolute rules in selection of buyers is important in designing a privatization program.

Often a government also wants to impose operating conditions; for example, that certain railroad lines be maintained, or that certain remote sections of the country be served. Sometimes it wants the buyer to

assume some or all of the state enterprise's debt; in other instances, in order to make the enterprise attractive to the market, the government itself will agree to take responsibility for the debt it had created. Often it does not want to accept conditional terms of sale and sometimes will insist on a cash transaction where the buyer arranges financing outside the government. All of these can be appropriate conditions. They will be subject to public scrutiny. And of course all of them affect the ultimate price that is paid.

5. Private Monopolies

One of the most common fears in developing countries, particularly among the opponents of privatization, is that privatization will result in the transference of a public monopoly to a private monopoly, and that a private monopoly would be even worse.

At the risk of saying something unpopular, I think this concern is exaggerated. There is not much to be said for a private monopoly. It certainly is not to be preferred, but at least a private monopoly is or can be subject to some indirect market competition and can be subject to more strict environmental or other controls, whereas a public monopoly can continue on, regardless, with remarkably little control. The key point is to make sure in the transfer that even an enterprise naturally monopolistic will be subject as much as possible to market forces.

But more importantly, there are ways to address the potential problems of creating a private monopoly. After all, government regulation can and usually does continue to exist. I can think of no free country where strategic sector companies have been privatized where there is not some continuing or newly established regulation by the government. Regulation has been almost the central administrative concern of the privatization program in Great Britain.

If we are frank, I think that the hue and cry that all a privatization program will bring forth is private monopoly, is often a convenient and politically popular excuse for inaction.

6. Market Shielding

The key point is that whatever restrictions government places on a privatizing transfer, it should not agree to market shielding usually in the form of economic protectionism. This means that installation of tariffs, perpetuation of large subsidies and other market shielding devices, while sometimes expediently adoptive, are almost always bad.

QUESTION 8: DOING THE PRIVATIZATION: WHAT ARE THE OPTIONS?

I will deal now with the different ways of actually selling a state-owned enterprise and getting it into private hands. We will see that one of these options--offering shares to the public through a national stock market--presents our second "which comes first" question. In most developing countries, if there is a stock market at all, it is very infant and not a sufficiently powerful vehicle for a privatization program aimed at transfer of sizable amounts of stock. The "which comes first" question is whether the country should first try to strengthen this stock market so it can eventually support a public stock offering privatization program, or whether it should start out early with a public offering privatization program in the expectation that the infant stock market will grow in response to the need.

1. Options Available

In any case there are several different options available as ways of bringing buyers and sellers together. There can be a public auction with bids entertained under whatever rules the government prescribes. There can be private negotiations with one or more potential buyers, whether this be for purchase of all, or part, of a company or for joint venture or contract, and there can be a public offering. In effect, therefore, creation of a capital market increases the options by adding this last one.

2. Popular Capitalism

This term is used to mean offering all or part of the stock of a state-owned enterprise to the general public, usually through the stock market. Popular capitalism was a major theme of the privatization programs in Chile and Jamaica and has been employed extensively in Great Britain. In Chile, about 100,000 new stockholders have participated in these programs.

In Great Britain, the number of stock holders under the Thatcher regime has increased from 2 million to 9 million.

What started as merely an alternate way of disposing of state-owned enterprises has become a goal in itself. Popular capitalism has been seen as a way of giving the general public a direct stake in private enterprise, and has been seen by governments of the left and right to have popular political appeal, creating a new category of voter allegiance. By now, popular capitalism is one of the four or five most prevalent objectives of privatization programs.

3. CONRAIL Experience

In terms of different options available, the United States' one major experience in privatization, CONRAIL--the rail freight operations in the northeast-- has an interesting twist to it. Under a Republican administration, the more conservative wing of our two major political parties, CONRAIL was to be privatized by negotiated bid. But it was the House of Representatives, controlled by the more liberal Democratic party, that called this approach off, almost at the last minute, and prescribed what was ultimately the largest public offering in the history of the New York Stock Exchange, and a successful one. Popular capitalism is not the exclusive property of any one point in the political spectrum, on the left or on the right.

4. Individuals and Institutions

Note that one of the important features in these public stock offerings is that they are generally made with emphasis on wide distribution, with as many individuals participating as possible. This is a trend in the opposite direction from that in the United States stock markets today, where an increasing amount of stock movement and subscription comes not from individuals but from institutions. While popular capitalism is a relatively small part of total stock movement in industrialized countries, it is nevertheless significant there and can be doubly significant in developing countries.

5. Privatization as Catalyst

By their very nature, one can not completely resolve "which comes first" questions. But on balance it is

our feeling in the Center for Privatization that, when offered for sale to the general public, an enterprise that appears to have a good future, and that is attractively packaged and priced, is likely to bring out capital far beyond expectations or guidelines from past experience. Importantly--particularly if these stock offerings are part of an established privatization program--flight capital may come back. In other words, privatization can serve as an important catalyst in developing capital markets. In my opinion, more often than not, offerings should not be held back on the grounds that the capital market mechanism is too frail.

The well-known case of Jamaica's second largest bank, NCB, being privatized is a good illustration. 51% of the bank's stock, which had been held 100% by the government, was offered to the public through a stock market that had been open only a few hours a week. This was not only the single largest offering going through that stock market, but represented 10% of the total value of the Jamaica Stock Exchange. The offering was preceded by an intensive publicity campaign, and all of its terms and conditions were designed to make it primarily a popular capitalism offering. The terms were such that the appeal was not primarily to the wealthy, who were restricted in their ability to purchase, but was aimed at the average citizen and at employees, 98% of whom subscribed. An amazing total of 30,000 individuals purchased the stock, which was attractively priced, and the offering was 170% over-subscribed.

Kenya presents another good example. An offering of the country's second largest bank was made, with the targeted participants again being popular capitalism. In fact, the Kenya terms and conditions were modeled on the experience of Jamaica. This time the offering was a minority 20%. Again there was an intense publicity campaign and the issue was again over-subscribed by a large number of participating individuals, many of whom were first-time stockholders. This time the over-subscription was 300%.

6. Need for Institutional Support

All this seems to imply that financial institutions need not play any role in privatization offerings under a popular capitalism program. This is not the case.

From the point of view of popular capitalism, institutional interest and participation is important to fulfill the role of after-market support following the initial offering.

Experience is somewhat mixed, but the preponderance of evidence is that persons buying stock under a popular capitalism offering usually have incentives to hold on to it and to some extent to do so even if the market later goes down. In the Jamaica bank case, over 90% of the original subscribers still hold the stock.

QUESTION 9: HOW DO WE DEAL WITH REDUNDANCY?

1. One of the major fears

One of the reasons statism has not worked is because many important decisions affecting the economic health of a state-owned enterprise have been made for other than economic reasons. Especially in developing countries and especially in the case of money losing enterprises, payrolls have been swollen way beyond economic necessity. Therefore streamlining is in order, and there is a legitimate fear of the economic consequences and political backlash from resulting unemployment.

2. Not a major factor

While this is a legitimate fear, the historical facts are that this has not yet been as much of a problem as these fears suggest. The fact is that there has not been as much unemployment as might have been feared. For one thing, many governments have yet to face up to these kinds of difficulties and have not tackled the privatization of the really tough cases. Most countries are still in the initial phases of privatization anyway and, as previously discussed, some of the decisions to defer these difficult and potentially explosive privatizations has wisely been deferred.

For another thing, many governments have concluded, also wisely, that the political heat is best borne if privatization is delinked and preceded by reduction in employment. For the government to do this takes courage and is tough to do, but that it is possible has been abundantly demonstrated in both Chile and Great Britain.

3. Means of dealing with redundancy

The point is that redundancy is a genuine problem but there are means to deal with the problem. To some extent, the problem can be shifted over to the prospective purchaser, provided that the government recognizes that the cost will result in a reduced purchase price, with possible "bad news" consequences later on allowing the opposition to say "we told you so."

Governments can, should and do provide their own safety net, usually supported by existing legislation, to provide for early retirement, severance pay, retraining and other temporary support costs. Paradoxically, the worse the performance of an individual state-owned enterprise has been, the lighter the comparative burden of the government's unemployment safety net becomes. There are plenty of cases where the government-paid redundancy cost, even over quite a period of time has been substantially less than the annual losses of the state-owned enterprise.

One of the important counterbalances to the fears of redundancy is the use of an employee stock ownership offering. Conceptually, this is entirely sound. After all, privatization does represent certain risks, and from many individuals' point of view, redundancy is one of them. Looked at from this point of view, an employee stock ownership plan, which includes employees who may become redundant, can serve both as an incentive and as compensation for the individual risk involved.

4. An economic pattern

There is or should be an underlying economic pattern here: when a privatized firm is streamlined, decreased employment results and redundancy is applied. But over a period of time, and sooner than one might think, the improved enterprise grows and employment goes up past what it had been during the state owned enterprise days of over-employment. To my knowledge, comprehensive developing country experience has not yet been collected on this point, but this was the pattern in Chile, and I believe has been the pattern in Great Britain and in Togo. For one thing, not many countries have had a large number of enterprises reach this stage with the ability to make a comprehensive judgement. Obviously, this pattern is more likely to apply in a

strong growing economy, which attracts investment and investors, than in a weak one.

QUESTION 10: SHOULD THE GOVERNMENT EMPLOY DIRECT CONSULTANTS?

Every country contemplating a privatization program deals with the question, "Do we go it alone? We want it to be our country's program, not an imposed import from somewhere else. For this reason, outside help could be embarrassing and counterproductive."

1. A special concern of developing countries

This line of reasoning is a special concern in developing countries. In most of these countries there is a relatively small pool of local talent with the experience and know-how to help in either the technical or the conceptual aspects of privatization. This fact, coupled with mistrust of the local private sector anyway, provides considerable justification to looking for advice and assistance from outside consultants.

2. History and reasons

The fact is that I can not think of a single developing country that has accomplished a privatization program without help from outside the country. The skills called for are a combination of consultancy, first-hand knowledge of accumulated parallel experience in other countries, and investment banking. These usually do not exist adequately in most developing countries. But beyond this, there are some reasons why using outside assistance makes a lot of sense:

- a. An outsider who operates independently and at arm's length is more likely to make uninfluenced and balanced judgments.
- b. We have previously discussed the insulation and transparency functions that are an important part of a privatization program. An outside consultant can often be used to take some of the political heat, particularly when it comes to realistic market valuations which may be difficult for politicians to accept.
- c. Experience shows that as a privatization program gets up a head of steam, it is helpful to subject it to a steady constant push. A push from outside can indeed be helpful, but not if it is of the

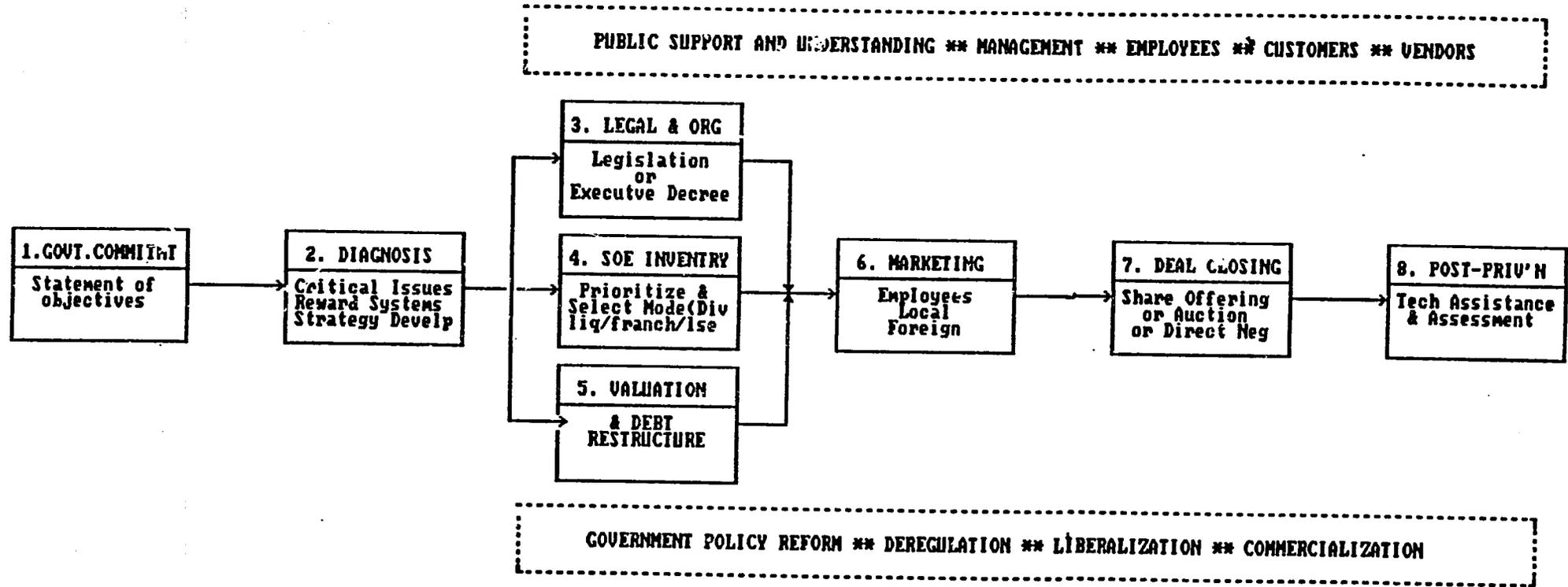
intermittent kind that results from the comings and goings of foreign consultants, and dies down when they are away. There is in fact a definite trend, when mounting a major privatization program, to install a continuing presence of outside help. The Center for Privatization has three such installations in place now, staffed with both foreigners and locals. This serves the additional purpose of transmission of knowledge whereby over a period of time the visiting experts transfer their skills to their host country counterparts.

CONCLUSIONS

1. Privatization is a world-wide phenomenon. It has an historical origin, born in the late 70's, largely out of the nationalizing experience from the 60's and coming into flower in the 80's. It is not correlated with rich or poor or with any one form of government. There is every sign that, as an economic movement, it is still in its early stages. A country embarking on privatization is not alone; to the contrary, it is in the mainstream.
2. Privatization is a continuous process, not an isolated series of transactions. Like any process it has first to overcome inertia and get started. As the process gathers momentum, it turns into a program. The process is lengthy and proceeds more slowly than expected.
3. The motivation is usually pragmatic. Developing country governments embark on privatization programs because they have serious problems or strong needs. Usually they have considered and even tried other alternatives that have not worked.
4. Privatization is a political process operating in the field of economics. It takes time, and the starting ingredient is political will. The key questions that arise are political, and the decisions and the routes taken have important political components.
5. There is a proper role for private enterprise and one for government. Privatization is the transfer of

economic authority over an enterprise out of government hands into private hands. Its ultimate objective is to achieve economic benefit by exposing the enterprise to market forces. In the true sense, privatization is a sorting out between private enterprise and government of what each does best. Private enterprise is an economic activity that is the best means of creating economic value. Government is a political activity that is best at guiding and implementing the broad welfare of a nation.

PRIVATIZATION FLOW CHART



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