TAB C

"An Overview of Privatization and the A.I.D. Experience"

by L. Gray Cowan

AN OVERVIEW OF PRIVATIZATION AND THE A.I.D. EXPERIENCE

by

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I. An Overview of Privatization

The world-wide interest in reducing the role of the public sector in national economies is essentially a phenomenon of the past three to five years. The growing movement to privatize industries, services, and agencies that have hitherto been controlled by government and the changed conception of the role of the public sector are largely products of the pragmatic realization that the state-owned sector is not working and an awareness of the enormous subsidies needed to maintain money-losing enterprises and services. The conviction is growing that private entrepreneurs can manage industries more effectively and can operate services more efficiently and at lower cost to the public than can government.

Europe and Canada

In Western Europe, the shining example of successful privatization thus far has been the program embarked upon by the Thatcher government in Great Britain. Motivated by the desire to promote public share ownership in divested state enterprises and introduce competition and market discipline into fields which had been the sole possession of government owned monopolies, Thatcher's government felt that privatization would bring both greater efficiency and widespread consumer benefits. The program has resulted in: approximately 850,000 former tenants becoming the owners of houses formerly belonging to local government authorities; majority private control of British Telecommunications has been achieved by share offering in the largest floatation ever made (to be surpassed in 1986 by the sale of the British Gas Corporation); and disposal of a variety of other enterprises ranging from road haulage to hotels to an automobile plant. The new shareholders of British Telecom realized an immediate profit on their holdings while telephone service has improved substantially under private management. Complete privatization, combined with reduction of the government's share in other enterprises, has netted nearly $30 billion so far, with a promise that this figure may be doubled with future sales of British Gas, British Airways, airports, and other state-owned companies.

Privatizing is on the agenda of other European countries, though not everywhere to the degree envisaged in Britain. In Italy, efforts are being made to overcome the multi-billion dollar annual losses of the government-owned holding companies, IRI and EFIM, by the sale of telecommunications and other units. Spain's National Industrial Institute has been ordered to reduce sharply the number of companies it controls to reduce its losses. West Germany is at the outset of privatization but intends to reduce its holdings in Lufthansa (the national airline), banks, and steel and aluminum factories. Despite the government's announced plans, little has been done to limit public sector holdings in Holland; in France, any serious privatization will have to await the outcome of national elections. In Spain, the government's privatization program has been argued not as a matter of ideology but of common sense. Europe's near neighbor, Turkey, has extensive plans for privatization and the necessary legislation is in place to dispose of a number of state enterprises, but concrete results thus far are limited.

Canada has for some time been in the process of privatizing some of its Crown Corporations by reducing the government's stake in them by sale to the private sector; in particular, the conglomerate Canada Development Corporation is now almost entirely in private hands.

Privatization in Britain and elsewhere has not been without its critics. In the U.K. the government has been accused of selling national assets simply as a means of increasing revenues to avoid the politically unpleasant necessity of raising tax rates. The parliamentary opposition has vowed to reverse privatization for ideological reasons, if it should get into power. But as the political constituency which has benefitted from privatizing continues to grow, it will be increasingly difficult and costly to revert to government ownership.

Privatization in the Less Developed Countries (LDCs)

For the LDCs, the increasing interest in privatization is reflected in the growing number of requests that USAID Missions have received over the past two years for advice and assistance in establishing privatization plans. Indicative of LDC concern are the figures that emerged from a cable sent by the Department of the Treasury to all Embassies and Missions in April, 1985 seeking information on the status of privatization efforts at each post. All but four of the nearly 60 replies received indicated that divestment and privatization of state-owned industries and services was of concern to their governments. The degree of interest ranged from the early stages of discussion to the initiation of action plans to divest or liquidate specific industries. The reason most often cited for this centered on the financial pressures created by subsidies. It was evident from the replies that one of the major obstacles to more rapid privatization was simply a lack of knowledge of how to go about the process.

All too often governments tended to see divestment as a simple process of announcing a willingness to sell and finding a suitable buyer at a price the government was willing to accept. One of the more difficult tasks facing the Missions was to convince governments that privatization is a long, slow and often frustrating activity. In most cases technical assistance is required in the early planning stages in evaluating the assets of the firms to be divested. For those to be sold, buyers must be found and domestic or external financing sought.

Hand in hand with privatization go assistance in developing capital markets, provision of credit facilities, and reform of macro-economic policies to enable the private sector to expand. Governments must be made aware that if industries are protected from market forces, little will be gained from privatization. In some countries the private sector has not yet been sufficiently developed to provide the domestic financing necessary to buy state-owned firms offered for sale. There may be resistance to sales to private foreign investors where it is feared that this will lead to loss of national control over industrial development and governments need to be convinced that this need not be the case. Examples of successful joint ventures can be cited to allay these fears.

Opposition to privatizing has arisen from the labor movement which sees a threat to jobs in overstaffed state industries, from the bureaucrats whose power of control over these industries will be reduced, and from prominent ex-politicians and military officers whose sinecures as board members will disappear.

Privatization concerns in the LDCs have centered not only on divestment of failing industrial enterprises but on privatization of agricultural parastatals and of services, particularly in municipal transport.

Agricultural marketing boards have been a characteristic form of government intervention in most former British and French colonies. Established originally to protect the farmer from fluctuations in the world price of agricultural export commodities, the boards continued to be used after independence to regulate food prices in the interest of the politically vocal urban inhabitants. The result was to reduce production incentives for the farmer to the point where food shortages, aggravated by weather conditions, could only be overcome by costly importing of food grains.

In the straitened financial circumstances of recent years, governments have begun to work toward liberalized agricultural policies, reducing official marketing and input roles to place greater reliance on market forces in setting prices for agricultural products. There is a somewhat greater inclination to allow the private sector to handle marketing of grain and sale of fertilizers provided the government can be assured that the sector has the capacities to do so. Since the price and constant supply of food to the urban population is of critical importance to political stability, governments are loath to entrust this important function entirely to private hands. Nevertheless, the importance of examples, such as that of Zimbabwe, where relaxation of government price controls substantially increased grain supplies in one year, is not lost on other governments.

Municipal transport services have, in most countries, required substantial subsidization and have provided less than satisfactory service. In cities where private transport has been undertaken at a profit in competition to the municipality and has provided more satisfactory service, there has been a move, as in Calcutta, to turn it over to the private sector. There has been increased discussion of similar moves in the case of national bus lines and even of railways, although in the latter case, finding a private buyer in any country has been extremely difficult.

Asia

Privatization in the developing world has, with some exceptions, been hampered by the lack of capital markets and credit facilities available to the private sector. Privatization cannot take place without capital in private hands to provide potential buyers for divested state-owned industries. Substantial progress has been made in Southeast

Asia in developing sophisticated financial institutions and consequently, privatization has made correspondingly greater progress. On the other hand, in only three cities of Sub-Saharan Africa (Abidjan, Nairobi, and Harare) can there be said to exist a fledgling capital market. A second major difficulty faced by many countries is simply that there is no real knowledge of the extent of the public sector; commitments have been made by numerous ministries without central coordination and as a result, the government may find itself with a financial interest in enterprises over which it has exercised no control.

In Southeast Asia, Malaysia has taken an especially strong interest in privatization, in part because of the examples furnished by Singapore and Hong Kong and, in part, because of the Prime Minister's interest. The government has recently sold a minority interest in Malaysian Airlines System and expects to relinquish majority control by 1988. Under discussion are the sale of facilities at Port Klong, and the contracting out of a variety of municipal services. Maintenance of the Malaysian national air force is privatized. Much more ambitious is the proposed divestment of the national telecommunications system, using the British example. In this case, as in others where international business is developing rapidly, the government was faced with the prospect of investing heavily in the modernization of the national communications system or having business bypass it for more efficient private systems. Privatizing was the logical alternative.

Thailand has plans to privatize its telecommunications system as well as railroads and municipal transport systems but they have not yet come to fruition. The Philippines government is struggling to divest itself of the 36 companies owned by the National Development Corporation which were taken over to prevent their collapse when they failed under private management. Of the well over 200 other companies owned by government, most require substantial subsidy.

Among the less developed nations of this area, Bangladesh has taken a major step forward in returning to private ownership jute mills which were nationalized over a decade ago and plans to privatize other major state-owned industries. The Indonesian Government is showing increasing interest in divesting some of its state-owned enterprises, particularly in the banking area.

In the Far East, Japan has reduced its already comparatively small public sector with the planned partial sale of telecommunications, the national airline, railways, and the tobacco monopoly. The government expects that competition will make these firms more efficient and profitable.

Under the guise of improving socialism, the Peoples' Republic of China has initiated widespread reforms in agriculture and industry aimed at improving individual incentive and industrial productivity.

Latin America

In Latin America, privatization has had a somewhat checkered history. In Chile, the military government has long been committed to privatization; and over a decade ago the bulk of state-owned firms was sold to the private sector. The results were not always good; many failed and had to be rescued by the government. But the experiment has served to strengthen the private sector and has led to the establishment of private pension funds alongside the existing state fund.

In Mexico, President de la Madrid's government announced early in his term divestment of 236 state-owned companies, but thus far fewer than fifty have been put up for sale (although these include important hotel and auto making firms). Questions have been raised about the seriousness of the government's intent since sale of some obvious candidates has been refused based on the familiar argument used elsewhere of strategic importance to national security.

Brazil's pragmatic new president, Jose Sarney, is determined to reduce the state sector of the economy, and a list of 520 companies to be divested has been prepared (100 of which are to be dealt with in the next two years). But there is still a long way to go--nine state-owned firms take up over three quarters of the parastatal budget. The government is willing to sell portions by share offering, but not a controlling interest. In Argentina, the civilian government is developing plans for privatization but they are only at an initial stage.

Uruguay's new government has expressed interest in divesting parts of its holdings in the industrial and agricultural sectors.

Africa

Privatization on the African continent has been progressing more slowly in part because of a lack of "how-to" knowledge, financial constraints, and political hesitation by governments. The pressure on governments to reduce the subsidy burden is growing; in some cases, African governments have been refused loans from commercial banks because their portfolios are entirely committed to servicing the debt and operating subsidies of the public enterprise sector.

In West Africa, Togo has made the most energetic efforts toward privatization. Under the direction of the Minister of State Enterprises, all of the country's public sector enterprises are up for disposal. The IBRD has provided technical assistance and advice on evaluation and finding buyers for them but thus far with little concrete results because of lack of investor interest.

Kenya's Task Force on Privatization has, for the past two years, been examining the disposal of some of the country's more than 400 enterprises in which the government has an interest. Progress has been delayed, however, because of political reservations to the sale of enterprises to the only potential buyers -- particular ethnic groups or foreign multinationals.

A more promising prospect for the immediate future in the African context appears to lie in leasing and management contracting of state owned firms, which avoids the political accusation of loss of control of public enterprises. A particular aspect of leasing, hotel operation, is becoming more common, as in the case of three hotels in Niger and similar possibilities in Tanzania.

All too often in Africa the choice lies between continued operation of enterprises at a loss or liquidation, a step which governments are loath to take. In the occasional instance, such as in Madagascar, former owners of nationalized firms are waiting in the wings to regain control. But African governments have not yet fully recognized that losses on the sale of divested firms will have to be accepted and that inflated government estimates of the value of state enterprises will not find ready buyers.

II. The A.I.D. Experience in Privatization

A.I.D has moved quickly, although cautiously, to respond to LDC interest in privatization. The Agency has initiated privatization programs in a number of countries or has provided technical assistance in planning for such programs. Activities undertaken under these programs provide an indication of the role the Agency has been called upon to play. Some illustrative examples are discussed below.

In Jamaica, the government has decided on a serious divestment program and a Divestment Committee has been appointed. An Economic Support Fund (ESF) loan in 1984 provided for an annual public audit of state enterprises and for privatization of thirty companies. A later agreement provided for the sale or lease under foreign management of hotels owned by the government. The A.I.D. Mission has assisted the work of the Divestment Committee by providing accounting and business consultants from the United States.

Responding to a request from the government of Costa Rica for assistance in divestment of parastatal enterprises, the A.I.D. Mission made available local currency to establish a Trust Fund to buy the shares of subsidiary enterprises now owned by the Costa Rica Development Corporation, a government enterprise. The Fund, a private entity, will take possession of the subsidiaries and offer them for sale to private investors; proceeds of the sales will be used to replenish the Fund. To assist the Controller General of the government in arriving at an acceptable minimum selling price for each subsidiary, the Mission will finance outside consultants to evaluate the firm's assets. The Divestment Program has been in existence only a short time but successful results are expected within the year.

In Honduras, a program for assistance in divestment of state-owned enterprises is being developed jointly by the A.I.D. Mission and the government. Legislation passed in the autumn of 1985 required divestment of firms now owned by the national investment company (CONADI) and this will be implemented with technical assistance provided by the Mission, especially in accounting and marketing.

A regionally based service has been established to advise the East African governments on divestment and privatization plans and to provide technical assistance in financing and accounting to develop these plans.

The USAID Mission in Mali has established an Economic Policy Reform Program, among the objectives of which are reduction of the public work force and the privatization or liquidation of selected public enterprises. The program is also designed to improve the efficiency and accountability of public enterprises (particularly agricultural parastatals) not considered ready for privatization at this point.

In addition to direct advice to governments by country Missions, the Agency has available technical assistance in privatization and capital market development by consulting contracts administered by the Private Enterprise Bureau (PRE) and through a consultant to the Bureau for Program and Policy Coordination (PPC).

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

PPC's consultant is preparing a detailed manual on the divestment and privatization process for use in Washington and in the field. He enables PPC to respond to requests from Missions for advice on proposed privatization projects, in an effort to apply the experience of other countries to the specific problems faced by the requesting Mission. Over the past two years, he has prepared a number of memoranda available to Field Missions on specific aspects of the privatization process as well as case studies of individual country divestment plans in Thailand, Tunisia and Malaysia. He has met with government and business specialists on privatization in London, Paris, Bonn and with the EEC secretariat in Brussels. He has also visited Missions in Bangladesh, Indonesia, Thailand, the Philippines, Sudan, Kenya and Jamaica.

Pressures for financial reform by the IBRD and the IMF have contributed to raising LDC interest in privatization. The World Bank is assisting in the preparation of divestment plans and is reviewing the current position of parastatals in several countries with a view toward rationalization and improvement in managerial capacities. It is also supplying technical and financial assistance to prepare individual state-owned enterprises for privatization. AID is coordinating its efforts with those of the Bank.

The Agency is also cooperating with the U.S. Treasury in urging the Multilateral Development Banks to liberalize their lending procedures to make available direct loans to the private sector in member states without government guarantee. The Asian Development Bank has already taken steps to implement this policy change.

III. Lessons Learned

AID's experience in privatization thus far has already provided lessons in effective assistance to developing countries that are planning divestment programs. Among the more important of these are:

-- The privatization process is essentially a political decision although economic forces may prompt it. It is essential to have a prior understanding of the local political situation, the power bases, and the sources of influence before proposals for privatization are laid before the government.

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

-- It is important that the government have a clear idea before embarking on privatization as to what its objectives for the program are and why it is undertaking it. Governments may not always find it politically desirable to enunciate these objectives publicly and in detail since any one of them may well alienate some faction in their constituency spectrum. But it is essential that within the inner circles of government the goals be understood.

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

-- Any strategy for privatization must take into account the groups working against it whose interests may be harmed if divestment is successful. These may include politicians and bureaucrats whose positions and power may be eliminated, those concerned over the sale of public enterprises to local private enterprise or sale to non-nationals. A divestment program must include strategies to deal with these opposing groups.

-- In a majority of LDC cases governments require technical assistance in evaluating enterprises and in finding markets for them. It is essential that options be clearly explained and understood by government officials and that a true picture be presented of the state of enterprises to be divested. Even with this, governments may still insist on inflated prices for industries to be sold. They may have to be persuaded to write off losses on earlier public sector investments even in the face of political pressures against it.

-- LDC governments should be impressed with the fact that privatization is a long, slow and often frustrating process; it cannot be accomplished overnight. It should not be seen as a panacea for all the financial and policy problems facing the governments. To be effective, privatization efforts must be accompanied by structural adjustments in areas such as foreign exchange control and policy decision making as well as measures to encourage expansion of the private sector by capital market development.