TAB I

6. "Public and Private Responsibilities in Privatization" by Dr. Madsen Pirie and Peter Young

PUBLIC AND PRIVATE RESPONSIBILITIES IN PRIVATIZATION

A strategy to promote privatization in developing countries

by
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THE ROLE OF WESTERN DEVELOPMENT AGENCIES

Western development agencies could do much to promote privatization in developing countries. In some cases developing countries have already started down the privatization road, and require extra support and advice. In other cases countries are actively considering privatization and need encouragement. And some countries need to be persuaded of the necessity of privatizing in the first place. Privatization should assume a much more important place in the thinking of development agencies.

As a first step, direct monetary aid to countries should be conditional to a greater extent on their economic policies. The adoption of sensible economic policies, including progress on privatization, should be sought. When aid is given for specific development projects, private sector involvement should be urged, and in so far as possible made a condition of development aid. For example, aid to construct and operate irrigation networks, roads, or electricity generation facilities could be given on the condition that these are privately built and operated.

A variety of new policies and initiatives are required, which could form the basis of a comprehensive program to boost privatization and economic growth in the third world. These initiatives can be broken down into two types: Information and advice, and financial assistance.

The Proposals:

A. Providing Information and Advice.

An important role for western development agencies is to provide information and advice to LDCs which are interested in privatization. Obviously the experience of developed countries in privatization does not translate exactly to the third world. Nevertheless, there are important lessons which can be learnt from this experience.

1. Units should be established within western development agencies with specific responsibility for encouraging privatization in the developing world. The units should co-ordinate the various policies instituted to promote privatization, including the policies of other government departments and agencies

2. A number of specialist teams are needed to provide advice on privatization to developing countries. These teams should be made up of officials with privatization experience from various government departments and agencies, managers seconded from newly privatized companies, and experienced individuals seconded from the financial institutions with privatization expertise.

3. Regular conferences on privatization should be held in Asia, Africa, and Latin America in which privatization specialists from both the developed and developing world could outline their views and experience and attempt to gauge third world problems and perspectives with regard to privatization. As privatization experience becomes more extensive in the third world it should be

subject to constant review. One possibility might be to make the USAID conference on international privatization an annual event. The production of a series of 'how to' privatization manuals would also be advisable.

4. Representatives of western governments should take a more active role in putting the case for privatization when visiting other countries. In particular, government representatives responsible for trade matters, who travel more regularly than other ministers, could be more forceful in pointing out the benefits of privatization in terms of increased economic activity and trade.

5. Delegations of LDC officials should be funded to visit Britain and other countries with an extensive privatization record for the purpose of gathering information on privatization. LDC officials should be seconded to western government departments involved in privatizing parts of the public sector.

B. Financial Assistance.

The major obstacle to privatization in developing countries is the lack of adequate capital markets. For this reason conventional western style privatization will prove difficult to transplant to the third world. However, there is much that the west can do to remedy the problem of the lack of capital. Indeed privatization itself could prove an important means of building up capital ownership in developing countries and thus spurring further economic growth. In fact this should be one of the main aims of privatization and policies should be crafted to help achieve this.

An additional problem in many developing countries is antipathy to foreign ownership. This is usually a legacy of the colonial period, when much of the economies of these countries was controlled by western interests. Indeed the desire for domestic ownership of industries was in many circumstances a key factor in the original nationalization of many enterprises. Thus the takeover of nationalized concerns by foreign interests is not a viable option in most countries.

1. These concerns about capital and foreign ownership do not apply in the case of the form of privatization known as contracting-out. Here the LDC government remains in charge of the government function, but contracts out its provision to qualified and experienced firms. A number of western companies specialize in providing such services as garbage collection, street cleaning, air traffic control, etc to LDC governments. This practice should be encouraged and expanded. Firstly because it saves money, allowing scarce resources to be spent elsewhere, and secondly because it builds up indigenous private sector expertise in the provision of these services. Western firms under contract in LDCs usually employ indigenous managers who should be able to gain sufficient experience to start their own contracting firms.

Accordingly western policy should be designed to increase the practice of contracting-out by offering advice about the writing of contracts etc, to encourage western firms to employ indigenous personnel, to train such personnel and others to form their own contracting companies. The provision of loans to those wishing to set up their own companies should be considered.

2. One method of attracting foreign capital without many of the

attendant political problems is the creation of freezones or freeports in LDCs. LDCs should be given advice and financial assistance to set up freezones. These can act as a focus for investment and private sector development, attracting and building up private companies which can provide the capital required for successful privatization. Freezones are already proving a useful innovation in the developing world and their number has increased dramatically in recent years.

The provision by western governments of tax incentives for western companies investing in these zones might be a useful part of this policy.

3. A major problem that is sometimes associated with the privatization of public sector entities in the third world is the need to dispense with surplus staff, both in the public sector enterprise concerned and in its overseeing agency. This might have significant domestic political consequences. One method of dealing with this problem is to provide substantial lay-off payments to the excess staff members, so they are able and willing to finance the transition to a new job or set up a business of their own. The cost of this can accurately be viewed as a capital investment. LDCs may lack the resources to make this investment and would therefore incur severe political hostility from the staff to be displaced, hostility which might prevent privatization being seen as a viable option.

In these circumstances it would therefore be sensible for development agencies to make funds available to LDC governments for the provision of suitably generous voluntary lay-off payments.

4. However more significant measures are required to surmount the lack of capital problem. The most radical suggestion would be for development agencies to make capital available for privatization of third world public sector entities by purchase of equity shares in the new company. Western governments, including the US government, have so far not favored this policy. Such a purchase of shares is in effect a method of giving funds to the government of the developing country, which it might use as general revenue or to finance some particular project. Thus aid is given, but with the added advantage of assisting privatization.

This equity participation by development agencies does have some advantages. Firstly, the participation of such reputable bodies will increase investor confidence. Secondly, through participation the agencies will be in a better position to monitor the progress of the particular privatization attempt, and give help and advice. Thirdly, the injection of funds in this manner will prevent the drying-up of the local capital market and permit more institutions to be privatized than would otherwise be possible.

Of course, the agencies should not hold these investments over the long term, but attempt to sell them as soon as possible to local investors, which should assist in the strengthening of the local capital market. Strict limits should be placed on the extent of share purchase by the western agencies. After all, the transfer of ownership of an institution from one government to another cannot really be called privatization. The agencies' purchase of shares should not result in the private sector owning less than 50% of the stock.

However, there are some disadvantages to this policy. Due to difficulty in attracting private buyers for their stocks, Western development agencies might find themselves owning and running various enterprises in LDCs, a role for which they are not suited. It might be found that one type of state ownership had been substituted for another. It would be preferable to try and place the public sector concerns to be privatized in private hands sooner than under the above policy.

5. One means of doing this would be for development agencies to buy stocks but to redistribute them immediately to the indigenous population. This would achieve one of the key objects of privatization, - to ensure a wider distribution of wealth and broad-based ownership of capital. There is a danger in LDCs of corrupt privatization, in which some state assets are sold off cheaply to cronies of politicians. Such an outcome would seriously discredit privatization in the developing world, and should be avoided.

Free distribution of stocks to the indigenous population would ensure a broad-based capital ownership, but nonetheless presents some practical difficulties. The policy of free distribution of stock has been advocated by a number of commentators, notably Dr David Owen, leader of the British Social Democratic Party, and Samuel Brittan, Deputy Editor of the Financial Times, but has rarely been implemented. A successful free distribution of stock did occur in British Columbia, where shares in the British Columbia Resources Investment Corporation were distributed to all members of the population who applied for them. 86% did so, and a brisk market in the stocks soon developed. The only fair method of share allocation is to distribute them amongst the entire population. In large LDCs this could result in stocks of very little value being given to very many people. This problem could be overcome by putting the assets of a number of state concerns into a holding company, then distributing the stocks of that company. The policy is generally more suitable for smaller LDCs.

6. A more attractive variation of the policy would be for the development agencies to buy a proportion of the stocks at the market rate, but then put them on sale to the indigenous population at a half or a third of the market rate. In order to achieve the objective of a broad-based ownership of the stocks, and to prevent them being snapped up by a few rich individuals or institutions, limits should be placed on the total amount of stock that any one person can buy.

This method of sale is similar to that employed in the privatization of British Telecom. Stocks were put on the market well below their market price, (as was evidenced by the fact that the value of the stock doubled on the first day of trading), and strict limits were placed on the number that could be purchased by any one individual. Over 2 million people bought stocks, most for the first time. An important component of this successful privatization was a very large advertising campaign to educate members of the public about the stock offer. Such an educational campaign would be even more important in LDCs, and development agencies might advise how this should be carried out and help provide some of the required funds to pay for it.

7. An even more appropriate privatization model to adopt might be that of the employee takeover or buy-out. Here we have some UK experience which is more applicable to LDCs than conventional privatization. In these cases ownership is transferred to those with little wealth or knowledge of stock markets. This form of privatization has proved uniformly popular with the employees of state-owned concerns, and is thus politically attractive.

The first big worker takeover in Britain occurred in the privatization of the National Freight Corporation, Britain's largest trucking concern. The NFC management persuaded the workers to invest some 6.2 million pounds, (about 700 pounds each), and the banks contributed the rest of the 53.5 million pound price to finance a buy-out of the firm. The workers own 83% of the firm and the banks the rest. Employee productivity has since increased by 30% and the company is doing so well that the original 1 pound stock is now worth 10 pounds, making many of the worker-owners rather rich.

Other concerns which have been privatized by means of employee buy-outs include the Swan Hunter warship yard, the Vosper, Grangemouth and Tyne ship repair yards, and the Victualic plastics firm. The British government has just recently invited immediate worker-takeovers of the 60 subsidiary companies within the state-run National Bus Company. Managers of about 20 of the subsidiaries have already notified the government that they are keen to launch buyout schemes, and are enlisting the help of accountancy and venture capital firms. The government itself has asked the UK subsidiary of Banker's Trust of the US to study the feasibility of multiple buy-outs financed through loans from financial institutions. Some parts of the public sector itself are now putting themselves forward as candidates for privatization. English Industrial Estates, a government agency which builds and manages factory developments in depressed areas, has proposed an employee buy-out to the government. The corporation's 320 staff in its 16 offices would be offered individual stocks in the new company.

One of the largest and most ambitious worker takeovers is currently being engineered at the Vickers and Cammell Laird warship yards in north-west England. A joint management and employee buy-out has been launched for the two yards which between them employ some 14,000 workers, all of whom have been invited by the management to join an employee consortium to bid for the state-owned firm.

Vickers management is presently educating the workforce about stock-owning, assuring them that the pension scheme will be as good as now, and arranging loans to workers that can be repaid through wage packets. Employees interested in joining the buy-out will be offered loans of up to 500 pounds free of interest to buy stocks. At the same time further preferential loans of up to 5,000 pounds will be made available at market interest rates but with capital repayments deferred for 2 years. An average investment of 300 pounds would hit the target of 5 million pounds from the worker's pockets. The worker's consortium will buy stocks at the preferential rate of 1 pound a share while financial institutions, pension funds and banks will expect to pay 5 times this rate, raising the difference between the worker's 5 million pounds and the 60 to 70 million pounds the government is expected to ask for Vickers.

In the above examples we can see that the situation differs little from that in the third world. The workers are not wealthy and know next to nothing about buying stocks. They need to be educated thoroughly about such matters, and may need to be loaned money to buy stocks. However the amount of money they need to put forward to acquire control of the company can be as little as 10% of its value. They can buy stocks at a preferential rate, with financial institutions putting up the rest of the money.

All this would not be difficult to organize in developing countries. Development agencies could help train management and employees in mounting buy-outs, educate workers about stocks, provide loan facilities for workers to buy stocks and repay the loans through their wage packets, and lend the bulk of the funds required to finance the purchase of the concern from the government.

An alternative means of implementing the above policy, or that of distributing stocks to the populace, or that of reselling stocks at a low price to the populace would be to seek the agreement of the LDC government to carry out the policy itself, then compensate it for the funds lost due to selling below the market price. Such an approach would result in development agencies having less influence over the privatization attempt, but might avoid political complications resulting from direct participation in the sale.

THE ROLE OF THE PRIVATE SECTOR IN THE WEST

Stimulated by western governments and welcomed by LDC governments, the private sector in the west could perform a much more significant role in encouraging privatization in developing countries.

1. The first and most obvious role for western private sector expertise is to assist in the actual privatization process. Western investment banks, accountancy firms, and advertising agencies have much experience in handling privatizations, and could apply their expertise in LDC privatizations too. Western investment banks should handle LDC privatization stock issues and do the underwriting. Management consultancy and accountancy firms should help prepare the state enterprises for privatization, and advertising agencies should conduct the publicity campaigns necessary to interest the LDC public in buying stock. Some western firms are already active in this field and do not need much encouragement to increase their commitment.

2. Western private investment in privatized companies should be encouraged by the creation of appropriate tax advantages. These tax advantages should apply in particular to mutual funds which specialize in the privatized equity of third world nations. Thus the formation of such mutual funds which would invest in privatization projects in developing countries should be deliberately encouraged.

The creation of such capital pools to promote third world privatization would be a very useful policy innovation. These mutual funds could combine their resources to actually achieve privatization in the third world. They would have a roving brief to find and develop profitable privatization opportunities in developing countries. The tax advantages, (which could take the form of making these funds a shelter from some capital taxes), could be justified both on the grounds of the social benefits their activities would bring in the third world and also on the grounds of the high risk nature of the investments.

3. The private sector should be encouraged to lend against equity held in third world privatized companies by investors in third world countries. In other words equity in such privatized companies should be regarded as security for a loan, enabling LDC entrepreneurs to commit their funds to privatization projects but retain liquidity. Governments might encourage this practice by acting as secondary guarantor.

4. Banks should be encouraged to convert part of their debt owed by LDCs into equity, and western governments might provide incentives for this. LDC governments could reduce their debt burden and interest payments by swapping debt for equity in companies being privatized. The stock given to the banks could have conditions attached, such as resale to indigenous investors within 10 years. Such a policy would also commit western banks to ensuring the success and profitability of the companies concerned.

5. Financial institutions should be encouraged to provide facilities to enable LDC investors to buy stocks in privatized companies on credit. Such facilities were provided, for example, to investors in British Telecom when it was privatized. These

investors were allowed to pay for their stocks in three installments over a period of 18 months.

THE ROLE OF LDC GOVERNMENTS

The most important role for LDC governments in promoting privatization is to create a climate which encourages investment. This means guaranteeing property and contract rights, and having an impartial system of adjudication for property disputes. Investors must be free from the fear of expropriation. The rule of law must be there to regulate transactions, with the conviction that government itself respects that rule.

It means having a tax structure that does not militate against achievement and success, and allows people to garner and retain the rewards of taking risks and engaging in enterprising activity. Tax rates must be low, on corporate as well as on personal incomes, and such tax burden as is necessary should fall more heavily on consumption than on sources of investment.

It means allowing mobility of capital, in and out of the country. Foreign investors are attracted by circumstances which make it easy for them to recover capital, as well as to invest it. It means permitting free trade, without tariff barriers to regulate or pre-select the types of activity that take place. The need is to discover and exploit comparative advantage, rather than to try producing expensively behind tariff walls what can already be produced more cheaply elsewhere.

It means having a proper understanding of privatization as a creative process designed to shift whole areas of economic activity, with their attendant interest groups, from the politicised, non-commercial state sector to the consumer-responsive profit-making private sector. Privatization should not be just a means of raising some funds quickly by selling off a few state assets, or a means of granting favors to a handful of individuals or companies by allowing them to buy these assets at low prices. It should involve a wide section of the population and attempt to involve as many people as possible in the wealth-creating process.

The contracting-out of public services to private companies is a difficult process which is fraught with many dangers of mismanagement and political favoritism. Consequently LDC governments should take especial care to establish a respected competitive tendering process. It would be wise to set up an independent board of respected figures to evaluate which services should be contracted out and to oversee the tendering process.

THE ROLE OF THE LDC PRIVATE SECTOR

The most important role which the private sector can play is to show interest in the potential privatizations, and put forward bids. Governments need to be convinced that there is a reasonable level of private sector interest in investing in concerns being privatized before they are prepared to start the privatization process. Thus private companies, trade associations, and chambers of commerce should conduct reviews of the public sector and suggest which entities could be returned to private hands and which interests would like to invest in them.

So the role of the private sector is also to help create a climate of confidence for privatization, a climate in which the government itself believes it can privatize without embarrassing failure.

CONCLUSION

Some of the above policy options are complementary, some are alternatives. The balance between the role of western development agencies, that of the private sector in the west, and that of LDC governments, will vary according to the circumstances. Western governmental agencies should attempt to keep their role to a minimum; to stimulate policy change of the desired sort, but to leave as much of the work to the private sector and LDC governments themselves as possible.

For example, western governments should try to take a secondary role rather than be a primary lender, to provide seed capital to get a privatization project started rather than finance it all. The extent of their involvement will obviously vary from country to country. As private sector and LDC expertise in privatization builds up, western governments will be able to reduce their commitments.

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