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CRITICAL ISSUES IN PRIVATIZATION: POLITICS, INSTITUTIONS, AND LABOR

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Bureau for Program and Policy Coordination
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by

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I. INTRODUCTION

During the past five years, developing country governments have increasingly become aware of the benefits privatization offers to the process of economic growth. But this familiarity has brought with it an increasing awareness of the complex problems and risks that accompany the privatization process. The early assumption that privatization was a discrete process involving only a willing buyer and a determined government was soon replaced with the realization that there not only many more players were involved but that extensive privatization was going to require institutional change and profound policy reform. All of these factors, in turn, created political risk for the ruling party or group in the degree that it depended on interest group support to remain in power.

The sections that follow deal with three specific aspects of the problems raised by a privatization program.

- The political factor is a constant preoccupation of any government, since the decision to privatize is in itself largely a political question. The risk involved must be estimated and the sources of opposition identified as far as possible in advance of the decision so that steps may be taken to reduce the risk by emphasizing to the public the advantages that will derive from privatization. Although it is unlikely that political opposition can be entirely disarmed, experience in Jamaica and Costa Rica, for example, has shown that it can be reduced to the point where it is no longer a serious threat to a major privatization program.

- Successful privatization will, in virtually every case in the developing world, require institutional change or reform ranging from constitutional modification to regulatory reform to skills development. Existing structures, such as the judicial system and the financial and accounting systems, may in their current form create serious impediments to accomplishing any privatization. If transfer of property title from the public to the private sector does not assure the buyer of legally recognized ownership of a former state-owned enterprise, private sector buyers will not be interested in investing. The privatization process offers opportunities to increase the skill levels of those in the bureaucratic, judicial and financial sectors that will improve the performance of the institutions that play a role in it. Privatization offices created to oversee the procedures offer their employees a knowledge of negotiations with the private sector they would not otherwise have.

- Rejection by the labor movement in many LDCs creates a major impediment to privatization. Labor sees in privatization a loss of jobs, perquisites, and prestige as well as a threat to wage levels. If the government fails to calm these labor's fears, the entire privatization program may be threatened. Persuading labor that the government takes its objections seriously and is endeavoring to meet them honestly and openly will go far toward public acceptance of privatization. The labor factor becomes a critical element in a privatization strategy; to ignore it may mean alienation of the public and of the potential private investor from any participation in privatization.

II. POLITICAL FACTORS IN PRIVATIZATION

A. Introduction

It has become increasingly clear with experience that the decision to embark on a privatization program is based as much on political factors as on financial and economic considerations. This paper examines the political impediments to privatizing and analyzes ways by which these impediments may be eliminated, or at least minimized, in planning a privatization strategy. The case studies of Jamaica and Costa Rica (Annexes A and B) demonstrate the relationship between these problems and the approaches used for their resolution.

Any decision to privatize involves a degree of risk for governments. The problem lies in reducing the risk to a politically acceptable level while still leaving the government in a position to achieve a successful privatization program. If outside agencies require too high a level of risk in return for their aid in privatizing, the government may refuse to act or, more likely, prolong the preparatory process to the point where privatization is not possible.

Privatization is likely to remain an important element in both bilateral and multilateral donor programs. Of course, simply changing ownership does not provide all the answers; unless it is accompanied by deregulation and policy reform, the benefits of private sector investment and management will be severely undermined. In the final analysis, the spread of privatization will depend on the ability of the political leadership to demonstrate concrete benefits from it to the public at large. Only in this way will a constituency be created that will ultimately guarantee an expanded role for the private sector.

B. Levels of Political Opposition in Different Governmental Systems

The degree of political risk deriving from the decision to privatize is directly related to the type of regime under which the country is governed. The more groups or individuals whose interests may be threatened by privatizing, the greater the risk. Although it may be possible to alleviate the fears of many of these, there will always remain those who refuse to accept the concept of privatization out of ideological conviction. It is doubtful that rational persuasion will change their position or eliminate their opposition; the government may have to take the calculated risk that their appeal will fall largely on deaf ears. Where little or no economic opportunity exists outside the political arena, the government will approach any potential threat of defeat with extreme caution.

A one-party system, of the type commonly found in Africa, faces increased risk in divesting state-owned industries even if it does not have a political opposition to cope with. As Goren Hyden has pointed out (Africa Report, Nov.-Dec. 1987, p.26), political order in one-party states often depends on the ability of the head of government to have discretionary use of public revenues for political purposes.

If privatizing means serious reduction in optional funds or perquisites available to those in power, it may be totally rejected even though the firms being privatized are losing money.

Regime maintenance may require negotiation with powerful party or ethnic interests, compromise in bureaucratic positions, and overcoming ministerial objections. Depending on the charisma and strength of the party leader, these may not prove to be critical barriers if, as in the case of Malawi, the leadership can count on widespread public support. Successful privatization in a one-party system may be a matter of overcoming popular suspicion of the private sector by keeping the process transparent.

The highest level of risk comes in a multi-party democratic system where the governing party may put its political existence at stake if its privatization program is not a demonstrable success. The greater the degree to which the government depends on popular choice, the more attention that has to be paid to detailed planning and public education before privatization can become a reality.

The regime that risks least in deciding to privatize is a military government. In this case, the decision can be taken by fiat from the top with little or no forced consultation with any group. As long as the interests of the military are not put in jeopardy (by privatization, for example, of firms seen to involve national security) there is likely to be little outcry except from military officers enjoying their board sinecures; arrangements may have to be made ultimately to take care of their concerns. Labor unions' views, on the other hand, are not usually a factor in a military regime.

A monarchy, headed by an active ruler with power, risks little in declaring for a privatization program. In the case of Morocco, for example, progress in privatization will depend on the public support given to it by the king. Without this, the bureaucracy will inevitably drag its feet and the politicians will hesitate to act for fear of incurring royal displeasure. Where the monarch is more of a constitutional figurehead, as in the case of Thailand, the decision to privatize may rest largely with the political leadership.

C. Sources of Political Risk

There are many groups in the public and private sectors of developing countries that have a vested interest in either the adoption or the prevention of a privatization program. These groups may contribute to the political risk faced by an LDC government.

1. Opposition From Political Parties

Where an institutionalized opposition party exists, a privatization program may become a convenient and effective weapon with which to attack the party in power. Opposition to privatizing from within the ruling party itself may come from factions seeking to embarrass the leadership for reasons having little to do with the privatization issue.

To the degree to which government is responsive to public opinion, a threat may arise from a groundswell of public opposition to privatization created by the opposition for reasons that have little or nothing to do with the case for privatization. The opposition can seek to exploit public ignorance of the meaning of privatization to its advantage before the government is ready to make public its case for privatization. Even in a populist regime, such as that of Rawlings in Ghana, privatizing will have to produce some immediately evident results or popular support will decrease rapidly.

Opposition parties may oppose privatization for a variety of reasons:

- Selling State Assets: One attack may stem from the accusation of selling assets owned by the people at less than popularly perceived value (the perception often being based on original amounts invested by the government in an enterprise or the enterprise's book value)), thereby creating a loss to the taxpayer. In fact, the market value of state-owned enterprises (SOEs) is almost invariably less than the amount of government investment in them.

- Purchasers of Privatized Firms: The opposition party may also reap political capital from charging that assets are being sold to political cronies, or questioning the credibility of those handling the sale by accusing them of bribery and corruption. In other cases, the opposition may appeal to nationalist sentiment based on the dangers of allowing production facilities to fall into the hands of outsiders such as foreign nationals or multinational firms. Often tied to this accusation is pressure for indigenization, particularly of management positions.

- Ideology: Political objections to privatizing may arise on ideological grounds, particularly in those countries where there was a strong socialist movement in the post-independence period. Although some of the ideological arguments against privatization may stem from genuine socialist convictions, ideology can also be a convenient screen behind which may be hidden perceived damage to personal interests arising from privatization. The government may even find that it has an ideological mole in its own ranks, so that word of privatization planning in official meetings may be leaked prematurely to fuel opposition arguments.

- Legislative Barriers: In countries where there is a strong legislature, the head of government may have to deal with the possibility that privatization legislation may be defeated on a vote. If the government's majority is slim, the ability of the opposition to swing a few votes (through an appeal to personal interests) may defeat the privatization strategy. Indeed, if the privatization legislation is considered sufficiently critical, the opposition may use it as a threat to overthrow the regime. This can be a very high risk factor in countries where politics is still a zero-sum game.

Political questions in privatization do not end with sale to the private buyer. It will be of little advantage to the political leadership if the sale results only in substituting a private monopoly for a public one, from which there is no guarantee of greater efficiency, more competition, or cheaper, better quality consumer products. The government may, in fact, lose credibility with the voters, and its opponents may gain, if it appears that the sale was engineered to give special advantage to a chosen private sector group. Based on its own past experience, the Moroccan private sector, for example, has reservations about privatization for this reason.

2. Opposition from Interest Groups

In any regime interest groups are a political factor, no matter how tightly political power is controlled. Even in the military governments, factions within the military itself may become interest groups. In democratic regimes, interest groups both within and outside the ruling party play a significant role in maintenance of party support.

Privatization presents an opportunity for interest groups to exert a variety of pressures on the government, since it may ultimately affect broad strata of society. The greater the degree to which the government is dependent on support of special interest groups such as organized labor, the greater the .hreat of group opposition to the maintenance of power.

- The Bureaucracy: Opposition from within the bureaucracy can be a critical impediment to privatization planning, especially if an alliance can be struck between bureaucrats and the opposition party or opposition factions within the majority party. Bureaucratic interest group objection may stem from a variety of sources. There may be genuine ideological objection to the disposal of SOEs; more likely, however, privatization represents a threat to both jobs and power.

  Depending on the structure of government supervision of SOEs, Ministry official who exercise direct control over SOE budgets and operations will resent the diminution of their status and powers. In situations where Ministry representatives occupy board seats on SOEs, there may be a loss not only of perquisites and position but a financial loss as well if board members are paid directors' fees and meeting expenses. It is easy to see, for example, why in Indonesia the young administrators who represent the Minister of Finance on the boards of important SOEs -- each one sits on several -- may not be proponents of privatization, since loss of board seats would be a loss of an important status symbol. This was a particular factor in Co-ta Rica, as demonstrated in the attached case history.

  Bureaucratic opposition can be particularly risky and difficult to overcome since it is often clandestine, as opposed to the opposition of the more vocal interest groups in the public sector. The bureaucracy can succeed in derailing a carefully planned strategy, discouraging potential buyers, and creating public suspicion of the government's intentions through a combination of losing files, scheduling of endless meetings and procrastinating in issuing directives.

- <u>The Military</u>: The military in many countries constitutes a special interest group that opposes privatization, ostensibly on national security grounds. It is argued that products of SOEs are required for military supply, and security would be threatened if the military were forced to depend on privately owned sources. This argument against privatization rests on somewhat spurious grounds, since most governments retain the power to requisition factories in case of national emergency. The real grounds for opposition may be that retired or active officers sit as members of SOE boards (as in the case of most Indonesian SOEs); privatization would result in personal financial loss as it would to bureaucrats (the same point applies to former politicians). Where politics is one of the most lucrative sources of income, the possibility of such appointments may be critical to party support by influential local figures.

- <u>Labor</u>: Labor is a special interest group that has substantial political strength in many countries. Labor leaders are naturally fearful that privatization will lead not only to loss of jobs but reduction in union membership. Seniority and pension rights may be at stake. Such fears are often well grounded, since excess employment is a frequent feature of SOEs. In many cases, such as Indonesia, these firms are used as a substitute for a social security system to protect workers' incomes. If the government receives labor support and labor leaders choose to use their muscle to oppose privatization, the degree of political risk grows in proportion.

- <u>The Private Sector</u>: There is also the risk of alienating parts of the private sector; privatization is not always regarded as an advantage by the more prominent entrepreneurs. In many developing countries, firms with close relations to the government may have benefitted from the same privileges that were extended to SOEs -- particularly in freedom from import restrictions, greater access to foreign exchange, and reduced competition. Some elements of the private sector may find their position undermined by the new competition introduced from privatized firms.

D. Economic Factors in Political Risk

Privatization may also present economic risks from the government's point of view that translate into real political risk. Several governments have hesitated to embark on privatizing because of fear of losing control of the pace and direction of development, especially in the industrial sector, and thereby exposing themselves to the charge of sacrificing the popular welfare to the private profit motive. Even if this charge is erroneous, it carries considerable political weight.

There is also a more generalized fear that the government may be blamed for consumer price rises that may occur when a formerly state-owned enterprise is privatized and then subject to market forces in the pricing of their products. Violent upswings in prices of consumer staples may trigger political upheavals that impair the ability of the regime to govern or remain in office.

Finally, privatization is not without direct financial cost to the treasury even where donor technical assistance is available. Where fiscal demands regularly outrun resources, as is the case in many African countries, the initial cost of privatizing may be more than the government is prepared to bear, especially if high-priced investment banking advice will be needed. It may be necessary to demonstrate that the cost of such advice is still less than the subsidy cost of maintaining an SOE in operation. Opposition charges of squandering scarce resources on foreign advisers for the doubtful purpose of privatizing may be difficult for the government to counter if it cannot prove that advice on privatizing is cheaper than continued subsidization. It is also important that the government realizes that long term tax revenues from increased production and profits from privatized SOEs can compensate in considerable part for the costs of initial advice.

Many LDC governments lack experience in the use of regulatory powers which may serve to blunt criticism of privatization. The political leadership should be aware that, in privatizing an industry considered essential to the public welfare, the government retains the power to regulate pricing and production of the product (such as that of a public utility) should this appear necessary in the public interest. An understanding of the use of this power can serve to reduce the risk of selling so-called "strategic" industries.

After the sale of an enterprise the government must assure itself that the terms of sale are observed, that payments are made in accordance with the agreed schedule and that labor retention covenants are kept. If the private buyer fails to live up to his commitments, the government may be placed in the difficult position of having to take back the privatized industry. This would fuel the opposition argument that privatization does not work.

For a long term privatization program to work successfully, the government must demonstrate that its decision to privatize is firm and enduring. If potential buyers suspect that there is even a remote possibility of renationalization, they will be unwilling to risk capital to buy divested industries. Should the impression be created that the government's decision to privatize could be overthrown by an opposition party at a forthcoming election, the offerings will find few takers. On the other hand, if enough privatizations are completed with clear benefits to stockholders and the public, enough supporters of further privatization will be created to counter opposition arguments (as the case of privatization of public housing in Great Britain amply illustrates). Privatizing carries its political rewards as well as risks; the problem is to impress the citizenry with the rewards in order to create lasting support for a long-term program.

E. Using External Assistance to Overcome Political Risk

Advice and technical assistance in the political field on privatization is an especially delicate matter. There is a fine line between offering advice that may be necessary to ensure that political objections do not upset the privatization strategy and being accused of interference in the internal affairs of the country. Advice on overcoming political impediments should be tendered only on official request. Acceptance of the advice depends on establishment of a firm and lasting relationship of trust with the political leadership and demonstration that donor support of privatization is long-term. Suggestions as to suitable specialists to be paid for with technical assistance funds may be made but the final choice of consultants should rest with the government.

1. General Considerations in Assessing Political Risk

Although donor agencies and consultants can supply advice on overcoming certain aspects of organized political opposition to privatization, their influence is limited by the fact that this is essentially a sensitive domestic issue in which evidence of outside interest may do more harm than good.

To be most effective in assisting the government to make the decision to embark on privatization, it is important that the Mission have detailed knowledge of the political system and the environment in which it operates. Some of the elements that may have to be considered are:

- Where does political power really lie and to what extent is it exercised independently of group interests or popular consent? Who is normally consulted before an important political decision is made?

- What is the interest (professed or real) of the opposition in opposing privatization? Is opposition to privatization merely a smoke screen for an ulterior motive? What is the real strength of the opposition's ideological position and how much public support is there for it?

- What real degree of risk is the government taking in privatizing as opposed to the risk it perceives--and what elements of this risk are susceptible to change as a result of outside pressure or advice? To what degree is political risk balanced by the need to reduce the subsidy burden or modernize public sector industries?

- Does the government want to restrict, for internal political reasons, the range of buyers excluding some groups as unacceptable offerors?

2. Reducing Risk from Political Party Opposition

The top leaders of government must be determined to privatize if organized party opposition is to be effectively met. As illustrated by the situation in Honduras, consistent public commitment by the head of government ensured passage of privatization legislation. The move toward privatizing the generation of electric power in Pakistan is in part attributable to the Prime Minister's public statements of commitment to the idea.

There is often a political element in the choice of the method to be used for privatization. The government has several options to reduce risk in privatizing. These are discussed below.

- Limiting Potential Purchasers: If one of the government's motives in divestment is to redistribute wealth in the community, an obvious option is a stock market offering directed particularly to the small investor. By limiting the number of shares any one individual may acquire, a constituency for privatization can be created as well as a ready market for the next offering. As the National Commercial Bank of Jamaica privatization illustrates, the government may gain political advantage by pricing the share offering at a level that will produce immediate gains to purchasers.

Should the enterprise be too large for a single buyer, a consortium of local buyers may be formed with technical assistance in forming a joint venture. Alternatively, a joint venture may be formed with foreign equity participation, but in which local buyers play a dominant and public role. It may also be possible to break up such enterprises by spinning off parts of the central industry for separate sale.

If there is a strong current of public opinion opposed to foreign acquisition of enterprises, emphasis can be laid on assisting local buyers to find the necessary capital to buy divested industries. In some countries, certain families or traditional authorities play crucial (albeit unobtrusive) roles even though they may not be part of the institutionalized political structure. Some effort may have to be made to find out who these are and to bring them quietly into the information network when planning is being undertaken. They may themselves be sources of capital for privatization and they may also have contacts with foreign capital sources which they may be prepared to use for privatization ventures.

It may appear politically desirable that the government retain a minority holding in a divested firm to avoid the accusation of selling out the public interest. For example, in the case of the Togolese steel mill. it was clear that the current market value of the firm was much less than the government investment. A market value sale would have constituted a serious embarrassment to the political leadership. To avoid this situation, a foreign management contractor was permitted to operate the firm under a complex contract agreement that paid the operator a share of the profits. If the government elects to retain a minority share, the government should be encouraged to keep its holding as small as possible and commit itself to ultimate full privatization as political circumstances change. The government of Malawi, for example, currently regards any firm dealing with the basic food supply, maize, as being of strategic national concern and therefore refuses to relinquish full control to the private sector.

Exclusion of some ethnic groups from competition in privatization is a highly sensitive political question that can only be approached delicately by outside advisors. Unless some way around it is found, however, the privatization process may come to a halt. In the case of Kenya, for example, one possible solution suggested was to restrict the sale of shares offered on the market to Africans, but Indians would be allowed to assume management of the firm under contract once the sale had been completed, The government could not be accused of selling to the Indian minority, but the management and entrepreneurial skills available in Indian hands could be utilized, under African ownership, to improve the performance of the divested firm. Such a formula might be applicable to other countries in which the ethnic problem plays a role. Recent privatizations in Malawi excluded Indian bidders entirely from sales offerings.

- Building Public Support: A campaign of public information and education on the meaning and advantages of privatization in support of the government's policy could be used effectively to mobilize public support. Such a campaign can supply published material and radio and television broadcasts designed to create a greater public understanding of privatization.

- Timing: Timing of the various stages of the privatization program can significantly minimize political risk. It is politically important to give public demonstration at an early stage in the process that privatization can produce visible beneficial returns. Technical assistance can provide advice to governments on which enterprises should be given priority in privatizing. It may be politically advantageous to go forward with a particular privatization if it gives prospect of immediate success in terms of quick or easy sale. This can be useful to convince the opposition of the benefits of privatizing, even though it may not produce the largest return. In some cases, temporary leasing out of facilities (such as hotels in the Philippines or Jamaica) may be an easy way to facilitate the move toward privatization without raising the political problems attendant on complete public sale.

  Internal political conditions may determine the precise timing of a privatization. If the government is operating in a period of crisis, or has made policy decisions that create public unrest (such as an increase in the price of food), the privatization may have to be put off until officials can concentrate on the sale process. Care must be taken not to choke off the equities market by too frequent sale offerings that decrease liquidity or overtax institutional capacity. Failure to bring about a successful sale only provides confirmation of opposition arguments that privatization won't work.

- Seeking external assistance: Governments may be prepared to accept external technical assistance and advice from some donors but from not others or may refuse any advice from international bodies. A foreign private sector firm with which the government is acquainted may be encouraged to provide the technical assistance needed for privatization. This may serve to avoid some internal political hurdles because the government can point to the source of the advice as being disinterested, particularly if the foreign firm is excluded from becoming a possible bidder for a firm that is scheduled for divestiture.

  In the case of Sierra Leone, for example, the government opposed turning to the World Bank for assistance in privatization because it resented the conditionality accompanying that assistance. There was some question also whether the Bank would be able to furnish the kind of advice that was needed. Instead, the government turned to a multinational firm with heavy investment in the country and with which it felt comfortable, believing that the private sector firm was likely to give more hard-headed and expert advice on the divestment of SOEs than could any donor. The advantage to the multinational firm is that it serves to reinforce the firm's position when it deals with the government later on questions of concern to the firm's own business. In Malawi, an Investment Coordinator, employed under a direct country contract, was given substantial responsibility to negotiate sales of firms being privatized.

- Permitting Competition: Before technical assistance is offered by donors, the government should demonstrate that it is prepared to permit competition with privatized firms. Any appearance that privatization is really only to the advantage of friends of the regime or those who can afford to buy stock should be avoided; otherwise it will only reinforce the political opponents' position. Privatization actions in the Philippines are a case in point; here the government has had to be careful that sales of SOEs do not expose it to the accusation that a new cronyism is being allowed to emerge. A stock offering sale resulting in immediate gain to purchasers but with subsequent deterioration of service to consumers (as appears to have been the case with British Telecommunications in England) could undermine favorable public reaction to the whole privatization plan.

3. Reducing Risk From Interest Groups

The opposition stemming from interest groups may be as much a threat to privatization as are the political parties. Where these groups are allied with the political opposition, the danger may be even greater. However, interest group opposition can be reduced in a number of ways:

- Bureaucratic Risk: Overcoming bureaucratic opposition is a matter of firm and persistent pressure by the political leadership. It will be necessary to enforce rigid deadlines for detailed planning and to brush aside spurious reasons for delay. Ultimately, threat of demotion or firing may be required if it appears that high officials are determined to dig in their heels but the risk grows proportionately if this becomes necessary.

  Alternatively, privatization planning may have to be removed from the usual ministry channels and put in the hands of a specially appointed group of committed and loyal civil servants (a privatization secretariat) which reports directly to the head of state and is empowered to override any objection or delaying tactic from below. There may be argument within the bureaucracy itself over which ministry or agency should be charged with the privatization mission (as between Finance and Planning, for example). In such a case, the head of government, with cabinet support, may have to make a final decision and be prepared to enforce it.

- Military Risk: If the military has sufficient political influence, it may be necessary to retain some active or retired officers (and politicians) on the boards of privatized firms, simply as a cost of successful privatization. If this is the case, special provisions may have to be included in the terms of sale to the private buyer.

- Labor Risk: To get their agreement to privatizing efforts, labor leaders may have to be brought into consultation by political leaders early in the planning process. Government will have to display understanding of their legitimate concerns and be prepared to count the cost of worker retraining programs or pension payments as one cost of privatizing.

F. Political Implications of Privatization for A.I.D. Missions

As already stated, the decision to privatize is essentially political, although it has obvious economic and financial overtones. Privatization involves not only divestment of enterprises but critical macroeconomic policy decisions. Technical assistance in privatizing combined with pressure for policy change touch on areas so sensitive as to threaten the life of the government in power.

It is almost inevitable that Mission officers dealing with privatization will, in some degree, become involved with political questions that are posed in the process of developing a privatization strategy. Apart from establishing a consistent and comfortable relationship with the major government officials concerned, the Mission will have to judge the rate at which the government is prepared to proceed with privatization. The process is invariably slow; perfectly reasonable technical advice may be ignored or tabled for political reasons that are neither obvious nor easily understood and that are therefore frustrating to the donor.

There is a danger that in the enthusiasm to press forward with a privatization, the Mission may give the appearance of getting out ahead of the government or of public opinion. The impression that pressure is being applied to encourage quicker action may be resented publicly by the government, even though officials may privately be in agreement that such pressure is necessary. It may be important also to be sure that all elements, political and bureaucratic, understand the technical assistance being offered. This may be even more desirable if the privatization action depends on enabling bills being enacted by the legislature.

No government is prepared to face the accusation that it is giving way to outside pressure in its decision making. Successful privatization may often depend on creating the feeling that the program is a government initiative, not one stemming from the Mission alone. Consultants supported by A.I.D. should make abundantly clear that they are in the service of the government and not of the Mission. Only then will the government be assured that the advice being given them is in the country's interests. The Mission may feel that it is being excluded from a role in the process, as was the case in Malawi. In this country the government made clear that it considered privatization decisions to be an exclusively internal political matter.

At the same time the Mission should avoid leaving the impression that it is dragging its feet, if the government appears to wish to proceed more rapidly. Before extending an offer of technical assistance, the Mission should make certain that the necessary specialized consultants are available so that the gap between acceptance of the assistance and its implementation is as short as possible. Reports or other data should be submitted to the appropriate government office in final form on schedule -- even though it may be obvious that action on recommendations may not be forthcoming for some time. It is highly desirable that one mission officer be responsible for the work on privatization over as long a period as possible and that he be able to devote his full attention to the program.

Estimating the rate at which government wishes to advance the privatizing procedure may be a major factor in planning technical assistance. Low key advice at the right time is usually far more effective than a hard sell approach that preaches the virtues of privatization; the latter may, in fact, have a serious boomerang effect. The government will be more receptive to advice that stresses the difficulties and pitfalls as well as the advantages in privatizing.

III. INSTITUTIONAL FACTORS IN PRIVATIZATION

A. Introduction

As experience with privatization in the LDCs has broadened, it has become increasingly apparent that critical barriers to successful privatization are the lack of suitable institutions and institutional capabilities to permit the privatizing process to go forward. Even with the best political will in the world, the transfer of public organizations to private hands is difficult, given the necessity of deciding which companies to privatize, the prices to be sought, and the buyers to choose. Beyond these hurdles, there remain frequently impediments that require changes in constitutional, legislative, and regulatory provisions to make privatization possible. Barriers exist also in institutional capabilities in LDC legal, accounting, and financial systems.

Technical assistance by donor agencies can be of major help in resolving the institutional problems surrounding privatization. Advice may be needed on the framing of privatization legislation, code revision to avoid restricting private sector operation, as well as macroeconomic policy changes designed to provide a more level playing field for the private entrepreneur. Donor help may be needed in creating specific new institutions or agencies, such as privatization secretariats or committees, to advise on and implement the privatization process.

This section examines some of the institutional and regulatory impediments to successful privatization and suggests ways in which they may be mitigated or avoided. Although countries with similar colonial backgrounds may have the same basic legal structures (such as the former French colonies whose systems are based on the Code Napoleon), present day structures may vary as a result of laws passed since independence. However, changes made in countries where privatization has been initiated may provide adaptable examples for resolution of similar legal problems elsewhere.

B. Impediments to the Transfer From Public to Private Owners

Hemming and Mansoor have argued cogently that,

"Privatization is...likely to be dominated in economic terms by other policies, in particular liberalization and regulation, and more effective variants of the incentive systems and control mechanisms, both statutory and administrative, concurrently in place. (<u>Privatization and Public Enterprise</u>, IMF Working Paper, 1987, p.32)

There will undoubtedly be substantial institutional change as new macroeconomic policies are introduced as part of programs to encourage the private sector but it is too early to estimate its effect. World Bank Structural Adjustment Loans are a strong factor in institutional restructuring. Deregulation and removal of government controls over private sector operation to encourage the growth of competition will make privatization easier. At the same time, new regulatory structures will inevitably be needed to control, for example, environmental impact or industrial safety, as the private sector grows. All of these changes are aimed at a reduction in the role of the state from one of control to one of monitoring economic development. They become part of privatization in the larger sense; without these fundamental policy, institutional, and regulatory changes, privatization in the narrower sense of simply disposing of enterprises run by the state will be slow to develop.

Changes in the statutes and codes required to embark on a privatization program in many LDCs are complex and often without precedent. They may be cumbersome and time-consuming, delaying the privatization process to the point where potential buyers will lose interest. Unless they are resolved before the privatization program is started, the private sector will understandably be most reluctant to cooperate for fear that full legal ownership of the privatized firm may later be challenged or become a matter of judicial determination.

1. Constitutional Obstacles

Fundamental to initiation of privatization is the determination whether the government has the basic legal power to dispose of publicly owned property without specific legislative assent or judicial consent. Freedom to dispose of public property may depend on fundamental documents such as a national constitution. In Portugal, for example, sale of nationalized industries is constitutionally forbidden. The Mexican constitution requires that industries regarded as "strategic" be state-owned, so that sale to the private sector is impossible. Such basic constitutional provisions can only be overcome by changes in the document itself (usually a cumbersome process that any government would be most unlikely to attempt) or by judicial interpretation, if this is itself constitutionally permitted.

Government's ability to dispose of state-owned industries may also be conditioned on their specific origin. If, for example, they were nationalized by a previous regime, they may enjoy a statutory position that differs from those established by the present government, as in the case of jute mills in Bangladesh, formerly owned by West Pakistanis.

This situation is well illustrated in the case of the SOEs in Thailand. SOEs are divided into two general groups depending on whether or not they are considered to have a juridical personality. This, in turn, depends on the arm of government that created them. SOEs that came into existence by royal edict or law, revolutionary council order, and civil or commercial statute have juridical personality, while those established by cabinet decision do not. These differing legal modes specify the reasons for setting up the enterprise and the powers and duties of boards and managers. The mode has, in turn, implications for privatizing the enterprise. It is very complicated to sell a firm established by Royal Act; on the other hand, one established by cabinet decision may be divested by a stroke of the pen. Most Thai SOEs of major importance derive their existence from royal or statutory action.

In those countries with a strong executive president system, it may be possible to sidestep some of the legal thickets surrounding the disposal of SOEs by a direct presidential decision that enables Ministries to sell firms under their direction. In Malawi, for example, once the Life President had agreed to the proposed privatization strategy, any existing legal obstacles were easily overcome. In others, such as Tunisia and Honduras where the legislature plays a substantive role, a Privatization Law may be passed overriding existing statutory impediments. Such a law may specify individual enterprises, or categories of enterprises, to be privatized or empower the government to make specific decisions under certain general guidelines. It is important, however, that such a law be very carefully drafted so that legislative intent is clearly delineated to prevent later objection to actions taken under it or accusation from those who oppose privatization that it was misinterpreted.

2. <u>Statutory/Legal Impediments</u>

A broad range of statutes or laws affects privatization. To be successful, a privatization program may require changes in laws or regulations that are indirectly concerned with the enterprises being privatized, foreign exchange regulation, the structure of corporate debt, restrictions on private sector operation or ownership, and laws governing banks and other financial institutions. A continuing barrier to privatization in many LDCs are statutory codes that act as deterrents to potential investors in SOEs scheduled for privatization. These include, among others, Investment, Labor, and Commercial Codes.

Many LDCs, particularly those which are former colonies, have had such codes since before independence but they are for the most part outmoded and contain provisions no longer applicable to the current stage of the country's development. They have been amended so frequently that they are little more than a hodge-podge of often contradictory regulations subject to bureaucratic interpretation and hit-or-miss application. The Codes have, however, proved useful to often inexperienced and ill-educated civil servants who are able to avoid the necessity of making a decision or taking action by hiding behind a maze of regulations. The result is that a foreign investor becomes frustrated to the point where he loses interest in the country.

Although it is unlikely that all the necessary modifications can be made prior to initiating privatization, the more that can be accomplished before a large number of privatizations are completed, the greater will be the confidence of the private sector in the government's ultimate intention to reduce public sector competition.

An important area of law for privatization deals with the legal form of an SOE and a private company. Most SOEs cannot be privatized without at least some modification of their legal form to conform to existing statutes governing privately owned firms, as well as modifying operating and management procedures. Examples of such modifications are:

- Fitting the firm within company law: In order to fit the newly privatized firm into the provisions of company law, it may be necessary to take legal steps to dissolve the SOE and recreate it under new articles of incorporation. Occasionally, amendment of the existing articles may suffice, but this may be as complicated as reincorporation. Particularly in many Central American countries, company law proves to be a serious barrier to quick privatization in that the consent of all private shareholders in a mixed company must be obtained prior to sale of the government share and the legal extinction of the firm's juridical personality must be the subject of a prolonged court proceeding.

  In cases where mixed ownership has already brought the firm under company law, the government may be able to sell its current holdings without legal complications. Joint ventures between government and foreign shareholders may require modification of statutes governing the proportion of foreign holding permitted in national companies. Clarification of the rights of debtors and existing shareholders may require statutory action before the company becomes privately owned.

- Transforming a Ministry Into a Company: Transforming a Ministry (which may even have been enshrined in a constitutional provision) or government agency into a private firm is normally accomplished in series of steps. The first of these requires a legislative act to turn the Ministry into a government-owned company. This is followed by a transformation into a public firm that may be sold to a private investment group or by share offer through a stock market listing. All of these steps require special legal expertise and an in depth knowledge of constitutional and company law. This procedure is most frequently used in the case of privatizing public utilities such as telecommunications or electric generating facilities which have hitherto been departments or agencies of government.

  An illustrative case is that of the Malaysian Telephone Company. The PTT Agency, Jabatan Telecom Negara, was first turned into a wholly government-owned company, Telecoms Malaysia Berhad, to which the assets, liabilities, and personnel of the Agency were transferred. The second step transformed the new SOE into a public limited firm with the necessary changes required in accounting and valuation. The final step was listing on the Kualalumpur stock exchange, after a new regulatory framework had been worked out.

- Modification of Accounting Statutes and Procedures: Privatization will usually require modification of some aspects of accounting procedures that may be mandated by statute. Government accounting regulations are usually substantially different from those of private business so that reconciling accounts of some SOEs (which are often chaotic in any case) with figures meaningful in a business may create a serious barrier to privatization. Where multi-nationals are concerned in joint ventures, accounting procedures must meet recognized international standards. Private accounting firms in Tunisia, Algeria, and Morocco recently met to establish common rules and procedures for the area, a task made somewhat easier since the systems of all three are based on standard French practice.

  One of the objectives of governments seeking to embark on privatization programs has been to bring the budgeting and accounting operations of major parastatals in line with those of the private sector. Parastatals tend to produce budgets late and without adequate documentation. Capital transfers from Ministries are off-budget and business development plans are lacking. An example of the effort to correct this can be seen in the State Corporations Bill passed in Kenya in 1986.

This Bill, which applies only to wholly owned state enterprises, lays down a series of regulations designed to control and supervise all SOE expenditures in order to prevent the waste and fraud all too prevalent in the past. SOEs are required to maintain a full internal accounting system and the books are audited annually by the Auditor General of Corporations. The legislation also provides for the old British colonial device of surcharge by which executives, as individuals, are held personally responsible for irregularities in accounts under their control; any missing amounts are made up from the individual's own pocket. Overall performance of the SOEs is monitored by the State Corporations Advisory Committee, composed of high government officials which has wide powers to advise the President on all aspects of SOE operation. The Government Investments Division of the Treasury is responsible for advising on SOE investments and performance evaluation.

The intent of the Bill is clear and its objectives highly desirable but a casual reading raises two questions: (1) does it go too far in prescribing rules for SOE financial decision making so that it becomes an invasion of management autonomy? and (2) does the government have sufficient skilled accounting staff to carry out the monitoring requirements laid down in the Bill? Implementation of the terms of the Bill will eventually provide the answers, but if financial and operational procedures of the SOEs can be brought under greater control using practices comparable to those used in business, it will make them more attractive to private investors in the event the government should decide to place them on the market.

3. The Regulatory Framework

Although legislative acts and statutory provisions deriving from executive sources in some countries may make the privatization process slower and more complicated, the corpus of regulations stemming from bureaucratic implementation of legislative intention or from direct exercise of bureaucratic power may provide an equal, if not greater, barrier to easy privatization in most LDCs. Every government exercises its regulatory power to some degree but, in many LDCs, the power, particularly at the Ministerial level, has been used to hinder investment and industrial development by needlessly complicating proposed actions or by discriminating against particular individuals or firms.

Regulations may be issued to require or forbid specific actions or the completion of myriad minor steps before an action permitted by statute can be taken. Prime examples are the issuing of export or import licenses, land tenure regulations, and business permits. Meeting regulatory requirements not only takes effort but offers endless opportunities for bureaucratic delays and bribery. No one source knows all the regulations; new and often contradictory restrictions appear to be invented on the spot. As with statutory provisions, regulations can be a convenient cover for inability to act because of bureaucratic incompetence.

Eventually, the frustrated potential investor may simply give up and take his money elsewhere. The so-called one-stop investment offices created by several LDCs have rarely been successful because Ministry officials are reluctant to give up even minor authority in the interests of saving the investor's time. Elimination of much of this thicket of petty regulations would simplify the privatizing process and encourage entrepreneurs to concentrate on the profit possibilities presented by divested firms rather than on the annoyances created in the process of acquisition.

Where privatization occurs in enterprises susceptible to competition, regulation will play an important role. As Hemming and Mansoor have pointed out,

> "Clearly the impact of competition policy -- and privatization -- on the efficiency of private enterprises with dominant positions in potentially contestable markets will depend upon how well the regulatory regime functions. Regulation will also determine the efficiency of privatized natural monopolies. Thus the effect of the current shift in the emphasis of industrial policy toward private competition depends largely on the effectiveness of regulation." [Promotion of Foreign Direct Investment in Africa, IMF Working Paper, 1987 p. 31]

It has been frequently pointed out that substitution of a private monopoly for a public monopoly does little to further the cause of increased competition. To correct this situation, two actions are needed. First, LDCs should adopt a regulatory framework that enhances competition and reduces protection for monopolies. Second, they need to improve the institutional capabilities of the regulatory agencies.

Inducing increased foreign private investment may in many countries require liberalization of existing regulatory structures rather than revisions designed to strengthen them. To cite only a few examples:

- Free convertibility of foreign exchange allows market forces to determine its accessibility as opposed to an allocation structure based on complex regulated procedures.
- Removal of regulated price controls provides price incentives for producers and elimination of wage rates constrained by regulation will permit greater labor market flexibility.
- Reform and simplification of tax codes and regulations to remove distortions prejudicial to the private sector will increase investor confidence.

If regulatory liberalization for the foreign investor can be combined with macroeconomic policy changes that enable the private sector to compete on an equal footing with public enterprises, the chance of a successful privatization program will be greater.

LDC governments hesitate in some cases to privatize a profitable SOE because of the loss of revenue to the hard-pressed Treasury. However, a profitable privately operated industry may produce more revenue for the government through well framed and fairly administered tax regulations than even a profitable SOE. LDC governments need more skill and experience in the use of regulatory instruments for tax revenues. These skills can be obtained through donor technical assistance for training regulatory agency personnel and taxation specialists. Regulatory and other barriers to foreign investment can be changed through conditionality attached to World Bank Structural Adjustment Loans, as has been done, for example, in the Cote d'Ivoire.

Governments are becoming increasingly concerned about the state of certain regulatory codes and outside technical assistance is being sought to rewrite them in their entirety. In most cases priority is given to the Investment Code because simplifying it is likely to encourage foreign investors and is less apt to provoke internal political objection than is rewriting, say, the Labor Code.

- Investment Code: The major objective of any Investment Code is demonstrate a stable and regulated environment for investment to encourage foreign investors. Insofar as possible a code should be clear and unambiguous, and should be seen to apply equally to all investors at all times. Certain automatic rights of investors are written into many revised codes; typical are those in the new Guinean code of 1987 which provides freedom for private sector firms to:

  - import necessary raw materials and equipment and export production;
  - set and implement their own employment policies;
  - choose their own customers and suppliers, under freely established prices;
  - repatriate earnings from imported capital and repatriate liquidated capital; and
  - enjoy free competition with parastatal enterprises which should operate under free market conditions.

  (Marden and Belot, Promotion of Foreign Direct Investment in Africa, 1987, p. 31)

  The code incorporates guarantees of freedom from expropriation unless it is required "in the public interest", in which case fair compensation will be paid. Equal treatment for local and foreign investors, equal patent and trademark protection and access to the judicial system is also built in. Similar clauses were included in the revised code in Madagascar in 1985. These provisions follow generally accepted international standards.

  The Guinean Investment Code is exceptional in that there are no requirements that local investors be part of a joint venture; other countries have devised joint venture regulations so complex that most investors would be discouraged from embarking on this type of investment.

  Most investment codes provide for some type of investor incentive for approved development projects including exemption from customs duties and income tax for a specific period. Few, however, contain specific incentives for investors in privatized firms; rather they are designed for new investment, although exceptions may be made for rehabilitation investment.

  A number of codes have not yet solved the problem of complex and time-consuming applications which often leave room for uncertainty as to whether the prospective investment will ultimately be qualified. There is no doubt that a carefully constructed Investment Code that measures up to contemporary international standards serves to reassure investors and therefore may act to support a privatization program. But the presence of a modern Code does not necessarily guarantee investor protection or, indeed, investor confidence. The government must gain a reputation for reliability in application of the Code and fairness where the courts are called in to decide in cases of dispute.

- The Labor Code: Labor Codes in many LDCs are generally designed to provide the fullest protection for the worker and often create serious difficulties for the owners of private, profit-making firms. Substantial pension payments may be required, compensation may have to be paid for loss of seniority rights, for lay-offs, and for reduction in staff, among other costs. Some Labor Codes make it virtually impossible for the employer to fire a worker once hired or they may interfere with his right to employ the workers of his choice. Lengthy and expensive judicial procedures may be laid down should an employer action be challenged by the worker or his union representatives. (A fuller discussion of the effect of Labor Codes may be found in Section IV.C).

Ultimately, however, what will figure most prominently in foreign investor decisions is an overall investment climate that includes political stability, bureaucratic predictability, and legal clarity. Without these, governments cannot expect to find eager buyers for their privatized SOEs.

4. The Bureaucracy

The privatization process can be slowed down or even brought to a halt by the inexperience of bureaucrats assigned to carry it out. Privatization is not simply a matter of offering an SOE for sale to a ready buyer; it involves questions such as valuation, preparation of the offering, decisions on who should be allowed to bid and negotiation for final disposal. Even the industrialized countries have found that government officers experienced in finance required special training for privatization. The need for such training was correspondingly greater in the case of LDC bureaucracies accustomed to working in relatively unsophisticated financial systems and who had had little contact with the private sector.

When faced with the complexities of a privatization, the tendency often is simply to delay the procedures indefinitely rather than admit ignorance of how to go about them. In some cases, the privatization assignment is simply one more task added to an already overburdened official's job, so that it receives scant and belated attention, if any. Even if the specialized training in privatization techniques were available, many LDC governments cannot spare the manpower for such training except at the cost of failing to accomplish other and more pressing tasks. The bureaucracy becomes, then, whether intentionally or by default an impediment to rapid and efficient privatization. In Malawi the investment coordinator's office was specifically charged under the technical assistance contract with training Malawian civil servants in privatization procedures.

5. **The Judicial System**

Privatization frequently involves the court system in decisions for which there is no precedent nor provision in local legal codes. Judges have neither experience nor training on which to draw and, as with the bureaucracy, the result is is inordinate delay in the judicial process. The court system may be heavily overloaded and court administration deficient to the point where a complex case never reaches the docket. Added to this is the ever present possibility of corruption of the judges, or the lawyers involved in the case so that a fair hearing of the facts may become almost impossible. Almost any aspect of privatization may involve a legal contest, ranging from constitutional interpretation to argument between the buyer and the government over financial details. Given the weakness of the court system as a whole, combined with susceptibility of the judges to outside influence, the privatization process may face insuperable hurdles.

6. **Financial and Accounting Systems**

Privatization will usually require modification of some aspects of accounting rules and procedures which may be mandated by statute. Government accounting regulations are often substantially different from those of private business so that reconciling accounts of SOEs (which are often chaotic in any case) with figures meaningful in a business may create a serious impediment to privatization. Where multinational enterprises are concerned in joint ventures, accounting procedures must meet recognized international standards. Private accounting firms in Tunisia, Algeria, and Morocco recently met to establish common rules and procedures for the area, a task made somewhat easier since the systems of all three are based on standard French practice.

Parastatals tend to produce budgets late and without adequate documentation, capital transfers from Ministries are off-budget, and business development plans are lacking. One objective on the part of government in a privatization program is to bring the procedures used by major parastatals in line with similar private sector companies. An example of the effort to achieve this by legislation can be found in the State Corporations Bill passed in Kenya in 1986.

C. Improving Institutional Capabilities for Privatization

1. Establishing a Privatization Office

Although the overall institutional environment is important, successful privatization usually requires establishment of an office specifically designed to bring it about. Ministries or other government agencies are not normally geared to carry out the technical steps involved in the process. Even if they were, privatizing is a full time job and civil servants are unable to devote their entire energies to it unless they are detailed to the task by specific direction.

Experience has shown that that the various steps required are most expeditiously carried out if one high level official rather than a committee is made responsible. The "privatization czar" would be a either a very senior civil servant (a Permanent Secretary, for example) or a political figure that has the full confidence of the leadership. It is highly desirable that he report to the President or the Prime Minister but have instant and continuous access to him. Directives issued by the privatization chief should carry the authority of the highest level of government so that civil servants will feel obliged to carry them out.

Those LDCs that have engaged in extensive privatization have usually created an institutional structure to oversee the process from the point of the decision to divest to ultimate sale of the SOE to the private sector. Some examples exist of Ministries being created to handle privatization. In the case of Canada there is a Minister for Privatization; in Togo the Ministry of State Enterprises was assigned the responsibility for privatizing. In Malawi the government appointed a Divestment Committee consisting of senior civil servants to make final recommendations to the Treasury on sales. This is usually less satisfactory however, than a single dedicated individual whose sole function is privatization.

The privatization agency, whatever its title, should be institutionalized as far as possible so that it has at least an air of permanency about it and should have staff and budget adequate to the task it is expected to perform. The particular structure devised for the privatization agency differs with the circumstances and bureaucratic traditions of each country. The powers of each agency vary as widely as does structure, depending on the degree to which the political leadership is prepared to delegate authority to an agency of government.

In some cases, authority to negotiate an entire privatization up the point of sale is in the hands of the Privatization Secretariat, with oversight by a Ministerial committee. In others, the government has mandated detailed procedures for choosing buyers (such as minimum pre-qualification to bid), limitations on acceptable bidders (such as ethnic qualifications), and requirements to guarantee public and transparent bidding arrangements. Although it may be desirable to lay down careful pre-qualification conditions to ensure against frivolous bids, mandating procedures too closely has the effect of reducing the negotiating flexibility of the Secretariat and hence its institutional usefulness.

A wide variety of approaches have been taken by governments to institutionalize the privatization process. The more complex of them are designed for long term, extensive privatization programs in countries with substantial numbers of SOEs. In less developed states, smaller privatizations may be handled by a single official or Minister with a small personal staff and some outside consultative assistance.

Other examples of various approaches include:

- Canada: A Ministry for Privatization, a Cabinet Committee and an Office of Privatization and Regulatory Affairs reporting to the Minister of Regulatory Affairs. (A description of the Canadian structure can be found in L.Gray Cowan, Privatization: A Technical Assessment, PPC/PDPR, AID/W, 1987, pp. 24-25).

- Brazil: An Interministerial Privatization Council administers the entire procedure. It is chaired by the Chief of the Planning Secretariat of the Presidency and is made up of the Ministers of Debureaucratization, Finance, Industry and Trade, and the Minister responsible for the SOE being privatized. It has an administrative secretariat but the leader in each case is the responsible sectoral Ministry.

- Malaysia: An Inter-Departmental Committee, chaired by the Director of Economic Planning has overall supervisory responsibility. It includes representatives of the Treasury, the Economic Planning Unit, and the Attorney General's Office.

- The Philippines: Oversight of the entire program rests in the hands of a Committee on Privatization which includes the Ministry of Finance as Chairman, and the Secretaries of the Budget, Government Reorganization and Trade and Industry with the Director of the National Development Authority. Day to day responsibility for disposal of SOEs designated by the government lies in the hands of an Asset Privatization Trust whose members are appointed by the President. (Some of these examples are drawn from Chas. Vuylsteke, Techniques of Privatization of State-Owned Enterprises, World Bank Technical Paper No. 88, 1988)

- Turkey: Privatization procedures are defined by legislation passed in 1986. Decisions on the entities to be privatized is made by either the Council of Ministers or the Board of the Public Participation Fund (PPF), depending on the category of the enterprise. Once the decision is made, the firm automatically becomes a public company whose shares are transferred directly and without cost to the PPF.

  Previous legislation under which the SOE operated is overridden and all further decisions regarding management of the enterprise, and the method of privatization are made by the Fund. Dividends and proceeds of sales are channeled to the government by the PPF. The government has previously called on foreign and domestic investment banks to prepare overall privatization strategies. The Turkish system appears to have worked well, if the example of the highly successful privatization of part of the Posts and Telegraphs Agency early in 1988 is any indication.

- Tunisia: A case history of Tunisian institutions developed for privatization is given in Annex A.

It also may be useful to provide for an Advisory Committee that can be called on when necessary, not only for advice, but which can act as a buffer between the bureaucracy and the chief privatization official. The Committee should include from the outset representatives of the private sector, possibly drawn from the financial community and Chambers of Commerce, as well as major interest groups such as labor unions. In this way the government can minimize the accusation that the it is acting in secret and lay the base for a public information campaign directed by the secretariat.

2. External Technical Assistance In Developing a Privatization Office

The array of expertise required by a privatization office will depend on the extent of the program envisaged. However, it is desirable that a central staff should be assembled which is sufficiently knowledgeable about all aspects of the privatization process so that it is able to judge the performance of outside expert consultants that may be required in highly technical fields.

It is quite unlikely, in any case, that any government would have within its own bureaucracy all the specialized skills needed in privatization -- ranging from financial experts, auditors, and legal counsel to specialists in manufacturing and marketing.

The services of local merchant bankers and other specialists, if they exist, may be brought in where special expertise on the local scene is needed. Malaysia, for example, used the services of a British investment firm that had played an important role in the privatization of British Telecoms, combined with those of a Kualalumpur investment bank in privatizing Malaysian telecommunications and the national airlines. After two earlier privatizations, the Jamaican government had learned enough to be able to carry out the 1988 privatization of the Telecommunications company virtually without outside advice.

In other instances, the most appropriate advice may be drawn from an internationally recognized investment banking firm with experience in privatization, particularly if the contemplated form of sale is stock market offering. When the Guinean government recently embarked on privatization, an outside industrial investment firm was hired to carry out almost the entire procedure (analyzing SOEs to be sold, locating possible buyers and advising the government during the subsequent negotiations). The role of government officials was minimal except in the final decisions but it could not have reasonably been expected that Guinean civil servants had any prior experience in privatization.

External technical assistance can be very costly unless it is provided by donor funds or the investment bank can be persuaded to undertake the job at less than in its normal fee (as in the case of the National Commercial Bank in Jamaica) in the expectation that further business will result. However, it may be well worth the cost to the government in terms of institution building, if the contract with the foreign banking firm specifies that members of the privatization office work closely with the bank's staff throughout the entire procedure. The experience thus gained will make for an informed judgement on the work of experts hired for later privatizations and will provide enough knowledge that staff members may need outside help only in the most highly specialized aspects of privatizing.

The Office is, of course, concerned with other aspects of privatization than just sale of SOEs. It may need assistance in dealing with liquidation and sale of assets, partial privatization involving continued majority or minority government ownership with or without the "golden share", choice of management contractor if the decision should be to go that route, and privatization of services. Dealing with these varied aspects of privatization with outside advice enhances the competence of the Office to deal with the private sector, and improves the government's overall relationship with business. The entrepreneur is reassured by the knowledge that there is an established government agency that understands his problems and with which he feels he can communicate.

The A.I.D. project for the divestment and privatization of assets owned by the Agricultural Development and Marketing Corporation provides a useful example of how technical assistance may be supplied. Here an A.I.D. financed in-country contract provided for the services of an experienced investment banker whose responsibility it became to commission valuations of the firms, seek out buyers, conduct selling negotiations, and advise the Divestment Committee on the best bids that met the criteria for each asset laid down by the government. In doing this he was assisted by special studies on financing that were carried out under the same contract by a prominent British investment banking firm.

3. Skills Development as a Concomitant to Privatization

Privatization offers avenues for the development of specialized skills that would not otherwise be part of the training or experience of government officials or those in the private sector. This training may ultimately enable the government to dispense with costly external experts in later stages of the privatization program.

a. In the Public Sector

A key obstacle to privatization lies in inexperienced and untrained bureaucrats that are expected to deal with the intricacies of the process. While it can be argued that the expert assistance required can be obtained from donors, there is no real substitute for government officers capable of evaluating advice given them by consultants. It is inevitable that an element of distrust, or at least of suspicion will arise that some alternative privatization route may be more in the interest of the government than that recommended by outside consultants. But there is no way of answering this question if the Privatization Office staff is not in a position to know what alternatives exist.

The process of privatizing or rehabilitating SOEs for privatization should lead to training greater numbers of auditors, and of finance, valuation, and marketing specialists, the results will be advantageous to both government and the private sector. A further benefit will derive from the contacts that Ministry officials will be able to make with international experts advising the Privatization Office. Familiarity with techniques of dealing with international donor agencies and potential multinational private sector buyers learned during privatization negotiations will gradually increase the confidence of government officials in their ability to argue the government's position effectively.

b. In the Judicial System

Of particular interest is the opportunity afforded to the legal profession for specialized training in privatization. The assistance of local legal firms is important in the privatization process because they are more familiar with restrictions and limitations imposed by in-country laws and regulations. They can be particularly helpful because of their knowledge of local political or family relationships upon which success of a privatization may depend. In return, local lawyers are enabled to add to their knowledge of new and complex legal fields.

The change from public to private ownership may involve highly diverse legal problems--for example, framing new legislation and regulations, especially in cases of joint ventures (the Republic of China took several years to complete new joint venture regulations). Moreover, members of local law firms can gain direct experience in the legal questions surrounding divestiture. This is particularly applicable to technical aspects of stock offering or management contracting and leasing. Training programs, such as that proposed for stock brokers in Tunisia in the legal aspects of market operation, are a direct result of increased market activity partially resulting from privatization.

New developments in the court system may be required by privatization. Decisions on legal ownership of property, property rights, legislative and even constitutional interpretation may be presented to the courts in the privatization process. In many cases, there may be no precedent for the court to draw on and new legislation may have to be framed or case law determined. Privatization can expand both the activity of the court system as well as the knowledge and experience of court officials.

c. In the Financial System

The financing of a privatization program will be of concern to the Treasury and to the banking system as a whole. It is likely to bring about at least some institution building in that both will be called upon by possible buyers to become familiar with financial instruments with which they have not dealt before. (For example, swapping of equity for debt, both internal and international, may be proposed as a method of financing the purchase of an SOE and the government will have to be prepared to decide on a swapping policy and to negotiate the details of swaps.) Local banks and brokers will probably need to work with an international adviser at the outset but the opportunity is given to establish local investment banks as experience is gained. In Costa Rica, for example, a local financial group was eager to form such a bank with outside help to engage in privatization offerings.

Privatization by large stock offerings will usually require institutional strengthening of embryo stock markets by staff development and additional information systems. The Tunisian government, for example, has sought the assistance of a long-term consultant to develop a new regulative structure for the exchange and to train staff, as part of a program of mobilizing financial markets for privatization.

A variety of other financial instruments can be introduced which will add strength to the institutions financing privatization. These include:

- liberalization of regulations to permit insurance companies and pension funds to buy shares in privatized state companies.
- mutual funds or unit trusts that will hold shares in mixed SOEs and private firms, in which individual

investors may buy shares. Such trusts have recently been established in Zimbabwe and are under discussion in Malawi.

- government guaranteed convertible bonds which will serve to increase the number of issues in the stock market.

d. In the Auditing and Accounting System

Privatization, particularly if foreign buyers are involved, will increase pressure for adoption of internationally recognized standards of accounting and new training standards for the profession based on these principles. Without the use of uniform financial reporting, analysis and auditing standards, the sale of SOEs is unnecessarily delayed until their potential profitability can be determined.

IV. The Labor Factor in Privatization

A. Introduction

As the number and frequency of privatizations increase worldwide, it has become more evident that in, many developing countries, opposition by labor leaders and the rank and file membership of trade unions to privatizing is a major deterrent to more rapid progress in completion of privatization efforts. Fear of political unrest stemming from the unemployment that may be a consequence of privatization has led many governments to approach privatizing very cautiously.

It is clear that any government contemplating privatization must take the concerns of labor into account at every stage in the process. The government should be prepared to meet with labor leadership at an early point in discussion of the SOEs to be targeted for privatization, both to listen to labor's position and to reassure workers that their concerns are being taken seriously. Demonstration early on of official intention to make special efforts to avoid loss of jobs will serve to reduce antagonism to privatization, particularly if it is accompanied by a well planned educational campaign on the proposed methods of sale of the SOEs.

Where there is already severe unemployment under state management of the economy, the government will be doubly concerned about any action that threatens to produce further loss of jobs. On the other hand, where there is an absence of trade unions, as in Malawi, the unemployment question may not arise as a factor in privatization. Labor reduction was not a matter of concern to the government in the sale of agricultural estates in part because much of the labor force is seasonal and the estates have a large labor pool on which to draw.

B. The Reality of the Unemployment Threat

Distrust of the private sector has been deep-seated for over a generation in most LDC's that were former colonies; its motives are suspect and its conduct stereotypically thought to be contrary to the interests of labor as a whole. Ideological opponents of private ownership can reinforce already held popular prejudice to convince labor that sale of publicly owned means of production to private owners will only result in exploitation of the workers.

Labor's immediate distrust of privatization is founded on (1) a perception that it will inevitably be a threat to pensions and other labor rights (often based on a lack of understanding of the process) and (2) an awareness that SOEs are in most cases over-manned and sale to the private sector will almost certainly mean a reduction in the work force. But the generalization that privatization will, in most cases, result in lower wages, deteriorated working conditions, and reduction in the labor force is subject to many exceptions and caveats that greatly reduce its validity both for the long and the short term. They include:

- The amount of reduction in the labor force depends to a large degree on its composition. Where the work force consists heavily of unskilled labor, there is considerably greater chance of job loss, since productivity can be maintained or increased by giving greater incentives to fewer workers. On the other hand, the loss of jobs through privatization may be minimal where the labor force is composed largely of skilled workers whose services cannot be duplicated or dispensed with.

  In the case of the National Bank of Jamaica, privatization meant little or no loss of employees because the vast majority were trained in banking operations. There was little redundancy since the bank was well managed at the time of privatizing and it could not operate without the skills of its present staff. To a large degree, the same situation applied in the case in Jamaica of the Caribbean Cement Company whose operations were not labor intensive even before privatization.

  In Turkey, the privatization of Teletas (the production arm of the telecommunications network) meant no serious staff losses because of the specialized skills of the workers. In Costa Rica, the proposed buyer of the national fertilizer company specified that, while it intended to move the location of the firm's research laboratory, all the scientists and technicians would be automatically continued if they were willing to move to the new site.

- Many positions are, in fact, "phantom workers". What may be perceived to be a reduction in force may not in fact be the case when phantom workers -- those on the roles who never appeared for work but were nevertheless paid -- are removed. When combined with attrition through death, retirement, or job change, eliminating phantom workers may naturally reduce the work force without loss of any real jobs. The unions have less objection in such cases since they mean no actual reduction in dues-paying members employed by the firm.

- Privatizing can be an instrument for increasing the work force over the long term. If a privatized firm is reorganized with new management and put on a profitable basis, it should be expected that its business will increase over time and job opportunities and wages will increase. Overall growth in the economy will follow with higher employment in other sectors, such as services that might not otherwise have been available.

  Funds derived from the elimination of subsidies and the sale of divested SOEs may be applied to development projects producing new jobs. As a bridging mechanism, the government may have to create temporary job or retraining programs to prepare workers no longer required by privatized industries for new employment. These may absorb some of the revenues gained from sales but they will still be less costly than continued subsidy payments to money-losing SOEs. The pressure to save jobs can be relieved if the government is prepared to find places for displaced workers in SOEs not yet scheduled for privatization but this represents only a temporary alleviation of the problem.

- The problem of unemployment is no more avoidable in rehabilitating than in privatizing. Putting a firm on a profitable footing will require the same reduction in the work force, no matter who is the owner. Placing it under a management contract, even though the government remains the owner, may allow the government some voice in employee lay-offs but if the government seeks to interfere too strongly with the manager's hiring and firing prerogatives (normally a condition of management contracts), the terms of the contract may be abrogated. If the government's major objective is profitability, short-run unemployment during rehabilitation may be the price that has to be paid.

C. The Dynamics of Management/Labor/Government Relations in Privatization

In order to accomplish a successful privatization involving all parties, the dynamics of the privatization process must be integrated with the concerns of labor, the private sector buyer, and the government.

First, insofar as labor issues are concerned, there are essentially five interested parties in the privatization process:

(1) The rank and file members of the work force, whether organized into unions or not. Apart from the actual loss of employment, they are concerned with the relationship between wage scales in the public and the private sector, pensions, seniority rights, and other perquisites.

(2) The leaders of organized labor, who are concerned with the preservation of their own power and prestige. These are based ultimately on membership strength and solidarity. Reduced membership as a result of lay-offs will inevitably undermine the position of union heads.

(3) The managers of firms being privatized, who have both a labor and a management interest. New private owners may seek to replace the entire management team of the former SOE or at least individual members of it. Many SOEs suffer as much from over-manning at the managerial level as they do at the worker level and managers are per capita more costly. Privatization not only threatens managers with loss of their own jobs but even for those who may be retained, the prospect may be of job insecurity or of dealing with a recalcitrant labor force. As a result, management may be as strongly opposed to privatization as is labor, although it is likely to be less vocal in its protest.

(4) The government as the seller of the SOE. Most governments cannot afford to alienate the important segment of the voters represented by labor whatever the form of the regime. In an elective system, the government may well depend for a significant part of its support on organized labor, especially in those countries where political interest group organization is only at the rudimentary stage. Withdrawal of union support over the issue of privatization could mean defeat of the governing party.

(5) The prospective buyer, whether individual or shareholder. The position of labor may be critical to the decision to buy a privatized firm. If trade unions adamantly oppose privatization, they will continue to be a source of problem to the buyer when he later seeks to reduce the labor force. The prospect of an indefinite period of strikes, slowdowns and protests that would interrupt production, as would delays caused by labor retraining, greatly diminishes the interest of prospective buyers. Similarly, the burden of high levels of pensions or other workers' rights that may have to be assumed by the buyer could reduce the firm's potential profit levels to the point where it may not be worthwhile to consider ownership.

It may be possible to persuade the labor leadership to take at least a wait-and-see attitude toward initial privatizations before raising objection by including restrictions on reducing the labor force for a given period after the sale.

Second, one must be aware of the constraints on government in dealing with organized labor. In planning privatization, government will have to take into account the social and financial costs involved, as well as its own interests as an employer and as a recipient of labor's political support. In many developing countries, SOEs have taken the place of a social security system. The government, as the employer, provides the worker not only with wages but the only available retirement support, unemployment compensation, some contribution to sickness insurance and, in a few cases, housing. A private employer is not likely to provide all of these perquisites (unless required to as a condition of sale) and the government will have to find some means of replacing them.

Finally, the privatization process must address the Labor Code and its implications for both labor and the potential purchaser of an SOE. The Labor Code has often acted as an inhibiting factor in the sale of SOEs in developing countries, no matter how well the privatization strategy has been planned. Potential buyers are interested in freedom to hire and fire, the skill level of available new employees and, within limits, freedom from government interference in setting wages (a universal minimum wage law, for example, would not be considered such interference). Some LDC governments may seek to limit the number of expatriates that may be employed in management or technical positions or the length of time any one expatriate may remain in the post without indigenous replacement. Expatriate managers may be subject to local political pressures to hire certain individuals or numbers of employees. In some cases, such as Panama, Labor Code provisions applying to SOEs and to private sector firms may differ. In other countries, provisions may also differ for SOEs created by the government from those applied to existing firms that have been nationalized.

Labor Codes drawn up in the first years after independence were often heavily weighted in favor of labor, partially as a result of the reaction against expatriate colonial employers and partially because of the heavy influence of socialist doctrines. After two decades, however, as it has become more evident that these restrictive codes have constituted a deterrent to much needed foreign investment, governments are now seeking a balance between labor and employer interests.

New liberalized codes in Africa allow greater latitude to the employer in making labor decisions affecting the economic health of the firm. The Guinean Code, for example, permits free hiring and firing and setting of wage rates but prescribes guidelines for overtime, vacation and maternity leaves. Several of the latest codes provide for incentives to foreign employers to provide training programs for workers which result in transfer of technological skills. Although employee rights are still prominently featured, grievance procedures are simplified to make for more prompt settlement with less loss of production time.

In privatization, accumulated pension rights provide one of the most serious roadblocks to sales. Most SOE pension funds are not vested, relying on the government to provide funds as needed. Investors considering purchase of major privatizations have balked at assuming accumulated costs of pensions and other rights, forcing the government either to assume this burden as part of the sales agreement or substantially reducing the price of the asset being sold. It is to the government's advantage, then, to eliminate major inequities by rewriting the Labor Code prior to privatization but this may not be possible in the face of determined union opposition.

D. Methods of Overcoming Labor's Objections to Privatization

A variety of methods are available to reduce labor's legitimate fears of the consequences of privatizing large SOEs. Each method has to be adapted, however, to the particular circumstances of enterprises themselves and to the state of the national economy as a whole. If an economy is in a period of growth, alternative job opportunities may be readily available so that the effect of privatization will scarcely be felt. This is more likely to be the case in an already industrialized economy. For example, after an initial drop, employment in the privatized British Airways increased as the company's business improved under private management.

But in the developing world it is much more often the case that the government is seeking to reduce financial pressures by privatizing because the economy is in a state of stagnation or even of decline. Unemployment rates are often highest among the young school-leavers with high job expectations; this group is the most politically sensitized and therefore most vocal in its demands. Failure to make entry-level job opportunities available can undermine the value attached to education as well as constituting a serious political threat to the government.

1. Educating Labor on Privatization

The level of public anxiety that derives from large scale privatizations can be lowered by a general education campaign, on the meaning of the term and on the implications of privatizing for the society as a whole. Part of this campaign can be directed specifically to answering the doubts and fears of labor.

A well-planned and executed educational campaign on the meaning of privatization can pay off handsomely through an increase in public acceptance of the government's plans. Ignorance of the steps involved (valuation, marketing, financing etc.) in selling enterprises owned and run by the state is to be expected, especially in countries in which state management of the economy has been pervasive.

To counter ideologically motivated disinformation against privatization, the government must seek to explain clearly and repeatedly the steps that are involved in the process of privatization. Government's own motives for privatizing should be publicly exposed, pointing up the long range advantages to come from it while not glossing over the short-range problems it will create. The government's explanations must be (and must be perceived to be) honest and straightforward; any attempt to conceal the intention of the political leaders will only harden labor's attitude and reinforce the negative public perception of privatization. If the government is considering labor participation in sale of stock, the conditions, as well as the meaning of stock ownership should be clarified in detail.

Successful privatization may well depend on how thoroughly the public is prepared in advance. Although a campaign may be aimed at the general public, special efforts should be made to see that labor objections are specifically addressed in the information being provided. In the case of the National Commercial Bank in Jamaica, the government not only engaged in a program of widespread public education but invited labor leaders to private meetings at the highest levels of government prior to announcing final decisions to privatize. In these gatherings, in order to ensure that the government had opportunity to hear the labor viewpoint, labor's specific concerns about pensions, worker rights, and unemployment were addressed in as much detail as possible.

Part of the goal in making special efforts to listen to, and provide concrete answers for, labor's questions is to preempt initiation of an organized labor opposition campaign before the privatization strategy is announced. Labor leaders should be aware that:

- Continued public ownership of a firm is no guarantee that current rates of employment will prevail. If economic conditions prevent further subsidy payments, the firm will ultimately be forced out of business with a consequent loss of all jobs.

- Ownership is not as important as profitability of the firm; profits are the only sure way to ensure stable levels of employment.

2. Planning for Employment of Redundant Workers

Experience thus far with privatization in the industrialized countries has shown that labor's fear that it will lead to job losses is generally justified. Over-employment is chronic in state-owned enterprises and reduction in the labor force is an almost inevitable result of the change to private ownership. In countries where multiple industrial opportunities exist, placement of surplus labor may not be a problem, although some retraining may be required. Facilities to deal with the problem, such as labor exchanges, are already established and social insurance is available for the unemployed.

In developing countries, however, where unemployment rates, particularly in urban areas, are high and there is little alternative industrial employment and no social security system governments will be cautious in privatizing large labor-intensive industries. The cost of throwing substantial numbers of people out of existing jobs in the interests of efficiency and higher productivity can be high, both financially and politically. Financial costs involve payment of severance, pension, and other benefits as well as for retraining programs; the political costs involve the potential loss of labor support for privatization. Governments have to balance these costs against the benefits of long-term relief from subsidy payments to money-losing SOEs and gains in economic growth.

Although it may appear easier simply to dump the problem of overstaffing into the hands of the buyer of an SOE, this too has a substantial element of risk. If the buyer is going to have to shoulder the costs of dismissal of workers and post-sale labor agitation, the price he will be prepared to pay for the firm may be reduced to a level unacceptable to the government. The government may have to consider seriously whether it is preferable to protect retirement and separation benefits than to attempt to preserve or create new jobs for displaced workers.

Despite the best efforts to alleviate labor's fears, they may be sufficiently deep-rooted that labor will never accept privatization of large enterprises. In such cases, the government may be well advised to put off privatizing larger firms until a track record can be set with smaller firms that will offer proof that the government's schemes to ensure that no loss of employment will take place are, in fact, effective.

If government's plans to take up any employment slack are made public before putting any state-owned firms on the market, labor resistance may be reduced. Announcement of plans to deal with unemployment may also serve to forestall legal action by trade unions seeking to prevent the government from embarking on any privatization at all. Should the unions feel that their only recourse to prevent privatizing is to seek court injunction against it, all privatization action could be held up indefinitely, even if the union's case were ultimately lost. If the charge is illegal sale of public goods or unconstitutional defiance of workers' rights, the case could be both long and costly.

Should the process become too prolonged, the regime may change or it may be decided that, if there is strong public support for the unions' position when the case becomes public, privatization is politically too risky and the government may drop the whole plan to privatize. Avoiding court action is in everyone's interest, but in the end, the government stands to be the greater loser if it is forced to back down.

Actions that may be taken to meet union demands include:

- Specific provisions for redundant workers: Privatization may eventually increase employment as a result of new product lines or more efficient management. But it may mean an initial loss of jobs even in industrialized countries (privatizing Japanese National Railways, for example, meant a loss of 92,000 jobs). Where SOEs have been forced to serve social as well as economic purposes, the consequences of redundancy are likely to be more serious. In France, the sale of the Compagnie Generale de Constructions Telephoniques brought about the eventual loss of one quarter of the work force, even though the buyer was required initially by the Labor Code to absorb all employees (Vuylsteke, I, p.129-30).

  The government has essentially two alternatives when faced with redundancy. First, it can simply leave the whole problem in the hands of the new owners, who will reduce staff to meet their needs. Second, the government can take an active hand in providing new jobs for redundant workers in other SOEs or through retraining programs. Tunisia, for example, provided jobs for workers in privatized or liquidated firms through what is essentially a public works program to tide them over for a temporary period while they sought reentry into the labor market. In some cases (Sri Lanka, for example) part of the proceeds of sales of SOEs has been set aside for severance pay; in the Sudan and Mali, special funds (in the case of Mali with outside donor assistance) have been set up to provide loans to workers to permit them to go into business for themselves.

There are cases, as in Guinea, where the government has retained in civil service positions workers of privatized firms who have been unable to find jobs in other private firms. This guaranteed employment may minimize the objection to privatizing but in the end does little to reduce the numbers employed by government. It may also be possible to create a special pool of former workers in privatized firms who would receive preferential placement in jobs for which they qualify. If accusations of favoritism in placement can be avoided, this may serve as a public demonstration of government's concern for displaced labor.

- <u>Retraining programs for redundant workers</u>: This is an obvious remedy, if the government and the new private owner can agree at the time of sale on the number of surplus workers. The problem with retraining, however, is that careful prior planning is required so that the workers are retrained for jobs for which there is some prospective need. All too often the tendency is to train for jobs already in surplus simply because the training facilities and personnel are available while failing to provide job placement services to go with the retraining.

- <u>Preserving Worker Rights and Perquisites in Privatization</u>: Apart from continued employment, one of labor's major concerns is the preservation of workers' pension and seniority rights within the privatized firm or in employment in other private sector firms. Employees of SOEs are often considered to be civil servants for purposes of pension and accumulate rights according to civil service standards that are frequently more generous than those in the private sector. Such employees may be given the option of remaining in this system or joining the private pension structure of the new employer without loss of retirement pay. The private employer may offer additional incentives such as longer vacations and health or other benefits. A third option may be to offer a

> generous lump sum redundancy settlement or severance bonus with early retirement. Although none of these represents the perfect solution to protecting employee interests at reasonable cost to the government, some combination of them will be necessary to prevent labor unrest.

Examples of the application of some of these schemes to deal with redundant workers are presented below.

Malaysia

One of the most specific policies laid down to provide for the transition of workers from public to private industries is laid down in the Guidelines on Privatization, issued by the Malaysian government. These guidelines provide that all employees in privatized firms must not lose any benefits they previously enjoyed under public employment. It is made clear to all prospective buyers that this policy applies to any purchase of any SOE and it becomes a requirement of ownership. Detailed employment provisions of the policy require that:

> New owners accept all employees who choose to stay with the firm. No workers may be laid off (except for disciplinary reasons) for five years. Should the worker opt not to join the new company, he must retire (if he is old enough) or simply resign.

In the case of two major privatizations, 99% of the former SOE employees opted to join the new company. Available data do not indicate what effect these obligations had on the sale price of the SOE.

Employment benefits were a matter of employee choice. The new companies offered schemes that included provisions for bonuses and share ownership which made for higher take home pay but less job security. Alternatively, employees could opt to remain within the government's civil service scheme which gave them government paid subsidized housing and car loans, although their wages were paid by the new private employer. This meant better fringe benefits and greater employment security but lower take home pay. For employees choosing this option, the employer continued to pay directly into the government pension fund for them. (Vuylsteke, II, pp. 67ff.)

Bangladesh

When the Bangladesh jute mills were returned to private ownership in 1985, the conditions of sale required the new owners to retain all current employees for a period of twelve months, after which the employees were, in theory, free to reduce staff as they saw fit. However, as Lorch points out (p.33), in practice it was extremely difficult to dismiss workers because of high severance pay requirements (three to five monthly wage payments plus one month for every year of employment) and labor opposition. Some employers decided to resolve the entire problem by paying surplus employees twelve months wages at the time of purchase.

The organized urban industrial work force was strongly (and even violently) opposed to privatization from the beginning. A general strike was called against the government's privatization policies in April, 1987 and Divestment Resistance Committees were created (Humphrey, p.112). Strikes and demonstrations that involved kidnapping of factory managers were common occurrences at this period and the government appeared almost powerless to control them. Labor pressure forced the government to reaffirm its continued support for SOEs and to relax its protection of factory owners against labor violence. The privatized mills were forced to meet the wage and benefit levels of state enterprises.

It is very difficult to secure any accurate estimate of the reduction in employment as a result of privatization in jute mills. Figures range from 1.4% to 10% depending on their source and whether phantom workers (whose wages were pocketed by managers) are counted. Early retirements and attrition provided some relief. Redundancy was as much a problem with managers as with the labor force and it was easier to reduce their numbers by using the golden handshake. On the other hand, the increased business in some privatized textile mills caused a rise in employment of as much as 20%.

Jute mill owners were also able to reduce labor costs by eliminating supervisory personnel, substituting unskilled for skilled workers, and by changing laborers' status from regular to casual employment that did not require payment of benefits. In a country like Bangladesh where urban unemployment is chronic, however, it is unlikely that further substantial reductions can be made in labor costs in the face of continued union opposition.

Panama

As is the case with other Central American countries, the Panamanian Labor Code imposes such severe burdens on the employer that it virtually prevents a private buyer from acquiring a state-owned enterprise through privatization unless prior detailed decisions are taken to resolve personnel questions.

Any attempt to reduce the labor force in the over-manned Panamanian SOEs invokes highly complex severance and benefit liabilities, certain established practices and acquired rights, as well as contracts calling for higher wages than are normal in the private sector. A further complication is that SOEs are divided between those that come under the Labor Code and those coming under the Administrative Code. Each Code carries differing implications for the treatment of surplus labor.

- Firms subject to the Labor Code. A group of SOEs (consisting chiefly of firms that were once private but later taken over by the government) are considered private stock corporations subject to the Labor Code. Those firms are subject to extremely rigid limitations on firing and substantial benefits are accrued for dismissal. Employees may contest dismissal with a final decision coming only lengthy judicial procedures. For employees with ten years or more of service, the cost to the firm of dismissal, even for justified reasons, can be very high. A firm being privatized with 250 surplus employees, for example, might pay as much as $2 million in accumulated labor liabilities. Severance pay and seniority bonuses are so substantial that most firms of any size have established funded contingency reserves to meet these demands.

  It will be obvious that any prospective buyer of a firm subject to the Labor Code would require assumption by government of all labor liabilities as a prerequisite to serious negotiation.

- Firms coming under the Administrative Code. Firms established by the government (denoted as parastatals) fall under the Administrative Code governing civil service employment They require no justification for firing and no benefits accrue. The purchaser of a firm under the Administrative Code is not regarded from a legal point of view as buying an existing corporation, but rather buying purely assets. Employees under the Administrative Code retained by the new company created by a privatization would thereupon come under the Labor Code and would begin a new contractual relationship with no previous accumulation of benefits.

It has been proposed that the most expeditious and economic way to handle privatization of a Panamanian firm under the

Labor Code would be to secure from all employees a voluntary resignation, after having negotiated with them financial incentives greater than what would have been obtained under the "unjustified dismissal" terms of the Labor Code. These negotiations would have to be carried out by the government. A similar negotiation could be held with employees under the Administrative Code offering them a bonus for resignation prior to privatizing.

Successful completion of the negotiations would make the sale of the firm much easier and would reduce political complications for the government. The new buyer would be under no obligation to take on any employees of the former state-owned company.

Prior to the current internal political and economic upheaval in Panama, there appeared to have been general agreement on the setting up of a severance pay fund. If the current situation changes, it is not clear whether the trade unions will agree to such a fund if they feel that their political power is being reduced by loss of membership. Employee reaction will depend on the generosity of the offer made by the government.

Peru

The inspiration for the proposed Panama program was drawn in part from the Peruvian employee buy-out experience. Faced with a labor code having essentially the same provisions as that in Panama, the government embarked as early as 1983 on a program of buy-outs that permitted full and partial privatizations. Privatization of a tuna cannery was accomplished through the resignation of all 1,800 employees in the state-owned factory after payment of a bonus to the workers. Similarly, a bonus was utilized by a fishmeal plant to reduce its labor force to 4,500 from 6,000 employees to enable partial privatization, and by a fish marketing firm to cut its labor force in half. As early as 1978, the government had pointed the way by cutting its own labor force by 2% by offering a bonus of eight months salary.

Bonus buy out programs, no matter what form they take, are relatively expensive for the government. However, if the cost of annual subsidy to a money losing SOE is compared with the one time cost of a bonus buy-out enabling the government to free itself from subsidy payments by privatizing, the latter is clearly to the government's advantage. In the case of the Peruvian fishmeal plant, the bonus program cost $24 million; the annual subsidy to keep the plant operating was $35 million.

3. Encouraging Employee Participation in Privatized Enterprises

One recently developed method of meeting labor's retrenchment concerns is to provide the opportunity for employees to become part or full owners of the firm being privatized through preferred stock offering, labor management buy-out, or employee stock ownership programs (ESOPs). The assumption behind these methods is that if employees become the new owners, much of their objection to divestment will fall away. As owners, they will (a) share in the profits to be made by the privatized firm, (b) have a substantial share in management decisions, and (c) enjoy greater job security if the firm prospers as a result of greater worker productivity. From the government's point of view, a sale with employee participation gives public evidence of official concern for fair treatment of the worker, reduces the need to deal with the surplus labor question, and obviates the political charge that the privatization program is a vehicle to enrich foreign or special domestic interests.

Structuring an employee participation program can, however, be costly both in time and money and it may not always be popular with a firm's labor force. Its advantages must be clearly explained, particularly in situations where workers are not familiar with the idea of stock shares and whose notions of investment extend little beyond the concept of owning land.

a. Employee Stock Offering Schemes

Once those eligible are aware of the possibility of returns both in dividends and capital appreciation from share ownership, most employee stock offerings have been over-subscribed. A wide variety of incentives have been used to raise employee interest. For example, a specific percentage of the offering is reserved for employees (usually between 5 and 10%). Shares are made available at a discount from the offering price ranging from 5% at the time of sale to 20% if the shares are held for at least two years. In many cases, special loan arrangements are made at low rates for employee purchases or payment may be arranged over one or two years through direct withdrawals from wages. Limits for individual employee purchases are often set, at least in the first offering period. Any remaining shares are then offered first to employees at the full offering price.

Another incentive is an outright gift of shares or free shares tied to purchases of additional shares. While this may be a denial of free market considerations and cost the government some revenue in the short term, this may encourage organized labor to support later privatizations. If the free shares have gone up in value, the public may be encouraged to buy next time an offering is put on the market. An additional incentive may be built into the initial offering price in that it may be set below market with the certainty that the shares will show an immediate profit, providing encouragement to purchase the next offer that comes on the market.

A combination of these incentives was used, for example, in the marketing of the National Bank of Jamaica stock. Employees were offered 20 free shares, up to 350 matching shares at the offering price, 850 shares at 10% discount, and a further 850 priority shares at offering price. Payment could be made over 24 months through salary deduction. Similar arrangements were made for employee purchase in the case of Teletas in Turkey. It has also been commonly used in major privatizations in France and the United Kingdom with conspicuous success.

The point is sometimes made that in many developing countries, employees do not have the capital available to be able to buy stock. This would not appear to hold true for offerings at least in the more advanced developing countries where demand has outstripped supply at the discounted price. With a stock offering, employees do not end up having a controlling interest in the firm but they do have a substantial stake in its future.

b. <u>The Labor/Management Buy-out</u>

In a labor-managment buy-out, a combination of labor and management gains a controlling interest in the firm being privatized, often by means of leveraging. Several examples of this are to be found in recent British privatizations, the best known of which is the National Freight Company. A management-labor group bought the company with a combination of a loan and employee equity subscription purchased by 80% of the employees. They were rewarded with a substantial increase in share value in a very short time. Other examples include a water supply company in the Ivory Coast that was taken over in a buy-out to avoid liquidation and in Chile where there have been a number of buy outs with full or partial worker participation.

A problem that may occur in such labor/management buy-outs is that if the firm fails to generate profits because of heavy initial debt service costs, worker/shareholders may sell their stock at low rates to investors to avoid losses. Control of the firm could then pass to a few individuals who might profit handsomely when and if the firm can be turned around.

The limited number of labor/management buy-outs that have occurred in the developing world is insufficient to judge their usefulness as an instrument for preserving jobs in privatization. They may be attempted if sufficient credit facilities to acquire the firm are available but workers investing their limited capital should be aware of the element of risk in the undertaking.

c. Employee Stock Ownership Plans (ESOPs)

Employee stock ownership plans are basically a financing technique that permits employees of a firm to acquire ownership of all or part of the firm's stock without personal investment on their part. The stock may be a new issue or a transfer of existing assets such as would take place in a privatization. An ESOP fund is created by borrowing from banks and the fund is used to acquire the company's stock. Each employee participant receives an allocation of stock to a personal account and as the ESOP loan is repaid (by employer contribution to the plan), the plan's trustees allocate to each employee his share of the total.

ESOPs have up to now been a peculiarly American initiative because of the tax advantages afforded by American law. Among others, these include:

- An annual contribution may be paid by the employer to each employee's ESOP account up to 25% of pay which may be deducted against corporate income tax.

- In the case of an ESOP loan, the company can claim an income tax deduction for both principal and interest paid, since these are treated as business expenses for the funding of an employee benefit plan.

- The individual ESOP stockholder may under certain circumstances defer taxes on profits of stock sold back to the ESOP.

- An exclusion from estate tax of 50% of the proceeds realized from the sale of the stock to an ESOP.

Tax reductions, both individual and corporate, provide powerful incentives for the formation of ESOPs in the U.S. but they are not usually found in foreign tax systems. It has been argued that it is the ESOP concept that is important; adapting it to the conditions in developing countries will require imagination and flexibility in changing the tax structure. Although ESOPs are a relatively sophisticated concept for developing countries requiring both legal skills and an acceptance of the concept of stock ownership, they may have application where there a relatively sophisticated financial system. It is unlikely, however, that they will become a common method of saving employees from job loss as a result of privatization.

V. CONCLUSION

It has been argued that the current interest in privatization is temporary, stemming from advocacy by the United States and the international lending agencies. There may have been an element of truth to this at an earlier point, but privatization has more recently taken on a life of its own that has little to do with any ideological base.

The ideological convictions that, in part, prompted the expansion of state control in many LDCs are being replaced gradually with a pragmatic approach shared by many of the younger, post-nationalist generation of politicians and civil servants. It became clear that the state had failed in its attempt to plan development totally. This, combined with falling commodity prices, higher energy and subsidy costs, and mounting debt charges required seeking an alternative approach that the private sector could supply.

There will continue to be a role for the state in supplying services that the private sector is not equipped to undertake. The problem faced by a donor and the host government is how best to achieve the most acceptable balance between state and private sector activities. In most cases, this will mean a substantial shift in the near term to greater reliance on the private sector to correct the current imbalance.

Full consideration by the government of the three problems discussed in this report are critical to the success of any privatization program. They are generic to all privatization in industrialized or developing countries but they are particularly important in LDCs where the institutional structure is still at the post-independence formative stage and where organized labor may constitute a significant interest group supporting a political party in power.

As the discussion of these problems suggests, they are surmountable if the government is firm in its determination to proceed with privatization. Taking them into account early enough in the decision making process and planning how best to deal with them may avoid the types of crises that would tempt the government to abandon any attempts at privatization. Public objections can frequently be traced to a lack of understanding of what privatization means and what it involves. A well-organized public education campaign at an early point in developing the privatization strategy may go far to allay public anxieties. It should be directed to those interest groups most directly affected and should make evident the government's desire to answer their questions as fully as possible.

Not all of the institutional changes needed to facilitate privatization can be accomplished before the process is begun. However, hesitation on the part of potential buyers of SOEs may be diminished if the government demonstrates that regulatory reform is high on its agenda.

In the final analysis, labor reaction is such an important factor in the success of a privatization plan that it must be dealt with as fairly and honestly as possible from the outset. Unless ways are found to overcome labor's initial hostile position, the advantages of privatizing, with all the other policy reforms it can bring, will be lost.

A.I.D. Missions can play an important role in reducing some of the impediments to privatization. At the institutional level technical assistance for regulatory reform, particularly in revision of Codes, can be an important aspect not only of privatization but of assistance to the private sector in general. Missions may be helpful in planning an educational campaign and in supplying information on privatization experience in other LDCs. Apart from the technical assistance that can be made available for such specific aspects of the privatization process as valuation and buyer search, policy dialogue focussed on reducing obstacles to free market operation and financial market development can be indirectly supportive of the privatization program, as can encouragement of competition to SOEs within the private sector.

Because of the high degree of sensitivity involved, Mission opportunities to reduce the political obstacles to privatization are limited. Experience has shown that Missions can be of maximum assistance when their role is low key and when they remain out of the public eye. The perception should be avoided that privatization is being managed or directed from the outside, or that it is being pushed in the interest of foreign ideological convictions. Reducing political obstacles is a matter of the government's judgment; the most an outsider can do is suggest some ways in which this may be accomplished. Even these suggestions should be made only on the basis of a thorough knowledge of the local political situation and then only with caution.

Despite all the obstacles and impediments that can be thrown up by its opponents, privatization can be accomplished even under the most difficult circumstances by a determined political leadership. Sensitive outside technical assistance can smooth the way to some degree but in the final analysis, the risks and the profits will be the responsibility of the national government.

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ANNEX A

Jamaica: Addressing Political Factors in Privatizing the National Commerical Bank and the Caribbean Cement Company

1. Introduction

The Jamaican government has embarked over the past six years on one of the most extensive privatization programs to be found anywhere in the developing world. A Divestment Committee was established in 1981 to provide the technical information to the political leadership on firms to be divested.

Divestment efforts covered a wide variety of SOEs including major divestitures (such as the National Commercial Bank and the Caribbean Cement Co.), leasing of land through the A.I.D.-sponsored Agro-21 Project, the sale and lease of hotels, and privatization of a number of smaller enterprises by private share placement. One of the early placements in the program was SEPROD Limited, a group of companies in consumer products and animal feeds that was sold in 1985 by a private share placement of $J30 million combined with a public share offering of $J8 million, the first such offering since 1973. This successful venture proved that the Jamaican private sector could be utilized in subsequent privatizations.

2. Privatizing The National Commercial Bank (NCB)

The privatization of 51% of NCB shares in December, 1986 was Jamaica's first exercise in major share offering. The 30.6 million shares were sold for $J90 million. Some 30,000 new shareholders were created and 84 million shares were applied for -- an oversubscription of 175%. (An account of the technical aspects of the privatization is to be found in Roger S. Leeds, Privatization in Jamaica: Two Case Studies, Harvard University, December, 1987.)

There was surprisingly little political opposition to the sale of NCB, compared to what might have been expected, given the political history of Jamaica over the past twenty years. The national political spectrum is based on two parties, the Peoples' National Party (PNP), led by Michael Manley, and the Jamaica Labor Party (JLP), led by Edward Seaga. The PNP which had been in power prior to 1980, espousing a socialist program of the London School of Economics variety. Indeed, many of the intellectuals supporting the PNP were graduates of the school. While in power, Manley's government had increased the role of the state in the economy with a number of nationalizations, including the NCB. By the end of the 1970s there were over 200

SOEs, accounting for 20% of GDP. Most were money-losers; their deficit increased from 4% of GDP in 1971 to 18% in 1980.

Although the PNP was officially opposed to privatizing because, it was argued, it would lead to sale of the national patrimony to well-off individuals and to foreigners, the party had itself engaged in a form of privatizing in the 1970s by disposing of idle state-owned sugar-growing land to cooperatives. This was seen as being in the interests of popular control of the means of production. The experiment was largely a disaster because of the failure of the coops to manage the new lands. As a result, the government became involved again in state farming.

Edward Seaga's campaign in 1980 was based on seeking "a new foundation for Jamaica's economic growth" and on opposition to the perceived socialism of the PNP. The new foundation was to include a substantial role for the private sector; democratization of ownership would be achieved by public offerings of shares in the industries owned by the state. It was expected that successful privatization would create political support for the JLP from those who would benefit from their new holdings. It was essential, then, in choosing a candidate for major privatization that there be the prospect of an immediate increase in share prices to create the new political constituency. The choice of NCB for privatization was a particularly happy one from a political viewpoint for a number of reasons:

- NCB was one of the few profitable state enterprises.
- NCB was a well-known institution to many Jamaicans who had dealt with it through its branches throughout the country. The public had confidence in the Bank's future and was comfortable with the idea of owning shares in it.
- The scheme for the sale of shares attracted labor leaders, who were consulted about the sale from the outset.
- NCB had a very loyal staff of 1800, who were not only prepared to buy shares but cooperated in the sale by distributing and accepting application forms at all branches.

Initially, the PNP was strongly opposed to the offering, branding it as an "act of ideological aggression" and accusing the U.S. ambassador of meddling in Jamaican affairs since the U.S.A.I.D. Mission was providing technical assistance. However, as the educational campaign on privatizing the bank progressed, the opposition tone grew less vitriolic as it became clearer that the offering, partly because of the NCB's excellent record of community relations, was widely popular. The opposition's hope for an ideological battle over the issue became less and less realistic.

The government made a conspicuous effort to consult with the opposition leadership to make sure that the PNP was fully informed about the details of the sale. Manley, a former official of his cabinet, and a high party official were invited to meet with the majority party leadership to raise any question they felt necessary.

A well thought out and intensive publicity campaign was mounted by the Jamaican Information Service to acquaint prospective buyers about what it meant to own shares. Full page newspaper advertisements were used repeatedly to build up popular enthusiasm for the offer and radio and television programs extolled the virtues of share ownership. Question and answer sessions were featured on radio talk shows; to avoid legal inaccuracies all published answers to questions were checked with lawyers beforehand. The theme of shares growing in value, as would an agricultural crop, was strongly stressed. In addition, the point that the shares could be used as collateral, emphasizing particularly that dividends could be used to provide savings to build a house.

Briefing sessions were held with all interested groups ranging from employers associations to labor leaders in an attempt to defuse the opposition attacks. As the campaign grew more intensive with the approaching sale, trade unionists began to realize that opposition could mean a rank and file backlash. As a general picture, labor redundancy has not been a major objection to privatization in Jamaica and in the case of the NCB, staffing was tight enough that there was little prospect of any loss of jobs with private sector control, particularly if employees were to become owners of a substantial part of the shares.

The opposition's tone grew markedly less strident after the visit by Neal Kinnoch, leader of the British Labor Party, to Jamaica shortly before the offering who apparently advised the PNP that further opposition could be counter-productive and make the party look like a spoil-sport in the face of the sale's general acceptance. The government stressed the theme that mass ownership was the road to economic democracy; and the opposition found it hard to counter the argument. The point of handing over control to a few individuals, Jamaican or foreign, was blunted by the limitation that no more that 7.5% of the shares could be held any one person or institution. This was rigidly adhered to in the sale process.

After the initial sale offering to the public at $J2.95 in October, 1986, NCB stock promptly climbed to over $J4.00 a share, partially as a result o deliberate underpricing by the underwriters and partially because of the stock's scarcity value. It later sank to a normal trading range of $J3.50 to $J4.50. Those who bought shares under the complicated allocation scheme of the opening offer were, needless to say, highly satisfied with their purchase and, indeed, many individuals wished they had bought more.

The evident success of the offering, with its heavy oversubscription, left the opposition with a short ideological leg to stand on. In the end, political opposition to the 51% privatization of the NCB's shares was largely ineffectual and the case was further weakened by the immediate rise in the price of the stock. The opposition made clear, however, that any further disposal of the remaining 49% would be opposed. Nevertheless, the government made no secret of its intention to divest the remaining shares at some future point depending on market strength.

The remaining 49% of NCB's shares continued to be held by the National Investment Bank of Jamaica (NIBJ). The government remained determined to carry out its expressed intention of complete divestment. In March, 1988 the offering was finally made but the results were not exactly what the government had expected.

The decision to make the offering had in fact been taken some months earlier but its execution was delayed by depressed world market conditions following the fall of the U.S. market in October, 1987. The financial advisers judged that conditions were improving to the point where the offering could be made public and the government was anxious to go ahead in view of the forthcoming elections due in a few months.

The offering was not, however, made in the same form as the previously successful public participation sale. Instead, it was to be by tender offer, limited to institutions such as banks, pension funds, mutual funds, and building societie. . The same ownership limitations were to apply--a maximum of 7.5% of the stock in the hands of any individual or firm. The government's reason for this type of offer stemmed in part from complaints made by financial houses that, because of the popularity of the initial issue, applications by institutions had been severely scaled back to accommodate the demand by individual buyers. To provide greater flexibility in NCB management, the government was interested in increasing the number of shareholders with substantial blocs of stock. Accordingly, the offer was made privately to 28 institutions, each of which was allowed to make up to five bids at five different prices.

The timing of the offer was critical; it had to be open long enough for bids to be prepared and submitted but not so long that bidders would have the opportunity for collusion on their bids. Since the Jamaican stock market is open only on Tuesday and Thursday afternoons, the offer was opened on Thursday after the close of the market and bids were to be returned by the following Tuesday morning prior to the market opening later in the day.

In setting its close scheduling for the second offer, however, the government underestimated the collusive skills of the Jamaican business community. When bids were opened they ranged from $J2.70 to $J4.25, with two-thirds of them under $J3.30, substantially below the current market price. The striking absence of bids above $J3.30 roused strong suspicion that there had been considerable communication among potential bidders over the weekend. Indeed, there was rumor that the government had gotten wind of the bidding trend from disgruntled bidders not included in the low-bidders group and realized what was happening.

Institutions were attempting to buy the stock at a substantial discount, assuming that a bargain could be had because the government was badly in need of funds to redress upcoming budget shortages. Some of the bidders argued, however, that collusion had never taken place; rather the bids were based on a correct analysis of the value of NCB stock. They claimed that at $J3.30, the trend in the stock was down and a bid of $J2.70 to $J2.90 was simply a realistic appraisal of the future value of the stock. It would appear, however, that this was rather too simplistic an explanation for the curious range of bids submitted.

In any case, the NIBJ Chairman was quoted as saying there was evidence that "a number of institutions had attempted to act in concert" and the government promptly withdrew the offer. To have done otherwise would have been to court political disaster by exposing the government to the charge that it was prepared to sell the stock at discounted prices to favored business interests. It would have played directly into hands of the PNP which had earlier indicated its objection to further divestment of NCB shares.

The net effect of the whole effort was to drive down NCB stock to a low of $J3.50. Journalists promptly reminded the public that the real losers were NCB and its current shareholders.

Under the circumstances, it was highly unlikely that the government would risk attempting to sell NIBJ's shares in the NCB again before the election. After the withdrawal of the sale offer, the PNP made a statement to the press that "If the JLP Administration carries through this act of betrayal, a future PNP government would have no option but to take appropriate action to right this wrong" (Daily Gleaner, Mar. 18, 1988).

Seaga's government immediately attacked the statement. In the legislature, he responded to the opposition "threats" saying:

> "We have heard various threats being made out of two sides of the same mouth. In one breath, the voice supports the divestment. In another breath, we are told that it is a sale of the national patrimony and we are constantly being barraged by threats of what another party will do if it becomes the government. Let me here announce that, if any other party becomes the government of this country, it is powerless to reverse this process. I go further and say it is absolutely powerless to reverse this process."

He went on to "enlighten the ignorant" that in the case of the NCB, the memorandum of Articles of Association of the Bank under divestment were drawn up in a manner so that 90% of the shareholders was required to form a quorum who must all agree to increase the ownership limitation from 7.5%. And so, he concluded, "Unless 90% of all persons owning NCB shares...meet in the National Stadium and by 100% vote decide that they want the government to become a shareholder which goes beyond the 7.5%. No power on earth can change that, save you tear up the Constitution and throw it away."

Despite these strong statements on both sides, the reality of the situation is that a reversal of the initial NCB sale through renationalization is extremely unlikely. The number of those holding shares in Jamaican companies increased from 3,000 to over 33,000 with the NCB sale. An additional 8,000 shareholders were added with the Caribbean Cement Company divestment. Such a constituency cannot be ignored, particularly since the shares have appreciated in value. Moreover, as some commentators have pointed out, however much the PNP may wish to increase the level of social services, there is little prospect that this can be accomplished.unless the country earns more or goes further into debt. Seaga is faced with the same scenario; more services can only be provided by higher borrowing.

The argument was made by some executives in the financial community that the government made a basic policy error in deciding to carry out the sale of the remaining shares by restricted tender bid, regardless of the weakness in world stock prices. Some blamed it on the government's immediate need for money (although it appears that this was probably a misperception since the fiscal year ended with a deficit of less than 1%). Others laid the fault at the door of the same British financial advisers who had successfully advised on the earlier sale, claiming that no foreigner could ever really understand the close relationships that existed within the relatively closed Jamaican financial community. There may be some basis for this, but it can be exaggerated; the advice of British investment bankers was in good part responsible for the successful offering in the first place.

According to some of the government's critics, a public offering on the same basis as the earlier one would have been successful, from both a financial and a political viewpoint. The earlier offering, they pointed out, was oversubscribed by $J160 million, more than enough to have sold 100% of NCB shares at $J2.95. There was at least some prospect that enough unsatisfied buyers remained to have carried out a second sale, thereby creating additional satisfied shareholders. On the other hand, market conditions were not as propitious in early 1988 and the sale price would have had to at least equal the current market price of NCB shares or the previous buyers would have objected strongly.

The government's objective in tender bidding was motivated in part by the consideration that too great a fragmentation in share ownership was undesirable. It effectively left control of the NCB in the hands of management and the employees who collectively owned a substantial bloc of shares. Individual shareholdings were not large enough to influence management decisions and unless they were organized, shareholders would be unlikely to elect representative directors to the board. Allowing financial institutions to hold 7.5% would at least permit the choice of experienced directors if the institutions could agree to vote as a bloc on who might represent them. The NCB's chief executive indicated that he favored this method of securing directors who would be able to offer expert advice on management decisions and exercise greater check over management actions.

3. <u>Privatizing The Caribbean Cement Co. (CCC)</u>

The CCC, 99.4% owned by government, has a checkered history. It lost money in more years than it was profitable and paid no dividends since 1976. The government took a substantial risk when, in June, 1987 the decision was made to place 100% of its shares on the market since they were in large degree a speculative investment. Under these circumstances, the sale of 89 million shares at $J2.00 per share was an impressive showing. Over 24,000 applications were made, including those from 99% of the company's 450 employees. Nevertheless, only 72% of the total share capital was sold, in part a reflection of (1) a depressed stock market, (2) the recent issue of a government bond that sopped up liquidity, and (3) of the thinness of the Jamaican capital market.

Part of the failure to sell the entire offering may also be due to the outspoken opposition of the PNP. The party termed the CCC privatization "a sordid transaction" and condemned it as doing "a great injustice to the Jamaican consumer and tax payer by transferring at discount prices the benefits to a few investors and speculators." (Cited in Leeds, op.cit. pp. 52-53)

It is difficult to say with any certainty that the PNP's position was a serious deterrent to prospective buyers; several Jamaican financial officers expressed doubts that politics was a major factor in the shortfall in sales. It is more likely that the past record of the company discouraged some buyers and that the interval between these two major offerings was too short given the thin capital market--there was just not enough disposable savings in the hands of small buyers to purchase additional shares.

4. Lessons from the Jamaican Experience

The limited Jamaican experience thus far would indicate that, partly as a result of the public education campaign by the government, political opposition did not make any serious difference in the success of the privatizations. Although the PNP's position was well know, its ideological appeal did not overcome the prospect of profit from buying shares.

There is no doubt that politics played an indirect role in that the issue served the purposes of the PNP as a weapon to attack the government in the legislature and gave the party a certain amount of free publicity in the process.

As a national issue, it was of little long range value, since any arguments against participation in buying shares fell on deaf ears once the share prices abruptly rose. The opposition realized that it was doing its own cause more harm than good in threatening renationalization. In the case of the CCC, the PNP's vituperative statements were almost pro-forma and they appeared to have little effect.

The Jamaican case illustrates two fundamental prerequisites in blunting political opposition to privatization. First, preliminary consultation with interest groups, particularly labor, paid off handsomely. Moreover, formal consultation with prominent opposition political leaders before the divestiture impressed on them that the government was concerned with hearing their point of view.

The skillful use of the mass media to explain stockholding, share purchase, and the potential uses of future dividend payments created a groundswell of popular support that the opposition could not overcome with theoretical argument. Careful and thorough preparation of the public may do more in the long run to ensure the success of a privatization than any amount of strategic planning confined only to government circles.

ANNEX B

Costa Rica: Politics and Privatizing CODESA

1. Introduction

Privatization has been of interest to the government of Costa Rica for several years. It is strongly supported by the President and the ruling National Liberation Party. It has been assisted by the A.I.D. Mission since the outset.

The Costa Rican political system is based on a weak presidential office with a strong legislature that has substantial power of decision. Despite these obstacles, President Arias has been able to overcome legislative opposition to privatization actions for seven companies which constitute 90% of the holding company for state enterprises, CODESA.

The A.I.D. Mission played a vital role in getting the privatization process under way. A principal supporter within the government was the Central Bank which was highly conscious of the losses being suffered by the larger state-owned enterprises. In 1983-84, these enterprises were absorbing one third of public sector credit to cover operating losses.

Objections to privatization were centered in opposition party legislators and among the bureaucracy. The former saw privatization as a threat to patronage jobs they could offer; the latter as a threat to perquisites and position. In order to dispose of the enterprises, a mechanism for transfer from the state to private hands had to be created in the absence of any consensus within the government on the management of the program. In February, 1985, a National Commission was appointed by Cabinet Resolution to be the final arbiter of sales recommendations. As part of the management structure for the sales, a Trust (FINTRA) was established based upon local currency accumulations of the A.I.D. Mission. The Commission's job was to offer the enterprise for sale; if there were no bidders from the private sector, the Trust would buy the enterprise from CODESA and would become the selling agent. The Commission, some of whose members had personal political agendas in accepting membership on it, failed to carry out the task for which it was appointed and, after a year and a half, was virtually cut out of the sale process.

The initial problem turned on the valuation of companies to be sold. The agreement called for the Controller General to set the prices. The method he employed (beginning with the original price to which operating losses, adjusted for devaluation of the colon, less a small depreciation, were added) resulted in a heavily inflated selling price that bore little relation to the current market price of the industry.

To support the privatization program, the Mission agreed to use up to $140 million of local currency accumulation to permit the Trust to make up the difference between the Controller's valuation and the ultimate selling price of the firm. Since the government wanted above all to avoid monetizing this local currency, the plan was to reduce CODESA's debt through a purely bookkeeping entry at the Central Bank balancing off the debt of the companies being sold with the local currency made available. The Mission had not, however, counted on this excessive level of valuation and it became clear that the mechanism could not work as envisaged. After a number of acrimonious meetings between the Mission, FINTRA and the members of the Commission, attempts were made to strengthen FINTRA and make it more independent of A.I.D.

The decision was finally made to call upon a retired A.I.D. Mission Director to attempt to solve the impasse. Approaching the problem from the point of view of the political relationships involved, he saw it as his task to establish a low profile, supportive relationship with the key people in government in order to influence the decision making process on privatization by working closely with them. His eventual success in doing this was in large part responsible for later progress in getting the divestment process under way.

He was gradually able to establish the government's confidence in him as it became clear that his perspective was 75% government and 25% that of the mission. Through a lengthy process of negotiation he was ultimately able to persuade the Commission and CODESA to proceed toward the same goals. The government's goals were clear: (1) to avoid monetization of the large sum of local currency; (2) to cut the debt of CODESA; and (3) to privatize. Of these, the first was clearly of greatest importance since the accumulation of the generated counterpart funds in the Central Bank had become a source of embarrassment to the government.

2. Internal Politics and Privatization

Arias' position on privatization was clear. He was prepared to sell shares in the firms CODESA held not only to bring about reform of their operations but to democratize ownership through sale of stock to the public. Privatization, if successful, would achieve a Presidential objective of broadening Arias' political base, at the expense of the opposition, by creating a constituency of those who benefitted from share purchase.

Costa Rica is a democratic country, with an operating opposition party structure, a relatively highly educated population and a high quality of life. President Arias had become convinced by a visit to Margaret Thatcher in May, 1987 of the advantages of privatization--both political and economic. Creation of a larger political constituency by democratizing ownership through stock holdings fit closely with the President's desire to work toward a centrist position to counter his right wing opposition.

However, the Costa Rican situation has a peculiarity which will affect the democratization process. The system has for a considerable period in the past relied on the Solidarity Movement as a vehicle for social change. The Movement, which embraces coops covering the entire country, would provide a method of distributing shares in divested firms which would ultimately reach large numbers of coop members as potential buyers. Accordingly, the President sent a letter to between 400,000 and 500,000 coop members urging them to buy shares directly through their coops for the sale of the sugar producing firm, CATSA.

The coop movement is fractured between moderate and liberal political positions; the far left has considerable political and economic power within the governing structure, since a very substantial portion of Costa Rica's three million people are members of coops, particularly in the rural areas. The President's political goal in privatizing is to set a median course between two evils, one, to avoid accretion of power to the extreme left through control of divested industries by purchase of shares by left wing controlled coops and two, to avoid the accretion of wealth in the hands of a few by allowing wealthy individuals to acquire substantial holdings in divested state owned firms.

One contrary position was recommended essentially by the left, i.e., that CATSA be run as a type of super-coop rather than as a fully privatized firm. However, the coops have, in Costa Rica as elsewhere, the reputation of being poorly managed, underfinanced, not profit-oriented, and disorganized. The governing party has maintained that CATSA should be run as an example of how a private company should operate; the only way this can be accomplished is by making coops shareholders in a private company which has largely autonomous management.

The political objective of privatization, then, became clearer. Presidential social objectives of bringing about change and reform in the economic system would be accomplished by democratization of ownership--but not democratization in the larger sense of the term implying individual ownership of shares. Rather, what is implied is ownership through membership in the coops of the Solidarity Movement. The coops would provide a more solid political base for the President than would individuals and they would be easier to persuade or even control. There was the risk that privatization could serve to increase the power of the left-dominated coops, but the President took the position that this risk would be substantially reduced if the opposition idea of one large company run as a super-coop could be defeated.

Opposition to privatization came also from another quarter. Within a few months after the announcement that the government planned to privatize parts of the public services sector, open trade union opposition arose. Based largely on the assumption that transfer of services to the private sector would cause loss of jobs and of employment guarantees now held by the workers, union heads argued that privatization was not in the interests of the workers. Where privatization involved worker participation in the new firms, there was some enthusiasm on the part of small groups of employees. But the unions claimed that the new privatized services were being established without adequate union consultation. Six central unions formed a Permanent Workers' Council which requested the Legislative Assembly to cease privatization efforts in areas considered strategic for social and economic development, such as banking, energy, health, communication, and railways.

President Arias, with the help of his Minister of Planning, fulfilled the role of the leader committed to privatization. His influence was able to diminish union opposition to privatization from late 1987 on, but the privatizing process continued to be slow in view of the political pitfalls built into it.

3. The Role of the A.I.D. Mission

The role of A.I.D. was a complicated one. In its eagerness to pursue a privatization program, the Mission ran the risk of getting out in front of both the government and public opinion. Not only was time needed to reduce political barriers but an educational process was required to overcome the skepticism of the potential share owners, the coop leadership. It became increasingly important to demonstrate that privatization was a Costa Rican government program which had the full support of the majority party and that it was not a goal being pushed upon the government by an external agency. Moreover, it had to be transparent that the consultant furnished by A.I.D. was to be first and foremost at the service of the government, with a liaison function with the Mission.

To dilute the prominence of its role in the privatization process, the Agency was interested in having the British play a part. A representative of the Adam Smith Institute in London was invited to prepare a report on future privatizations in Costa Rica. The Report recommended a number of possibilities, including the telephone company. These would be done with the assistance of British investment bankers with support from the A.I.D. mission. It is unlikely, however, that the government will be interested in further privatization until it disposes of all the companies held by CODESA, particularly in view of the political reaction to attempts to privatize parts of the national electric company in 1988.

By late 1988, only three major companies remained to be divested, CATSA, a sugar mill which was to be sold to the private cooperative sector; FERTICA, a fertilizer plant, 40% of whose shares were to be sold, and CEMPASA, a cement plant in which an equal percentage of shares were to be sold. In the case of CATSA, the company was restructured into a profitable business by FINTRA and, after some early problems, is likely to be sold to several large cooperatives. Any remaining shares will be put through the securities exchange.

FERTICA shares were originally to be sold to a Norwegian company, Norsk Hydro, and a letter of intent was signed to permit the sale and negotiation of a management contract. However, the possibility of political backlash because of sale to a multinational caused the government to renege on the agreement. The intention now is to transfer the shares of FERTICA to FINTRA which will arrange the sale of 40% of the shares to a wide group of Costa Rican investors that will likely include employees and some users of the firm's products. Political sensitivities were particularly strong in this case since Cost Rican agriculture is strongly impacted by FERTICA's pricing policies and there is fear of unemployment resulting from privatization.

CEMPASA, a well-managed and profitable firm, has been left to the last because FINTRA's attention has been devoted to the other two, but it is expected that CEMPASA will be restructured and offered in the same way as the preceding firms.

The government will continue to have political difficulties with its privatization deals not only from the left, but from the old guard of Arias' own party, which was committed to the idea of CODESA as a holding company from the very beginning. The government is particularly anxious, however, to complete the sale of 40% of FERTICA before the end of its term of office in 1990 but if a reasonable price is to be obtained, FINTRA will probably require more time to reorganize the firm into a profitable operation.

4. Lessons From the Costa Rican Experience

The Costa Rican privatization program was certainly stimulated by the interest of the Mission, but substantial politically motivated delays were encountered at the early stages. It clearly was designed to have important social and economic effect on the country but at the same time it was meant to support the desire of the President to enlarge and solidify his party's political base through democratization of ownership in the peculiar circumstances of the Costa Rican internal political structure.

The Mission's own role would have been made easier if greater thought had been given initially to the political implications involved in a privatization program. The whole program was put in place too hurriedly without, it would appear, sufficient consultation with, or at least consideration of, the intricacies of the local political situation. Technical errors were made in establishing FINTRA and the whole process was made needlessly complicated by the establishment of the Commission as an added layer of bureaucracy. Nevertheless, the accusation that too high a price was paid in local currency for firms to be divested is unfair. The chief point to be kept in mind is that the government's primary concern was to avoid monetizing any of the local currency balance so that what might have appeared to be an excessively high valuation in local currency is beside the point. The price was a bookkeeping transaction which served to lower the available local currency balance and concomitantly reduced pressure on the government to monetize any of it.

Annex C

Tunisia: Institutional Development for Privatization

1. Introduction

Tunisia has had a long standing interest in privatization beginning during the Bourghiba regime and continuing into the present Ben Ali government. Most of the SOEs required subsidies that were proving to be an ever greater burden on an already strained national budget. Even more important was the need to increase the efficiency of firms engaged in export production in the light of the government's hope of greater entry into the European Common Market. Privatization, leading to a greater place for the private sector and reduction of the role of the state in the economy was a major step forward in the government's planning.

2. The Decision to Privatize

The government made the formal decision to embark on a privatization program in 1986. Legislation was passed in 1987 (Law No. 87-47 of Aug. 2; full text is in the *Journal Officiel* of Aug. 14, 1987) formally setting up the commissions under which the restructuring of public sector enterprises, including privatization) would be accomplished.

Within the Sixth Plan of economic and social development, the Law provided for creation by decree of a list of firms to be restructured. A seven member Restructuring Commission, composed of bureaucrats, was named to carry out the provisions of the Law. Its major task was to evaluate the industries to be divested, completely or partially, "according to currently used methods." The Commission was free to consult with any experts it desired.

The Commission's work was to be embodied in a report sent forward to a second Interministerial Commission that was to authorize, based on this report, the actions necessary to carry out the privatization. In turn, these actions were to be implemented by the Ministry of Finance and the Ministry responsible for the industry being divested.

To add to this already cumbersome structure, a third Commission was created whose job was to implement the decisions of the Interministerial Commission as they applied to future stock offerings. It was attached to the stock exchange. This Commission was charged with seeing that the shares of the firm were listed on the exchange and with providing prospective share buyers with all the necessary information on the financial and technical aspects of the firms. The privatization law detailed the special conditions applying to small investors, who were to be given priority buying rights. In those cases where shares were to be distributed free to employees as part of the privatization agreement, the shares were required to be held for two years before they could be sold. The Law also specified the taxes from which privatized firms would be exempt for a period of five years after the sale by stock offering and special financial arrangements that could be used to pay for the shares purchased.

The 1987 Law was the result of almost two years of reflection and debate, both public and within the ruling party. Since Tunisia operated under a one party system, there was no question of strong party differences based on philosophy or ideology as in the case of Jamaica. Nevertheless, there was substantial disagreement within party factions between those who believed whole-heartedly in encouragement of the private sector through privatization and those who felt that a strong case could still be made for state intervention in the productive sector of the economy. Both sides overstated their case in the debate; those who argued for immediate and total privatization of all state owned enterprises were clearly out of touch with the political realities of the country. Those who argued, on the other hand, against any privatization for ideological or personal reasons were equally out of touch with the trend in government thinking on the necessity of dismantling the structure of subsidies.

The passage of the Law on restructuring public enterprises was an indication of the government's determination to reduce the size of the public sector. It rapidly became evident, however, that the three tiered Commission structure was more a hindrance to privatizing than a help. The implementation process was too complex and time consuming and the consent of too many bodies was required before implementation. Coordination of the work of three Commissions required a degree of staff support that was not available. Members of the Commissions had no special knowledge of the privatizing process and were often at a loss to know what action to take. They were, in any case, often busy with their own full time jobs, leaving little time for consideration of the complex problems of valuation of firms or seeking out prospective buyers. No priorities for divestment were laid down and no overall strategy was developed. As a result, little had been accomplished in the months before the overthrow of the Bourghiba regime.

The Ben Ali government that assumed power in November, 1987, was more eager to get on with divestment than was its predecessor. Its first step was to dissolve the Commissions created under the Law so as to make way for a new and streamlined decision-making procedure. The Commissions were replaced by a single body, the National Commission for the Restructuring of Public Enterprises (CNAREP). CNAREP consists of five members, the Ministers of Finance, Planning, Public Service, and Social Affairs, and the head of the Central Bank and was chaired by the Prime Minister or his representative. The Minister responsible for the firm under discussion (Ministre de la Tutelle) at the Commission's monthly meeting sat as a temporary member.

The Commission has full authority to make decisions on privatizing or restructuring and some 30 decisions have been made since it came into existence in January, 1988. It bases its decisions on a brief document (tableau de bord) which is produced by a secretariat headed by the Director General of Public Enterprises. The document consists of a review of the financial and technical position of the firm, capital resources, cash flow and market position as well as other pertinent details depending on the individual case. The secretariat makes recommendations for the Commission's consideration on the form of divestment In the process of gathering the necessary information, interviews are held with the firm's management, officials of the responsible Ministry, bankers, and any other interested parties. Commission members study the document and meet to make a decision which is ratified by the Prime Minister. Decisions are usually made in one meeting unless more information is desired, in which case the Commission can summon the firm's manager or other officials (such as officers of the stock exchange) to meet with it.

Cases are brought before the Commission by the various responsible Ministries but priority is given to those brought by the Prime Minister or the President. An overall criterion applied by the Commission is that, if the state is to disengage from an industrial activity, there must exist a competitive situation so that a public monopoly is not simply replaced by a private one. So, for example, the Societe Tunisienne d' electricite et de gaz (STEG) is not likely to be privatized for this reason as well as for reasons of national security. While the government would be happy to dispose of the phosphate mines at Gafsa, no private buyer is likely to come forward prior to major restructuring.

The presence of the Minister of Social Affairs on the Commission is indicative of one of the government's major concerns. The Ministry is expected to provide input on the question of potential unemployment that may result from a privatization action. The government is most anxious to avoid political pressures stemming from an increase in the current high level of unemployment and every effort is made to see that displaced workers have job opportunities open to them.

In a few cases, such as the sale of supermarkets in which bank loans are guaranteed by the government, the employment issue is not critical and the banks may proceed to foreclose if necessary. In others, such as the Gafsa phosphate mines, the goal is to reduce the present overemployment by attrition. So far, management has been able to reduce employment figures from 14,000 to 11,000 with an ultimate goal of 7,000. One major privatization, a refrigerator manufacturing company, has been held up by a condition attached to the sale that the buyer employ all of the current work force. Buyers find this condition unacceptable and it is unlikely that the sale will be completed until some way is found around it.

Not all firms to be privatized are money-losers; a tourist agency which had been losing money became profitable over the past two years. The decision to privatize in this case was based on the view that it was simply not a business the government should be in.

Unlike other privatization programs, the Commission in Tunis does not operate from a public list of firms to be privatized nor is there a strategy of privatizing large firms or those losing the most money at the outset. Experience with the list of state owned firms made public in the earlier Privatization Law was unsatisfactory in that firms not appearing on the list assumed that they were not to be part of the program even when they were losing money heavily. In consequence, they felt that they could continue the inefficient financial and management practices that had made subsidies necessary if the firms were to remain in business. The new Commission made clear that all state owned firms were candidates for restructuring; any one of them could become the focus of the Commission's attention at any time. Management was thus encouraged to greater efficiency in the expectation that the restructuring secretariat could knock on the door at any time.

CNAREP has clearly streamlined the process of privatization, at least at the top level of government. Its restricted membership, access to the highest authority, and limited documentation has made decisions on the form of divestment both rapid and simple. Technically, the Commission currently operates without legal sanction in that the Privatization Law of 1987 with its three Commissions is still applicable since it has not been repealed. CNAREP came into being with the new government; it is highly unlikely that any of its actions will be subject to legal challenge. A projected new law is in process of completion, designed to give CNAREP proper legal status and replacing the earlier multi-tiered commission structure.

The current institutional structure begins to fall down, however, at the point of implementation. It is difficult to avoid the tendency to confuse policy decision with policy implementation. CNAREP is aware of this and makes an effort to circumvent it. In principle, there is a clear line of follow-up to a Commission decision. After ratification it is transmitted to the Ministry responsible for the enterprise which is thereby charged with its implementation. After two months, the Ministry is expected to make a progress report to the Commission or to the Office of the Prime Minister. Given the inevitable bureaucratic delays, however, this schedule may slip.

If the Commission has attached conditions that are particularly difficult to fulfill (such as employment of all current workers), finding an individual buyer may not be possible. The process of working out details of a stock offering (share price, employee purchase preference, sale timing etc.) can consume substantial time. Implementation may depend on the efficiency and knowledge of the members of the Minister's cabinet and the amount of time they may have to spend on the subject. What may be needed most, however, is a senior staff member of the Prime Minister's office who bears the authority of the Commission and whose job it is to devote his time to follow-up details and negotiations. Without this support the streamlining of decisions is unlikely to bring about the expected results.

3. The Role of the A.I.D. Mission in Tunisian Privatization

The A.I.D. Mission in Tunis has supported the government's desire for a privatization program from the outset. It furnished technical assistance, consultation services, and confidential advice on the privatization process and on macroeconomic policy changes to facilitate privatization.

In April, 1987, the Mission provided financial support to an international conference on privatization organized by the Institute of Management, which drew on experts from Europe, the Middle East and the United States. The purpose of the conference was essentially consciousness-raising on the issue of privatization for civil servants, the private sector and the public in general. The conference achieved wide press coverage and succeeded in raising the level of knowledge and interest in the topic throughout the country. Papers prepared for the conference were circulated both inside and outside government.

The government's decision to pursue privatization as a major policy was made more concrete with the passage of the Privatization Law a few months later, followed by the creation of the implementing Commissions. The change in government produced no reversal of the government's determination to privatize. Over the following months, the government's needs in technical assistance became clearer and the Mission prepared a project designed to direct resources to CNAREP, other government agencies, and the stock exchange to assist in planning and organizing privatizations.

The Project, embodied in a Memorandum of Understanding (MOU) signed with the Prime Ministry of the new government, was divided into five components:

- Preparation: Financing would be provided for consultant assistance in selecting and preparing companies for privatizing.
- Asset Valuation: Technical assistance would be provided from both foreign and Tunisian sources to assist the Commission in selecting appropriate valuation methods and in company analysis.
- Marketing: Technical assistance would be made available in selecting methods of sale, preparation of sale promotion materials for potential buyers, and on marketing strategy.
- Financing: Technical assistance would be offered to promote domestic financial market development as part of the privatization effort. A conference on this subject, using outside experts, was organized in May, 1988 as part of the program.
- Follow-up: This part of the program is designed to monitor post-privatization actions by government and the private sector so that errors can be rectified and appropriate actions taken to keep the privatization program responsive.

Detailed implementation of the assistance program also envisaged training in stock market mechanics, financial analysis and corporate finance, both inside and outside the country, visits of stock market officials to foreign stock exchanges, and training seminars.

It was agreed that A.I.D. would recruit and pay two long term (2 year) consultants but they would be responsible to

Tunisian authorities. One of these, a privatization specialist, would be stationed in the Office of the Prime Minister. He would directly assist the CNAREP with advice on policies and procedures in the privatization program, organization and operation of the Commission itself, and advise on short term consultants to be hired for specific tasks requested by the Commission. The other, a financial markets specialist, would provide technical and management assistance to the stock exchange to promote the organizational development and institutional capacity of the exchange. In addition, he would be expected to advise on new financial instruments for the Tunisian financial markets, assist in preparing offering prospectuses for firms being divested as well as individual company reports and investor information.

Finding senior consultants with the requisite skills and language competence did not prove easy. To be of most help, the CNAREP consultant would have to gain the fullest confidence of the most senior Tunisian officials since he would be dealing in areas of high political sensitivity and would be privy to information few individuals in the country might have.

As part of the program under the project, a second conference on privatization under Tunisian sponsorship, with Mission financial assistance, was held in April, 1988. The objective was no longer to discuss the philosophy or desirability of privatization (government policy was assumed to be fully determined) but rather practical training in the nuts and bolts of the privatization process, using case histories of completed privatizations in France and Turkey. A Tunisian case was also used as an illustration of the preparation of a firm for privatization.

By early 1989 CNAREP had taken a number of decisive actions ranging from a number of outright privatizations, decisions to privatize components of some SOEs, and restructuring in preparation for privatization. Four hotels, a tile factory and a flour mill have been sold or liquidated. Identified for either divestiture of components or progressive privatization include the nationalized fishing industry's trawler operations, and government-owned shares of two consumer goods factories which will be placed on the stock market.

4. <u>Lessons Learned From the Tunisian Experience</u>

The A.I.D. Mission was able to contribute substantively to Tunisia's privatization efforts through support for greater public awareness of the benefits of reducing the public sector. Technical assistance has been programmed in direct response to the expressed needs of government, yet with understanding that there were many parts of the privatization process which Tunisians felt they could handle themselves.

The Mission's success thus far in assisting Tunisia to develop institutional capability in privatization is attributable to a number of factors:

- Early support of Tunisian interest in the subject and a willingness to assist the government in its public education campaign.
- Support for and interest in the project from the top of the Mission and development of a relationship of confidence between high authorities of the government and Mission officers over a period of time. The government was able to deal with the same officers over the entire period so that there was a clear understanding of the technical assistance needed.
- The Mission did not get out ahead of the government at any time in planning for privatization. While the process did not go as rapidly as the Mission might perhaps have wished at times, there was an understanding of the political difficulties faced by the government and the Mission was content to proceed at the government's pace. Throughout, an effort was made to ensure that privatization was seen publicly as a Tunisian program, not one which was being urged on the government by a foreign agency.
- Mission officers listened to the government's expressed priorities rather than seeking to suggest a privatization plan from the outside. Advice was offered when sought, not proferred. High officials of the Tunisian government were engaged from the outset in the selection of long-term consultants. As a result, confidence was built that the Mission's technical assistance was disinterested.

The Tunisian experience illustrates the importance of keeping the institutions for privatizing as simple as possible to expedite decision making while at the same time ensuring that the process of privatization is closely integrated with the operation of the financial market. It also points up the need to tailor donor technical assistance to the specific needs and goals of the government. It may help to speed what is at best a slow process but even more importantly, it can aid in ensuring that the government is satisfied with the results of the privatization procedures adopted.

ANNEX D

Malawi: Privatization of ADMARC Assets

1 Introduction

The decision by the Government of Malawi (GOM) to embark on privatization had its origin in the program of structural adjustment worked out in the early 1980s with the World Bank and the International Monetary Fund. The program was directed toward a rationalization and restructuring of major government-owned industrial operations within the broad framework of restructuring the economy of the country as a whole.

A major part of the rationalization was to be applied to the Agricultural Development and Marketing Corporation (ADMARC), whose basic purpose was to develop and market the country's crop of food grains. Established in 1971, the corporation had expanded beyond its basic function to include ownership of tea and sugar estates and a number of industrial firms. Many of these ventures were not successful financially and the GOM Treasury was called upon annually for substantial amounts to subsidize their operation.

ADMARC's limited number of managers were devoting much of their attention to detailed supervision of ancillary enterprises with which they were unfamiliar, rather than to the improvement of the marketing of agricultural commodities. The corporation lacked the liquidity necessary to purchase the annual maize crop, further increasing its dependence on government funding.

A Ministry of Finance White Paper of April, 1986 recommended (1) that ADMARC's portfolio should be reviewed for divestment to create greater liquidity for its core activities and (2) that the Corporation's management be completely restructured. The government's decision to embark on privatization was a result of policy dialogue initiated by the World Bank which was continued by the Mission after the initiation of the project.

The GOM requested assistance from A.I.D. in August, 1986 to carry out a divestment and restructuring program. The Mission responded with a project consisting of two major elements:

- A technical assistance grant to fund consulting services for the sale of ADMARC enterprises. The GOM consulting contract with Deloitte Haskins and Sells (DHS) provided for the services of an Investment Coordinator (IC) to direct the program and a technical assistance team to prepare a series of special studies dealing with particular aspects of the privatization process. Among the tasks specified under the contract were a review of the objectives of the privatization policy, identification of legal, administrative and financial constraints, and preparation of action plans for each firm being privatized. The technical assistance team determined that the ADMARC assets needed to be categorized in the light of the aims of the divestiture program. The IC prepared reports summarizing the condition of each asset and then graded them according to tests developed by the team. After grading each asset was placed in one of five tiers:

I. Full divestiture through negotiated sale or competitive bid
II. Divestiture through negotiated sale or a public share offering
III. Partial divestiture through negotiated sale
IV. Restructuring prior to divestiture
V. Retention by ADMARC

The Divestiture Committee retained the authority to make changes in the categorization and did so on more than one occasion .

- A.I.D. provided $15 million of Economic Support Funds (ESF) funds which were to be disbursed to the GOM as the program progressed. The hard currency was to be given on a ratio of $1 for each 3 Malawi Kwacha (MK) of the value of assets sold by ADMARC. This "carrot" played an important role in facilitating and speeding the sale of both estates and industrial firms. Later, a special credit facility was created with local currency to enable Malawian buyers to participate in the purchase of estates.

The Mission felt that its influence was limited by its not being included as a member of the Divestment Committee of senior civil servants appointed to execute the program. However, the government has remained firm on this point, maintaining that this was a government committee, in which the IC was included as an employee of the government under an in-country contract.

The GOM made clear that its major interest was to divest money-losing ADMARC assets as quickly as possible to reduce subsidy costs to the Treasury, as well as to restore liquidity to the corporation. Privatization proved to be a very useful instrument to achieve these goals while at the same time allowing ADMARC to maintain a minority interest in most of the assets.

The combination of expert assistance and grant funds was critical to achieving the GOM's goals. The program as a whole has brought new investment and increased the size of the corporate sector. But it has not achieved a secondary objective, a substantially greater spread in local private ownership of former government assets. Given the current distribution of wealth in Malawi, however, and the lack of an operating capital market, it is unlikely that large numbers of new small investors can be attracted to the market in the absence of financial instruments that will facilitate their participation, such as Employee Stock Ownership Plans or Unit Trusts.

The program had completed sales of three companies, two development estates, and seven agricultural estates through March, 1989. Negotiations were at the final stages for seven additional agricultural estates and several large industrial firms. Sale of one of the most important of these, the National Seed Company of Malawi, was completed in March, 1989.

2. Privatizing The National Seed Company of Malawi (NSCM)

NSCM was established in 1978 to ensure a supply of high quality seed (maize, tobacco, oil seed, groundnuts, soybeans and other legumes) for Malawi's agriculture. The seed was produced largely by local contractors under the control of the seed technology unit of the Ministry of Agriculture. The company had a *de facto* monopoly of seed supply and 65 to 70% was sold to Malawi small holders, with a small amount available for export. ADMARC was the company's major sales outlet until recent years when sales declined substantially as a result of high prices and ADMARC's and NSCM's lack of management capability.

Until recently, the company was owned 72.5% by ADMARC and 27.5% by the Commonwealth Development Corporation (CDC), a British development firm, and was operated by CDC under management contract. NSCM was by 1987 in serious financial difficulties. Outstanding loans from CDC and GOM amounting to nearly one million pounds sterling were coming due in 1988 and long term borrowing accounted for 79% of the capital employed in NSCM's operation.

The firm's management made optimistic projections for its future, provided that it could diversify its product to meet growing local market needs and increase its export capability. However, it seemed clear that financial constraints would prevent any such expansion from taking place.

Management argued that not only was capital restructuring necessary but that it was critical to recruit an international seed company with experience in Africa and its own proprietary technology to create an increase in NSCM's market. CDC realized that it did not have the requisite technology or management skills. CDC also indicated a willingness to convert an earlier loan to the company into equity since the burden of repayment and servicing of the loan would have seriously crippled the company's prospects of profitability. The IC recommended that ADMARC accept the need for capital restructuring and that the CDC be encouraged to seek suitable domestic and/or foreign partners.

However, the GOM Ministries responsible for food security were initially opposed to control of NSCM by foreign investors, arguing that this could pose a serious issue of national security. Given the pressure on food resources in Malawi, with a shortage of land and a 4% annual population increase, the government regarded an adequate supply of seed (particularly of new strains of hybrid maize) as critical, especially in view of a shortage that had occurred as a result of seed export in 1987. Foreign majority ownership of the company was undesirable unless the government retained the power to control export of seed according to estimated domestic need. A compromise was suggested by the IC under which the government would retain a veto, as a board member, on certain issues, including seed export.

a. The Privatization Process

The process of identifying a likely buyer for NSCM was somewhat less complicated than was the case for other ADMARC assets since a highly specialized company was needed. The desired buyer would need to have African experience, be an internationally known firm with a strong reputation in seed technology, and be willing to inject substantial capital. CDC was prepared to waive its rights of first refusal to buy additional shares coming on the market

CDC and DHS carried out international inquiries, since it was clear that no local firm could meet the criteria. Two desirable candidates were found: an internationally known pharmaceutical firm, which subsequently indicated that it was not interested, and the London subsidiary of Cargill Inc., an internationally known American grain trading firm, which became the remaining qualified buyer.

Cargill had sold its operations in South Africa and was looking for a seed firm elsewhere in Africa. Seed was a product needed by all African countries and Malawi was, according to Cargill technical managers, the most suitable country both in climate and rainfall for seed development. Cargill was satisfied with the political stability that Malawi had demonstrated over a period of years and was already familiar with the country since it owned 51% of a Malawi cotton ginning company (ADMARC owned the remaining 49%).

Cargill was not, however, prepared to become simply a passive investor. Wherever it operates, Cargill seeks majority ownership and/or management control. (This did not apply in the case of the cotton ginning firm since government-controlled prices were imposed at both the production and the selling ends and Cargill's participation was essentially on a fee per ton basis for product processed). Cargill's approach to the seed business was particularly suited to the NSCM since it was prepared to inject capital without regard to immediate dividends. Profits were to be ploughed back into expansion of the firm with a view to enlarging both domestic and export markets. Cargill saw the seed business as a long term (five to ten year) proposition before sufficient new product could be developed to make the firm profitable. Its market research indicated a strong pent-up demand by Malawian farmers for new and more productive strains of hybrid maize and a ready market for seed surplus to Malawi's needs.

There was initial opposition to the sale from some government officials, based in some degree on a lack of understanding of the details involved. Cargill was forced to undertake a public relations exercise to convince the opposition of its determination to achieve majority control. In persuading the Committee to approve the Action Plan, the IC acted as a stable point of reference, in Cargill's view, not as a government advocate.

The new owners formally took over operation of the company in October, 1988, although the final documents of sale were not signed until March, 1989.

b. <u>Structure of the New Company</u>

The major hurdle in the protracted negotiations was the government's demand that it retain a 51% controlling interest in NSCM for reasons of national security. Cargill would only go through with the deal if it could secure a controlling interest. Although the GOM's Divestiture Committee (composed of senior civil servants) had approved the 51% interest at its meeting in May, 1988, the IC sought to resolve the dilemma in a new action plan presented to the Committee for consideration some months later. In it the IC proposed that:

- The ADMARC/GOM share be reduced to at least 20%, with ADMARC and the government each retaining one seat on the board. Voting in the board would be by individual vote, regardless of shareholding.

- Any decision by the company to export seed would require the affirmative vote of all of these board members.

- The Ministry of Agriculture must be an active participant in all company decisions regarding seed production. Cargill would be required to make available its technical knowledge to any Malawian body concerned with seed production. (Cargill found no problem in complying with this provision.)

- Any changes in rules governing board activities or shareholding would require the affirmative vote of both the ADMARC and the GOM's board members.

- Cargill, as technical partner, could take a minimum of 40% of the shares and a maximum of 60%; the GOM/ADMARC a minimum of 20% and CDC would retain at least 10%. Cargill would agree to invest substantial capital in the company and would commit itself to Malawi's and to regional interests.

Cargill required as a fundamental pre-condition of its participation in the business that the company be able to carry on its operations without involving Cargill in any breach of the U.S. Foreign Corrupt Practices Act.

After further negotiation, the final agreement on ownership provided that Cargill assume 55% shareholding control, with the added understanding that it would invest a minimum of $1,000,000 of new capital. ADMARC and the GOM would together retain 22.5% and CDC would take the remaining 22.5%. To maintain its level of ownership, CDC converted to equity part of its loan to NSCM. The board would consist of five members, three nominated by Cargill, one by ADMARC (whose alternate would be nominee of the government) and one nominated by CDC. The provisions for agreement of both the ADMARC and the government nominees on certain board issues were retained. The board chairman was to be appointed by Cargill.

The compromise finally arrived at satisfied all the requirements of the interested parties. The government secured a technically competent partner, capable of bringing wide relevant experience and capital to the company and who could assume day to day operational management. Board membership provisions took care of the government's security concerns and CDC continued to be a minority investor.

c. Issues Relating to the Privatization

Although ADMARC received no direct financial benefit from the sale, future dividends would be forthcoming from shares it continued to own. NSCM was strengthened in that it was relieved of its outstanding debt and, under its new management, would be operated more competently; indeed, it is doubtful if the company could have survived without these changes. Conversely, ADMARC managers that had been concerned with NSCM could now devote more of their attention to the problems of ADMARC's primary business and the corporation was relieved of the burden of additional working capital for NSCM.

The sale involved no further concentration of industry than was already the case. NSCM was a government controlled monopoly before the sale; now it is essentially a privately controlled monopoly. Although there is no legal prohibition against competition to NSCM arising, it is unlikely that this will occur under the special circumstances of the seed industry. The sale did not meet one of the A.I.D. Mission's objectives, that of spreading Malawian ownership of industrial production, but in the case NSCM, the government's interest in ensuring needed supplies of high quality seed made wider ownership a secondary consideration. It is possible that, as the capital market develops, ownership could expand if ADMARC's share holdings in NSCM are offered for public sale.

d. Role of the A.I.D. Mission in the Privatization

Cargill officers made clear that the deal would not have been completed without the A.I.D. program for assistance to ADMARC divestment.

A.I.D. provided the technical assistance funds needed for the Investment Coordinator and the T.A. team. The IC eventually achieved the complete confidence of the GOM's Divestment Committee and was perceived to be a neutral negotiator whose task it was to bring about an agreement between buyer and seller that would be the best possible for the asset, ADMARC, and Malawi's national interest.

The sale would not have been successful in the absence of the incentive offered by the A.I.D. grant. It served to fix the government's attention on the divestment process and made the government more inclined toward compromise since the GOM needed the hard currency. The grant was important in another sense. Unlike the strictures and restraints imposed from the outside by the IMF, which are perceived as negative forces, the A.I.D. grant was a positive incentive in that it helped the government to arrive at a decision to divest without feeling the pressure of external dictation.

3. Privatizing An Agricultural Estate: The Kavuzi-Mzenga Case

Kavuzi and Mzenga are two adjoining tea and macadamia nut estates in northern Malawi. They consist of roughly 2000 acres planted in tea and 1000 acres in macadamia nuts with an additional 3,500 acres available for expansion of planting in one or both crops. Kavuzi, a fully irrigated estate is just beginning production of top quality tea, while the nut trees are approaching maturity, although recovery rates thus far have been poor. Prior to the recent sale, the estates were fully owned as development properties by ADMARC. Except for sugar estates, they are the most valuable of the Corporation's agricultural holdings and substantial investment both in time and money has been made in them. Some observers have felt that much of this investment was wasted through ADMARC's failure to accept expert advice in development and management of the estates.

In its final report on divestment, the Technical Assistance Team recommended the estates be put in Tier 1 of the priority categories established under the Technical Assistance contract -- i.e. that they be divested immediately in their entirety. The Divestment Committee agreed, ruling out any restructuring or rehabilitation of the estates prior to sale. While ADMARC had done a good job in its development thus far, it was felt that the private sector was both willing and able to complete the task. ADMARC acknowledged that it had neither the financial, managerial, nor technical resources to put into further development.

a. The Privatization Process

Since ADMARC had already made a substantial investment in the two estates, it was particularly important to have an accurate and fair valuation of the properties. A valuation model was prepared by DHS, which held the technical assistance contract. The model was based on projected and discounted cash flow models. From this a range of values was generated, using different assumptions on yield, operating costs and foreign exchange rates.

The buyer agreed in the course of negotiations to pricing of the estates on a target rate of return basis. This served to increase the sales price to a figure substantially higher than the offer of the next highest bidder. The reasons for this were peculiar to the buyer, although the buyer later realized that a lower price might have been paid.

The availability of the estates was publicized through notice in the Malawi press and through direct solicitation of contacts in the tea and macadamia nut growers groups throughout the country. Several factors served to limit the number of local bidders -- the remote northern location of the properties, low world prices of tea but most importantly the sheer size of the transaction. One potential local buyer, the Namin' Gomba estate in the south of the country, dropped out at an early stage because of the substantial investment that would be required, and its feeling that the macadamia nut planting had been overvalued.

Although enquiries came from as far away as Japan, four potential buyers were ultimately identified, the Commonwealth Development Corporation (CDC), Lonrho (Malawi), and an unidentified U.S. firm. Within a few months, all but CDC had withdrawn. Lonrho's decision to withdraw was based on the belief that CDC would be prepared to pay more for the properties, since,as a development firm, it was not under pressure to seek immediate capital returns. CDC was also attracted by the location of the estates and the presence of a tea processing factory. No local buyers were among those in final contention, basically because the estates were a large, complex project, requiring heavy capital input, highly experienced management, and were not projected to be profitable for several years.

CDC finally made an offer of MK 25 million ($1.00 = MK. 2.65) for the properties in August, 1988 after lengthy negotiations with the IC. The sales agreement stipulated that Kavuzi and Mzenga estates would be bought by a neighboring estate, Kawalazi, that was owned jointly by CDC, a Malawi parastatal holding company, Spearhead Holdings, and by FMO, the Dutch international development bank. The new Kawalazi would be owned 72.5% by CDC, 25% by FMO and 2.5 % by Spearhead and the three properties were placed under a single management structure. CDC's higher price was in part conditioned by its stake in the neighboring estate that permitted a cost-saving synergistic relationship in irrigation, crop processing and management.

From the sale, ADMARC received a net of MK 7.4 million and retained an option to buy 10% of the new company within one year of the sale. Payment was derived from rollover of loans from a local parastatal, FMO, the European Investment Bank, and CDC. Existing CDC foreign currency denominated loans to the government were renegotiated to be made payable in MK and these were converted into cash as part payment for the properties. These were supplemented by a debt/equity conversion by CDC.

b. Issues Raised by the Sale to CDC

Local vs. Foreign Ownership. The GOM's high priority of restoring liquidity to ADMARC and the prospect of better management and higher productivity from the properties outweighed the question of expanded local ownership. Sale of the estates to CDC, a foreign development firm, was partially offset by retaining a Malawian presence through Spearhead's minority holding. In addition, CDC is committed to indigenization of the management of the estates as rapidly as possible.

From the government's point of view, sale to CDC was advantageous because of the cash price paid and CDC's intention to dispose of the property to local buyers at some future date. As a development corporation, CDC's strategy is to divest holdings when they become commercially viable and to invest the proceeds in new development projects. Such divestment has, in the case of Kawalazi, an extended time frame, in that the CDC managers estimate that the estate will require 25 to 30 years before it provides a commercially attractive return on investment.

A foreign sale also avoided the sensitive question of any involvement of the Asian community in the ownership of ADMARC assets. An Asian owned Malawian food processing firm inquired about the properties when the sale was announced but received no reply until some months later when the CDC offer was already under negotiation. Sale to local Asian interests was, in any case, impossible, since Asians are legally forbidden to own land outside the three main urban areas.

Since there are over 70 tea estates and 25 tea factories in Malawi, no significantly greater concentration of market power will derive from the Kavuzi-Mzenga sale. In the case of macadamia nuts, a single grower out of 20 produces half the crop and processes the crop entirely. When Kawalazi begins production, market concentration will be reduced and processing will be spread.

Strengthening the Assets by Divestment. The new owners took control of the properties in January, 1989 and within a year it is expected that some MK 40 million will have been invested in improvements. Over the life of the project, an investment of MK 130 million is envisaged, with only 14% coming from retained earnings. Infrastructural improvements will include a new dam for gravity-feed irrigation and new macadamia cracking and processing facilities. Apart from physical improvements, the properties will benefit from a reduction of MK 3.8 million in foreign exchange exposure through CDC debt for equity conversion and a potential MK 5.2 million further reduction if FMO carries out its intention to convert its loan into equity.

In the case of ADMARC, apart from the direct benefit to its liquidity of MK 7.4 million in cash, the sale produced a number of indirect advantages. An estimated MK2 million in annual operating costs of the estates will be eliminated as well as future capital improvement expenditure. As a result of the sale, ADMARC managers will no longer be required to spend time on micro-management of the estates and on dealing with the cash drains they caused. Management will be able to concentrate more fully on the Corporation's core activity, marketing of grain.

One aspect of the sale added to ADMARC's profit as well as producing a hard currency gain for the government. The IC convinced the GOM to waive the 3% stamp tax, amounting to MK 729,000, normally due on a transfer price of MK 25 million. As a result, the buyer paid the full sales proceeds to the Corporation. Because A.I.D.'s BOP support is calculated on the gross sale price, the government received $US243,000 more than it would otherwise have gained and lost only MK82,000 in stamp tax revenue. The government's BOP support for the whole transaction amounted to $8,333 million. The GOM also permitted the buyer to transfer the tax loss carry forwards from Kavuzi-Mzenga to Kawalazi but this proved to be only a minor incentive, since positive net income would not be generated for some years and substantial tax-loss carry forwards would be generated within Kawalazi in the intervening period.

Although the decision of the Divestment Committee was to sell 100% of the estates, ADMARC management later negotiated with CDC an option to buy 10% of Kawalazi within one year. The wisdom of this decision is debatable. The Corporation believed that Kavuzi-Mzenga is within a year or two of producing substantial cash flow and that this purchase option would provide an opportunity for ADMARC to recapture some of its investment in the development of the estates.

However, positive cash flow does not necessarily translate into dividends. The new owners intend to use any cash flow from Kavuzi-Mzenga to finance increased overall operating costs from the consolidated estates. Continuing ADMARC involvement is no longer needed nor desirable. After ADMARC has seen Kawalazi's long term financial projections, it is possible that the Corporation's board will have second thoughts on exercising its option.

It is unlikely that there will be any significant effects on employment as a result of the sale. All three of the estates have experienced shortages of employees in the past because of their remote location and lack of worker housing on the properties. The new owners plan to construct new housing to increase the incentive for workers to settle in the area. Kawalazi's management has determined that some 400 additional workers will be needed over the next two years, restoring employment levels to an earlier high of 1,646 workers. It would appear, therefore, that the consolidation of the estates will have a beneficial effect on local employment and on workers' living standards over a period of time.

4.. Privatizing the Grain and Milling Company

The Grain and Milling Company Limited (Gramil) was founded in 1968 to meet Malawi's growing demand for maize flour, the staple food of the rural areas. In 1972 the company began to mill wheat flour primarily for bread which became a staple of the urban diet and a holiday food for the rural areas. Gramil became a wholly owned subsidiary of ADMARC in 1985.

It has three main milling operations in the south, central and northern regions of the country that produce maize and livestock feed. Only one mill, in the southern region, produces wheat flour, milled primarily from South African wheat. Maize flour comes from domestic production and livestock feed from milling byproducts, local raw materials and imported premixes.

Gramil's current 25% share of the domestic feed market has been declining because of a shortage of wheat byproduct, erratic premix supplies, and lack of quality control. In maize milling, Gramil has a predominant 75% share of the market, most of the remainder going to two small Asian owned mills. Village mills process a still small but increasing share. Demand for maize flour from Mozambiquan refugee camps increased demand greatly up to 1988 but production has been falling recently. Relief agencies began to import their own maize flour, some of which found its way to the Malawian domestic market. Drought created maize shortages and village mill production affected the market in outlying rural areas.

Wheat flour has been Gramil's most profitable product where the company has over 75% of the market. Import of wheat flour was banned by the government from 1985 on but import licenses began to be issued in late 1988 at the insistance of Press Bakers, the largest bakery, which argued that imported flour would reduce the price of bread. The government's concern was to control inflation even at the expense of the domestic milling industry.

The price of imported wheat flour from South Africa was substantially less than Gramil's production costs because of the weakness of the rand and a subsidy paid by the South African Wheat Board to South African millers. Under these circumstances, Gramil was losing market rapidly to imported flour.

The company accumulated losses of MK 3.2 million from 1978 to 1985, leaving a negative shareholder equity of MK 2.2 million. Largely as a result of the ban on wheat flour imports from 1985 to 1988, there was marked improvement in turnover and profitability, showing a positive balance sheet in 1988 for the first time in seven years. This is unlikely to be repeated, however, so long as wheat flour imports are permitted. Profit margins on maize milling are less than on wheat and are made even thinner by the introduction in 1987 of private trading in grain purchases which required Gramil to pay higher prices to the producer. The extreme political sensitivity to maize flour prices allows Gramil to pass on only a small part of its increased costs, even though consumer prices are officially decontrolled.

A contributing factor to the poor financial showing was that, over an extended period, Gramil suffered from both a weak, politicized board and management. In an attempt to shore up management, an expatriate manager, seconded and paid for by the South African government, took over from 1986 to 1988 with improved results. When his contract expired, he was replaced with an ADMARC senior manager, who is acting as a caretaker until negotiations for sale of company are completed.

Gramil's asset base has continued grow in recent years with an investment of MK 5 million by ADMARC and a MK 2.2 million long term loan. Retained earnings have increased and fixed assets revalued to reflect more realistic replacement costs. The company's borrowing is still at a manageable level; its debt/equity ratio being only 0.21, so that growth could be financed by expanding debt if profits appeared to warrant it.

a. The Divestiture Process

In categorizing the firms to be privatized, the IC's report placed Gramil in Tier I -- suitable for immediate 100%

divestment. ADMARC management preferred to have the company restructured and rehabilitated before selling and had already been negotiating with an outside firm for a management contract. The Divestment Committee agreed to partial divestiture, arguing that the strategic nature of the milling business required that the government maintain a minority position.

Although the IC recommended in an action plan a few months later that the company be restructured by the sale of a minority share to a technically competent manager, with sale of ADMARC's remaining interest to other investors after two years. The action plan proved unworkable, however, because the board was highly politicized and had a vested interest in continuing business as usual. Ultimately, the decision was made by the Divestment Committee to sell ADMARC's controlling interest in order to be able to commercialize the board. Categorization of the firm served to focus the government's attention on key issues although the category was changed as a result of changing market conditions and availability of more information on the firm.

Valuation of Gramil proved to be more difficult than expected. The first valuation in June, 1988 concluded the company was worth MK 11.4 million but it was done in a cursory manner and was rapidly outdated by events. The government lifted the ban on the import of wheat flour, which cast doubt on the previous valuation of Gramil's wheat flour milling operations. With the expression of buyer interest by Press Group, a second valuation in March, 1989 reduced the value to MK 7.4 million in view of the company's uncollectable debts and other factors. In the light of questions raised about the accuracy of this valuation, it is likely that a third effort will be made before the sale is completed.

Two buyer searches were carried on, one for new shareholders and another for a technical partner to supply a new management team and milling experience. The IC suggested a final ownership pattern of 25% each to three groups of owners, the technical partner, active investors (bakers, feedlot operators and other mills), and passive investors (pension plans, insurance companies, and private investors), with the remainder being retained by ADMARC/GOM.

The IC tried to resist the Press Group as a majority partner in order to keep the door open for Asians and other local active investors. However, Press indicated that it wanted only the technical partner as a minority shareholder. At no time was formal solicitation of offers made either in the newspapers or in the government gazette. The Divestment Committee finally agreed to Press Group's desire on the grounds that it was the only Malawian firm financially capable of developing Gramil and the only local firm with experience to manage a strong foreign technical partner. No requirement was laid down that shares be set aside for other active or passive investors (although Press would probably have acquiesced in the end) and the IC was instructed not to negotiate with any Indian bidder.

Criteria for a qualifying technical partner laid down by the Committee included:

- Ability to mount a management team that would take responsibility for all operations.
- Acceptance of a permanent minority shareholding position and ADMARC's position as a board member and minority shareholder.
- Elimination of management fees and acceptance of dividends as the sole source of returns.
- Agreement to make a cash investment in Gramil (estimated at MK3 million.
- Provision of proof of regional experience.

Again, no public solicitation of potential technical partners was made, either in Malawi or abroad. Instead, presentations were made to 12 firms with regional milling experience. The choice was finally narrowed down to three South African millers, one Kenyan, one Zimbabwean and one European. The Kenyan firm withdrew because it did not wish to purchase South African wheat, four others because of low prospective return on investment, leaving the only remaining South African firm as the only candidate. Given the very small number of millers able to meet the Committee's criteria, failure to make public solicitation was probably justified.

As of March, 1989, the sale had not yet been concluded. The price to be paid by Press Trust remains the chief stumbling block. Press is likely to offer between MK 3 and 4 million, while the Committee is not expected to accept less the MK 5 million, based oh the most recent valuation of MK 7.4 million. The pace of the sale has undoubtedly been slowed down by the GOM's refusal of to divest completely, the presence of a politicized board, and the uncertain prospects for continued import of subsidized South African wheat flour.

b. Issues Arising from the Divestment

Concentration of Ownership and Abuse of Power. If the sale goes as indicated at present, the Press Group will be the predominant force in the maize milling industry in the country. While this would appear to be a concentration of power, the government keeps a very close eye on the price and availability of maize flour so that it is highly unlikely that Press would be able to use its position to abuse market power. In any case, competition in maize milling from village mills is growing. Gramil's position in livestock feed is declining and smaller producers are gaining market share.

In the case of Gramil's role in wheat milling, there is room for concern that Press and Premier together would be more interested in importing cheap flour than in a healthy milling industry in Malawi, especially since Premier exports flour from its South African mills. Although Gramil's wheat milling may become unprofitable, the Press Group may not be concerned so long as Press Bakers has access to inexpensive flour.

However, this concern could be exaggerated because South African flour subsidies could be removed at any time; the GOM could reintroduce a ban on importing flour and Press Bakers may prefer to source flour locally to reduce inventory and control quality. Should the transport link to the Mozambiquan port of Nacala be restored, South African wheat would lose its competitive transport cost advantage and cheaper European or Australian wheat could be used. Bread price and supply are matters of intense national concern in Malawi and a new commercialized board with ADMARC membership would serve to discourage collusion between Press and its technical partner to reduce Gramil's capacity. Should Press decide to replace Gramil"s wheat milling equipment, the emphasis will be on high utilization of it, regardless of Press Bakeries interests.

Malawian bakers could suffer from concentration of Gramil's ownership in Press hands. Gramil could give price breaks, favorable delivery schedules, or better quality product to Press Bakers. Competitors' prices for bread are somewhat higher than Press Bakers' but quality is also higher. New bakers are entering the retail market despite Press Bakers' efforts to buy small bakeries to cut down transportation costs by expanding regionally.

The IC originally suggested the sale of Gramil's three milling operations to separate buyers which would have addressed the problem of widening ownership. This was not acceptable to the GOM because of concerns over smooth distribution of maize flour among surplus and deficit regions of the country and food security. For similar reasons, the government rejected 100% divestment of Gramil; control over Malawi's most important staple completely by the private sector was unacceptable and the government is obliged to protect the interest of the smallholders from whom the maize is purchased.

In other sectors, Press Group has shown no inclination to take advantage of its monopoly situation and it would not welcome the publicity that would ensue if it appeared that it was driving other millers or bakers out of business. In any case, wider asset distribution was not one of the Divestment Committee's major concerns; it did not direct that additional minority shareholders be considered in the sale. Implicitly, the Committee made a clear decision that divestiture of Gramil into the hands of competent, motivated and technically skilled management was much more important than maximizing the distribution of assets.

Impact of the Divestiture on ADMARC. The corporation will receive a substantial infusion of cash when the sale is completed, further achieving the government's goal of greater liquidity for the corporation. Gramil owed MK 3 million to ADMARC at the end of 1988 and had invested an additional MK5 million in share capital. From this there had been little cash return on either equity or debt. Even the interest charged on the loans was at concessional rates. The sale will relieve ADMARC of this outstanding debt and, under new management, the Corporation will stand better chance of receiving dividends on its equity investment, even though it will probably be reduced to 25% ownership. The interests of both the GOM and ADMARC will be protected by the Corporation's position on the Gramil board.

Under the former contract management, ADMARC had almost ceased to pay attention to day to day Gramil management. Although a senior ADMARC manager is at present seconded to Gramil, this is a temporary situation and he will be replaced by the technical partner's new management team. ADMARC will therefore not find that the burdens on its corporate management staff will be significantly lifted by the Gramil divestment.

5. Lessons from the Malawi Experience

The ADMARC privatization project in Malawi produced substantial concrete results in a little over 18 months. The process has been more rapid and less complicated than in most other developing countries where privatization programs have been in existence for a much longer period. Although it must always be recognized that each country has its own particular political and economic framework within which privatization is carried out, the Malawi experience affords a number of lessons that are applicable in other A.I.D. recipient countries. Among these are:

- The value of an integrated technical team to make preliminary studies of individual assets in order to recommend the form and priority of sales efforts. Categorization of assets proved particularly useful in that it provided a logical framework within which to proceed and results could be demonstrated.

- The Malawi experience shows conclusively that consistent commitment at the highest political levels is required for a successful privatization program.

- The combination of a full time Investment Coordinator who had the full confidence of the government and a technical team that included finance and banking specialists greatly facilitated the divestiture process. The fact that the IC was employed on an in-country contract gave the GOM the assurance that he was advising in the best interests of the country.

- The USAID Mission can materially assist the privatization process through continuing policy dialogue. The Malawi case illustrates, however, that the Mission must be clear on its own objectives in supporting privatization, as well as those of the government. If, for example, broadening of ownership and investment opportunity is an important Mission concern, this must be made clear in the project agreement at the outset. In the Malawi case, spread of ownership took a definitely secondary place to the government's desire to get on with the task of divestment. This provides demonstration that short term privatization goals may conflict with long term economic growth prospects that depend on a broad based economy.

- Apart from the provision of high quality technical assistance, the necessity of providing a financial incentive as was done from ESF funds in Malawi may be open to debate. The government would probably have eventually proceeded with divestiture in the absence of the hard currency incentive through simple financial necessity. But it is clear that the "carrot" served to focus the attention of high government officials on the privatization process; it facilitated and speeded the decision to sell to unavailable buyer. Since the government benefitted not only from the proceeds of the sale but from the resulting hard currency addition, some political and bureaucratic hurdles were more easily surmounted than would otherwise have been the case. The "carrot" also served to reinforce the Mission's efforts in policy dialogue because the government had a tangible reason to listen.

- Despite the Mission's disappointment in not being included as a member of the Divestment Committee, it would appear that USAID can be most effective in a project of this nature by keeping a low profile. The GOM regarded the divestitures as a sensitive matter of national concern and was therefore averse to sharing some of the internal problems that had to be resolved by discussion within the Committee and government ministries.

- The privatization of ADMARC assets served to reinforce the growing interest of the government and of business about the place of the private sector in the Malawian economy. In the absence of a capital market, it became more evident to the government that new financial instruments had to be introduced that would permit broader investment in the shares of divested assets. To encourage this, the Mission may be asked to finance the cost of a feasibility study for establishing a unit trust (mutual fund) to develop the equity market and afford the small investor an avenue of participation.