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THE WORLD BANK/IFC/MIGA

OFFICE MEMORANDUM

RECEIVED
002
92 APR -6 AM 8:5

DATE: April 2, 1992

TO: Mr. Sven Sandstrom, Chairman, Policy Review Committee

FROM: Lawrence H. Summers, DECVP

EXTENSION: 33774

SUBJECT: **Minutes on March 20, 1992**

Attached please find the minutes of the meeting on the Privatization Paper held on March 20, 1992.

Attachment

cc: Messrs. S. Eccles (CTR), C. Koch-Weser (MNA), J. Linn (FPR), V. Rajagopalan (OSP), W. Ryrie (CEX), I. Shihata (LEG), J. Wood (SAS), Y. Terasawa (MIGEX)

Messrs./Mmes. N. Birdsall (CECDR), S. Husain (LAC), W. Kaffenberger (CEX), G. Kaji (EAP), A. Karaosmanuglu (EXC), K. Kashiwaya, (CFS), S. Kikeri, J. Nellis, M. Shirley (CECPS), W. Thalwitz (ECA), G. West (MIGA).

PRIVATIZATION PAPER

Policy Review Committee Meeting on March 20, 1992

Minutes

1. Present were:

S. Sandstrom, EXC, Chairman
S. Eccles, CTR
W. Kaffenberger, CEX
C. Koch-Weser, AFR
J. Linn, FPR
V. Rajagopalan, OSP
I. Shihata, LEG
L. Summers, DEC
J. Wood, SAS
G. West, MIGA

The agenda of the meeting (attached) organized the discussion around the policy recommendations in the paper.

2. The Bank should lend directly to SOEs functioning in competitive or potentially competitive markets only to facilitate an agreed time-bound program to privatize these enterprises.

Some members of the Committee found the evidence in the paper that ownership matters convincing, but felt that the recommendation should be reformulated in favor of a strong presumption (instead of a prohibition) against lending to such enterprises, with a burden of proof on those who espouse such lending. A second, minority point of view was that lending to SOEs should be permitted without a government commitment to privatize, provided that the operation supported broader reforms leading to improved efficiency of the SOE sector.

Mr. Summers presented a draft reformulation of the original recommendation to the meeting which adopted the language of a strong presumption, and proposed that direct lending to competitive SOEs should only take place where there are clearly specified reform measures leading toward privatization and a strong emphasis on private sector development in the overall country strategy, recognizing, in particular, that ownership matters in improving efficiency. It was agreed that the Chairman would review this recommendation. The Chairman subsequently decided that this (and other) policy recommendations should be dropped and that the paper should on focus the review of experience without attempting to draw specific policy conclusions.

3. Greater efforts should be made by Bank staff to actively seek alternative private management and capital for SOEs in non-competitive sectors and, where available, private alternatives should be preferred.

Given that private financing may not be available to the extent suggested by the paper, members felt that the paper should be made more operational by specifying concrete steps to help Bank staff assist governments in seeking private management and capital, such as promoting management contracts and leases, spinning off competitive activities, increasing competitive provision of services, changing regulations to allow entry, and meeting with potential private investors. Mr. Summers indicated that these approaches would be laid out in the paper in more detail.

4. The Bank Group, including MIGA and IFC, should study and experiment with greater use of its guarantee authorities.

It was agreed that the broader issue of post-privatization finance needed more attention. The paper should more systematically document the efforts and the experience of the Bank Group and others to address the broader issue of support for post-privatization finance, including the use of guarantee authorities.

5. The Bank should directly finance a portion of severance costs in the context of a larger investment or TA operation.

While several members supported this recommendation, others strongly opposed it. The Chairman questioned the need for a policy change, suggesting that severance costs could be covered by the government through the budget or by the proceeds from the sale.

6. The IFC should be allowed to bid on privatization advisory services, funded by Bank credits, only in IDA countries.

The meeting decided to defer this recommendation to the PSD Committee which subsequently decided not to accept this recommendation and not to change current policy.

x x x

Following the meeting, Mr. Summers and the Chairman agreed that the paper should concentrate on the review of lessons of experience and not include any policy recommendations. Specific issues which had been identified through the work on the paper and were of concern to operational managers, such as the financing of severance costs, could be reviewed in more detail following the completion of the paper.

The World Bank/IFC/MIGA
O F F I C E   M E M O R A N D U M

DATE: March 19, 1992 12:52pm

TO: See Distribution Below

FROM: Sven Sandstrom, EXC (SVEN SANDSTROM)

EXT.: 81138

SUBJECT: Policy Review Committee: Privatization Paper
Agenda for meeting on March 20 at 3:30 p.m. in E-1227

The paper is clearly written and helps us focus on key policy issues. A major conclusion of the paper is that "ownership matters" and that this has implications for Bank policy and assistance strategy.

I propose that we take the paper's five major policy recommendations as the agenda for the meeting, focusing the discussion on the questions and issues set out below. Given the rate at which events are unfolding around the world in the area of privatization and our limited experience on the efficiency of SOEs when they operate in the context of a market-based economy, we should also consider whether it is premature to define new Bank policies at this time.

1. The Bank should lend directly to SOEs functioning in competitive or potentially competitive markets only to facilitate an agreed time-bound program to privatize these enterprises.

Is a general prohibition on Bank lending to SOEs in competitive or potentially competitive markets except to facilitate their privatization legally defensible? Is a criterion for lending based on ownership consistent with the Bank's Articles?

Is the proposed policy operationally too rigid? Given the likelihood that public enterprises will be a factor in the landscape for some time, is it realistic to insist on a time-bound action plan to privatize for all operations? The result could be that the Bank loses a key instrument to support some governments in their transition to market based economies. Would it not be preferable to allow flexibility, recognizing that improvements in enterprise efficiency and profitability can be realized without explicit commitment to ownership change?

2. Greater efforts should be made by Bank staff to actively seek alternative private management and capital for SOEs in non-competitive sectors and, where available, private

alternatives should be preferred.

While the recommendation that Bank staff should more actively seek private sources is reasonable, do significant opportunities in fact exist for many of our Borrowers? In what specific ways should staff make greater efforts? Even where private finance is available, do we want to preclude Bank lending co-existing with private capital funding, given the role Bank support can play in strengthening a broad policy dialogue?

3. The Bank Group, including MIGA and IFC, should study and experiment with greater use of its guarantee authorities.

Is it not the case that a wide range of guarantee instruments already exist which can be used when appropriate? In what specific areas is the coverage of existing instruments considered inadequate?

4. The Bank should directly finance a portion of severance costs in the context of a larger investment or TA operation.

Severance costs are one among many costs of transition and have no foreign exchange implications. The Bank's Articles allow provision of foreign exchange to finance local costs only in exceptional circumstances. Why can severance costs not be budgeted directly by the purchaser, or the Government, thereby reducing the net proceeds from sale of the enterprise?

What evidence is there that lack of financing of severance costs is a major problem? Is there sufficient reason to change our basic policy of disbursing only against goods and services?

What role can social/renewal funds play in this context? Should the paper say more about this and social safety nets?

5. The IFC should be allowed to bid on privatization advisory services, funded by Bank credits, only in IDA countries.

If there is a fundamental conflict of interest in allowing IFC to "bid" in IBRD countries, does this not apply also to IDA countries? The justification for the proposal is that in poor countries the market does not supply the desired quantity and quality of privatization advisory services. Is this correct? Does experience support the assumption that other private firms would not be interested in advisory services in IDA countries when IDA funding is assured?

Is there merit to the proposal that that IFC be allowed to compete in IDA countries on a pilot basis, with a full assessment to be done after two years? What new information would be obtained?

*****

Finally, how responsive is the paper to previous indications to the Executive Directors concerning its content? (See in particular page 2 of the June 20, 1991 supplementary Board paper on "Strengthening the World Bank Group Effort on Private Sector Development", and the October 8, 1991 Board note on "Privatization: Lessons of Experience for Bank Group Lending -- Outline for a Policy Paper".) Internal issues of an administrative character should preferably be dealt with in the forthcoming PSD Progress Report rather than in the Privatization Paper.

DISTRIBUTION:

TO:	Larry Summers	(LARRY SUMMERS)
TO:	Visvanathan Rajagopalan	(VISVANATHAN RAJAGOPALAN)
TO:	Johannes Linn	(JOHANNES LINN)
TO:	D. Joseph Wood	(JOE WOOD)
TO:	Caio Koch-Weser	(CAIO KOCH-WESER)
TO:	Ibrahim Shihata	(IBRAHIM SHIHATA)
TO:	Stephen Eccles	(STEPHEN ECCLES)
TO:	William Ryrie	(WILLIAM RYRIE)
TO:	Yoshio Terasawa	(YOSHIO TERASAWA)
CC:	Attila Karaosmanoglu	(ATTILA KARAOSMANOGLU)
CC:	Rest of Distribution Suppressed	

<u>PRIVATIZATION POLICY PAPER</u>

<u>RECOMMENDATION ONE (MODIFIED)</u>

IT IS RECOMMENDED THAT THERE BE A STRONG PRESUMPTION AGAINST THE BANK'S LENDING DIRECLY TO SOEs FUNCTIONING IN COMPETITIVE OR POTENTIALLY COMPETITIVE MARKETS, UNLESS SUCH LENDING IS TO FACILITATE AN AGREED, TIME-BOUND PROGRAM OF PRIVATIZATION. LOANS AND CREDITS TO SOEs NOT SCHEDULED FOR IMMEDIATE DIVSTITURE MAY STILL BE JUSTIFIED, WHEN THE BANK OPERATION FACILITATES THE SIGNIFICANT INVOLVEMENT OF THE PRIVATE SECTOR IN WAYS OTHER THAN MAJORITY OWNERSHIP; THAT IS, IN THE FINANCING OR MANAGEMENT OF THE ENTERPRISE. (INDIRECT LENDING TO SUCH ENTERPRISES COULD AND SHOULD CONTINUE -- THROUGH PROPERLY STRUCTURED FINANCIAL INTERMEDIARIES -- AS LONG AS LOAN APPLICATIONS FROM PUBLIC AND PRIVATE ENTERPRISES COMPETE ON A LEVEL PLAYING FIELD WITHOUT GOVERNMENT GUARANTEES.) THE RATIONALE FOR EXCEPTIONS TO THE PRESUMPTION WOULD HAVE TO BE SET OUT <u>EX ANTE</u>, IN THE COUNTRY STRATEGY PAPER, AND SHOULD TAKE INTO ACCOUNT THE EVIDENCE THAT OWNERSHIP MATTERS. EVALUATION OF THE EFFECTS OF DIRECT LENDING TO SUCH SOEs SHOULD BE INCLUDED IN THE PERIODIC UPDATES OF THE CSP, AND IN THE NEXT CSP.

THE WORLD BANK / INTERNATIONAL FINANCE CORPORATION / MIGA

Office Memorandum

DATE: March 18, 1992

TO: Mr. Sven Sandstrom, EXC and Mr. Lawrence H. Summers, DECVP

RECEIVED 92 MAR 18 PM 4: 2 009

FROM: Koji Kashiwaya, CFSVP KS

EXT.: 31192

SUBJECT: Report on Privatization

1. The paper is too optimistic on what will become available from the private sector spontaneously, and perhaps for that reason is shying away from emphasizing the catalytic role the Bank can play, although it makes a passing reference to the useful role that guarantees can play in privatization.

2. While private capital flows have increased somewhat in the past few years, it must be remembered that these flows remain significantly below historical levels and far short of what is required in these countries. MDB financial support and official aid can be expected to increase gradually in the future, but the bulk of the needed finance would have to come from private sources. However, commercial banks and ECAs are very concerned about country risk (especially in the light of more stringent capital adequacy guidelines) so much so that without some new mechanisms to encourage lending, we cannot expect sufficient private flows to LDCs.

3. I urge that the paper provide a clearer vision on the need for Bank Group action for the future. It is essential that the Bank espouse a more organized catalytic role to stimulate private flows. Undoubtedly the role that the Bank plays in helping formulate appropriate macro and sector settings is very important. In addition, carefully applied Bank support in project financing can be used to stimulate participation by private institutions and export credit agencies. The Bank should increasingly play the role of a core promoter to catalyze large amounts of finance for projects, rather than compartmentalize and relegate its guarantee authority to special and "experimental" situations as the paper currently suggests.

4. Finally, footnote 60 does not properly describe the reduction in commercial risks to the government that can be achieved through expanded cofinancing operations (ECOs). The point to be emphasized is that guarantees should be used in the context of a proper balance of risk sharing between the public and private sectors. We are making the same point in the Board review of the ECO program that is slated for Board consideration in May.

cc: Messrs. S. Eccles (CTR); K. Jaycox (AFR); J. Linn (FPR), V. Rajagopalan, (OSP), W. Ryrie (CEX), I. Shihata (LEG), D.J. Wood (SAS), Y. Terasawa (MIGEX)
Mr. Karaosmanoglu, EXC
Mrs. S. Kikeri, CECPS

SR:mo

The World Bank/IFC/MIGA
O F F I C E   M E M O R A N D U M

DATE: March 19, 1992 12:52pm

TO: See Distribution Below

FROM: Sven Sandstrom, EXC (SVEN SANDSTROM)

EXT.: 81138

SUBJECT: **Policy Review Committee: Privatization Paper**
Agenda for meeting on March 20 at 3:30 p.m. in E-1227

The paper is clearly written and helps us focus on key policy issues. A major conclusion of the paper is that "ownership matters" and that this has implications for Bank policy and assistance strategy.

I propose that we take the paper's five major policy recommendations as the agenda for the meeting, focusing the discussion on the questions and issues set out below. Given the rate at which events are unfolding around the world in the area of privatization and our limited experience on the efficiency of SOEs when they operate in the context of a market-based economy, we should also consider whether it is premature to define new Bank policies at this time.

1. The Bank should lend directly to SOEs functioning in competitive or potentially competitive markets only to facilitate an agreed time-bound program to privatize these enterprises.

Unnecessary
evidence based
on 12 firms
privatized in 8
Countries +
Developing Countries

Indian oil
Lending Guidelines
Bank

Is a general prohibition on Bank lending to SOEs in competitive or potentially competitive markets except to facilitate their privatization legally defensible? Is a criterion for lending based on ownership consistent with the Bank's Articles?

Is the proposed policy operationally too rigid? Given the likelihood that public enterprises will be a factor in the landscape for some time, is it realistic to insist on a time-bound action plan to privatize for all operations? The result could be that the Bank loses a key instrument to support some governments in their transition to market based economies. Would it not be preferable to allow flexibility, recognizing that improvements in enterprise efficiency and profitability can be realized without explicit commitment to ownership change? yes

helps Govts.

2. Greater efforts should be made by Bank staff to actively seek alternative private management and capital for SOEs in non-competitive sectors and, where available, private

alternatives should be preferred.

While the recommendation that Bank staff should more actively seek private sources is reasonable, do significant opportunities in fact exist for many of our Borrowers? In what specific ways should staff make greater efforts? Even where private finance is available, do we want to preclude Bank lending co-existing with private capital funding, given the role Bank support can play in strengthening a broad policy dialogue?

3. The Bank Group, including MIGA and IFC, should study and experiment with greater use of its guarantee authorities.

Is it not the case that a wide range of guarantee instruments already exist which can be used when appropriate? In what specific areas is the coverage of existing instruments considered inadequate?

4. The Bank should directly finance a portion of severance costs in the context of a larger investment or TA operation.

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5. The IFC should be allowed to bid on privatization advisory services, funded by Bank credits, only in IDA countries.

If there is a fundamental conflict of interest in allowing IFC to "bid" in IBRD countries, does this not apply also to IDA countries? The justification for the proposal is that in poor countries the market does not supply the desired quantity and quality of privatization advisory services. Is this correct? Does experience support the assumption that other private firms would not be interested in advisory services in IDA countries when IDA funding is assured?

Is there merit to the proposal that that IFC be allowed to compete in IDA countries on a pilot basis, with a full assessment to be done after two years? What new information would be obtained?

*****

Finally, how responsive is the paper to previous indications to the Executive Directors concerning its content? (See in particular page 2 of the June 20, 1991 supplementary Board paper on "Strengthening the World Bank Group Effort on Private Sector Development", and the October 8, 1991 Board note on "Privatization: Lessons of Experience for Bank Group Lending -- Outline for a Policy Paper".) Internal issues of an administrative character should preferably be dealt with in the forthcoming PSD Progress Report rather than in the Privatization Paper.

<u>DISTRIBUTION:</u>

TO:	Larry Summers	(LARRY SUMMERS)
TO:	Visvanathan Rajagopalan	(VISVANATHAN RAJAGOPALAN)
TO:	Johannes Linn	(JOHANNES LINN)
TO:	D. Joseph Wood	(JOE WOOD)
TO:	Caio Koch-Weser	(CAIO KOCH-WESER)
TO:	Ibrahim Shihata	(IBRAHIM SHIHATA)
TO:	Stephen Eccles	(STEPHEN ECCLES)
TO:	William Ryrie	(WILLIAM RYRIE)
TO:	Yoshio Terasawa	(YOSHIO TERASAWA)
CC:	Attila Karaosmanoglu	(ATTILA KARAOSMANOGLU)
CC:	Ernest Stern	(ERNEST STERN)
CC:	Jane Armitage	(JANE ARMITAGE)
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Rajagoplan S 5-055

THE WORLD BANK/IFC/MIGA

OFFICE MEMORANDUM

RECEIVED
002
92 MAR 13 AM 8:2

DATE: March 12, 1992

TO: Mr. Sven Sandstrom, Chairman, Policy Review Committee

FROM: Lawrence H. Summers, DECVP

EXTENSION: 33774

SUBJECT: Privatization: Lessons of Experience for Bank Group Lending

Please find attached five copies of the draft summary and text of the Report on Privatization: Lessons of Experience for Bank Group Lending. The Report is scheduled for discussion by the Board on April 23rd.

The Report has had two formal Bank wide reviews, the most recent one which I chaired on February 25, 1992. I also chaired an earlier meeting on December 19, 1991, with a group of senior managers from IFC, MIGA, Bank operations and Legal to discuss the more contentious policy recommendations. The February review meeting included representatives from each of the regions, Legal, CFS, IFC, MIGA, and OED; we also received follow-up memos from almost all vice-presidential units. In addition, the text on MIGA and IFC draws on inputs from them and has been cleared by them, and we have consulted Legal and ECA (see below).

Many participants in the review meeting were supportive of the paper's general approach--LAC and MNA representatives especially. Still, a number of concerns were expressed and issues raised. In particular, the representative of the Legal Department called for a policy meeting to examine the recommendations of the paper. The concerns raised and the changes incorporated in the present draft are as follows:

1. We expanded and improved the evidence base of the paper. It takes more account of regional variations in conditions and outcomes; and it provides more documentation of just where and how public enterprises are deficient (but also notes the conditions in which public enterprises perform well); it notes the probability that privatization will result in improved performance is higher than the probability that SOE reform will succeed. Any language that might have been interpreted as ideological has been eliminated.

2. In response to comments that the emphasis on divestiture did a disservice to the breadth of the Bank's reform assistance, the paper now situates privatization in the context of private sector development and overall public sector reform.

3. More attention has been paid to the necessity -- and difficulties involved-- of creating and sustaining adequate regulatory frameworks, and heavier emphasis has been placed on the importance of transparency. We have added a decision matrix which advises on steps to privatization depending on enterprise conditions (competitive and non-competitive) and

country circumstances (extent of market friendly policies and capacity to regulate).

4. Some participants were concerned about whether the Bank Group has adequate and appropriate instruments to support privatization in borrower countries, especially in the absence of adjustment lending. The paper now argues that privatization is but one instrument, and recommends that the Bank Group -- including IFC and MIGA -- search for other support mechanisms, such as guarantees of non-commercial risk. We also recommend direct lending for severance pay (see below). Staff from FRS and Legal have expressed concerns about the recommendations on guarantees and severance pay, respectively.

5. Participants from ECA were concerned about the sensitive and rapidly changing nature of privatization in their region. The authors worked with staff from ECA; the section on privatization in ex-socialist economies now more fully reflects the concern in the region that the process is a risky and complex one and may not succeed.

6. The Legal Department raised questions concerning the recommendation on severance pay. The authors met with Mr. Shihata, and the wording on severance pay reflects discussions with him. He is not here. In his absence, staff from Legal are concerned that the draft does not sufficiently reflect the point that a balance of payments gap is not a necessary prerequisite for adjustment lending.

7. The recommendation on IFC bidding will be revised to reflect the decision of the Private Sector Development Committee after its meeting in early March.

8. Regarding future Bank lending to infrastructure SOEs, the paper recommends that Bank staff actively seek alternative private capital sources. Where these are available they will be preferred, provided that the conditions of the private investment are structured so as to enhance efficiency and promote modernization and expansion, and as long as access to the poor to essential services is safeguarded. The paper notes that country conditions are not always supportive of private sector involvement; thus, where the Bank does lend to public enterprises we recommend strengthening conditionality to enhance competitive conditions, and opening up entry. Or Country?

9. Even with the amendment recommended in para. 8, there was no complete consensus reached on this or the recommendation that the Bank lend to SOEs in competitive or potentially competitive markets only to facilitate a time-bound privatization program. Some endorsed both and called for even stronger measures; others dismissed them as unnecessary or counterproductive. This is a matter of judgement where senior management will have to decide.

When the outline was discussed at the Board, some EDs asked that the report discuss the division of labor within the Bank Group. Others disagreed stating that the issues have been extensively discussed in the context of private sector development. In his response, Johannes Linn noted that the paper will examine privatization in the broader context of private sector development, but will not duplicate other papers on private sector development since its focus is on practical guidance for privatization.

We look forward to receiving your comments. We need to deliver the final and printed version to the Office of the Secretary by April 2, 1992, and would hope to have all your suggestions by March 20th. Thank you.

Attachments

cc: Messrs. S. Eccles (CTR), K. Jaycox (AFR), J. Linn (FPR), V. Rajagopalan (OSP), W. Ryrie (CEX), I. Shihata (LEG), J. Wood (SAS), Y. Terasawa (MIGEX).

Messrs./Mmes. A. Karaosmanoglu, E. Stern, J. Armitage (EXC), G. Kaji (EAP), W. Thalwitz (ECA), S. Husain (LAC), C. Koch-Weser (MNA), J. Einhorn (TRE), K. Kashiwaya (CFS), T. Thahane (SECGE), R. Picciotto (CPB), Y. Rovani (DGO), I. Husain (AFR), V. Thomas (EAP), P. Hasan (ECA), M. Selowsky (LAC), L. Squire (MNA), G. Nankani (SAS), N. Birdsall (CEC), D.C. Rao (IEC), E. Grilli (DPG), A. Golan (EDI), G. Pfeffermann (CEIED), A. Shakow, S. Lateef (EXT), D. Bock (OSP), H. Köpp, M. Baird (OED).

THE WORLD BANK/IFC/MIGA
OFFICE MEMORANDUM

DATE: March 3, 1992

TO: Mr. Sven Sandstrom, Managing Director

FROM: V. Rajagopalan, Vice President, OSP

EXTENSION: 33419

SUBJECT: Privatization Policy Paper

1. Re Mr. Summers' memorandum of February 26, reporting on the Vice-presidential review of the privatization paper, I continue to have doubts about the wisdom of trying to use a paper on lessons of experience with privatization to set overall Bank policy on lending to state-owned enterprises. The analysis in the paper covers a limited number of countries and a relatively short time-period. Moreover, there remain many questions about design of privatization programs and policies that will produce sustained private sector development of the right sort.

2. I do not disagree with the general thrust of the paper's recommendations, i.e., a much more restrictive posture on lending to SOEs. But this is a complex issue and a potentially controversial policy shift. It needs to be handled carefully, both with regard to SOEs operating in competitive markets and those providing infrastructure.

3. The forthcoming power sector paper reaches very similar conclusions but in a more direct way. It is a policy paper per se rather than a lessons of experience paper and covers a much longer and broader base of experience. The infrastructure policy paper will also deal with lending policy towards SOEs.

4. In short, I believe it would be better to approach the Bank policy review deliberately and in stages. The review of privatization experience should be confined to lessons for Bank support of privatization efforts. Once the Board has discussed this -- still controversial -- subject, we can turn to the Bank's own policy towards SOEs. Otherwise, we will appear to be ideological and risk alienating a substantial segment of the Board.

THE WORLD BANK/IFC/MIGA

OFFICE MEMORANDUM

DATE: February 26, 1992

TO: Mr. Attila Karaosmanoglu, EXC

FROM: Lawrence Summers, DECVP

EXTN: 33774

SUBJECT: PRIVATIZATION: Meeting to review draft paper

On February 25 a Bank-wide meeting was held to review the privatization paper. Many participants were supportive of the paper's general approach -- especially those from LAC and MENA. Still, a number of concerns were expressed and issues raised. In particular, the representative of the Legal Department called for a policy meeting to examine the recommendations of the paper.

Concerns raised and our proposed changes to the next draft are as follows:

1. Participants in the meeting, and several of those providing written comments, were concerned that the paper made some "broad brush" assertions that ran ahead of the documentation offered; in response, the evidence base of the paper will be expanded and improved. It will take more account of regional variations in conditions and outcomes; and it will provide more documentation of just where and how public enterprises are deficient (but also list the conditions in which public enterprises perform well); it will note that the probability that privatization will result in improved performance is higher than the probability that SOE reform will "take" (a less sweeping argument than that presently advanced).

2. Participants and commentators felt that the resolute emphasis on divestiture did a disservice to the breadth of the Bank's reform assistance; thus, the paper will situate privatization in the context of private sector development and overall public sector reform, and note that privatization is but one of the available techniques used to enhance efficiency.

3. Participants and commentators thought that the paper underestimated the importance of proper regulation; consequently, more attention will be paid to the necessity -- and difficulties involved-- of creating and sustaining adequate regulatory frameworks. Once again, regional variations will be shown. Box 6, "Simulation Analysis of the Efficiency Consequences of Regulation," will be dropped entirely.

4. Several participants took issue with the paper's implication that poor privatization may be more costly than no privatization;

therefore, heavier emphasis will be placed on the importance of transparency. The speed versus transparency tradeoff will be dropped, but the paper will warn against transparency becoming an excuse for inaction. The regions have been asked to provide the authors with examples of costly premature privatization.

5. Concerns were expressed that the "tone" of the paper often did a disservice to its message; thus, the paper will be combed to eliminate wording that is, or could be interpreted to be, ideological.

6. Concerns were raised as to the appropriateness of Bank instruments to support privatization in countries without adjustment operations, since technical assistance is a low-leverage mechanism. The reasoning will be that privatization is but one instrument (see point #2), and that the Bank's search for other support mechanisms leads it to consider the guarantee option and the severance pay issue (discussed below).

7. In response to the above reasoning, and to a number of queries on the section recommending changes in Bank policy, the paper will argue that: the Bank Group -- including MIGA and IFC -- should explore ways to increase use of the guarantee authority. The idea is to facilitate the involvement of the private sector in cases where reluctance to lend is based on perceptions of country risk. A new section on the Role of MIGA will be inserted, and the existing guarantee recommendation dropped. It will note that the Bank may complement MIGA's work, but should not substitute for it. Evidence from Latin America shows that when macro and regulatory frameworks are "right," investment capital can be raised without any guarantees; the paper will highlight more the Bank's role in creating these conditions.

8. Participants from ECA felt that the sensitive nature of privatization developments in their region merited a more nuanced presentation; in response, the authors will work with staff from ECA to ensure that the section on privatization in ex-socialist economies is up-to-date, and reflects the views of the region.

9. The Legal Department has raised questions concerning the recommendation on severance pay, and stands ready to prepare a legal opinion should the recommendation be included in the paper. The authors will discuss the matter with the Legal Department. A recommendation on severance pay is an issue on which management may have to make the final decision.

10. The recommendation on IFC bidding will be revised to reflect the decision of the Private Sector Development Committee after its meeting in early March.

11. Regarding future Bank lending to infrastructure SOEs, we propose to recommend that Bank staff actively seek alternative private capital sources. Where these are available they will be

preferred, provided that the conditions of the private investment are structured so as to enhance efficiency and promote modernization and expansion, and as long as access to the poor to essential services is safeguarded. The paper will note that country conditions are not always supportive of private sector involvement; thus, where the Bank does lend to public enterprises we propose to recommend conditionality to enhance competitive conditions, and opening up entry.

12. Even with the amendment recommended in para. 11, there was no complete consensus reached on this or the first recommendation -- that the Bank lend to SOEs in competitive or potentially competitive markets only to facilitate a time-bound privatization program. Some endorsed both and called for even stronger measures; others dismissed them as unnecessary or counterproductive. This is a matter of judgement where senior management will have to decide.

cc: Messrs/Mmes: D. Bock, (OSPVP); J. Wood, I. Sud,(SASVP)
G. Kaji, (EAPVP); M. G. Aiyer, (LACVP)
M. Selowsky, (LACCE); V. Thomas, (EAPVP)
L. Squire, (MNAVP); J. Armitage, (EXC)
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M. Shirley, S. Kikeri, J. Nellis, (CECPS)

SecM91-1345

FROM: The Acting Secretary

October 8, 1991

PRIVATIZATION: LESSONS OF EXPERIENCE FOR BANK GROUP LENDING

OUTLINE FOR A POLICY PAPER

Attached is an Outline for the paper entitled "Privatization: Lessons of Experience for Bank Group Lending". This Outline will be considered at a seminar of the Executive Directors to be held on Tuesday, November 5, 1991.

Questions on this paper should be referred to Mr. John Nellis (ext. 37482).

Distribution:

Executive Directors and Alternates
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President's Council
Vice Presidents, Bank, IFC and MIGA
Directors and Department Heads, Bank, IFC and MIGA

PRIVATIZATION: LESSONS OF EXPERIENCE FOR BANK GROUP LENDING

OUTLINE FOR A POLICY PAPER

Country Economics Department
Public Sector Management and Private
Sector Development Division
September 25, 1991

PRIVATIZATION: LESSONS OF EXPERIENCE FOR BANK GROUP LENDING
OUTLINE FOR A POLICY PAPER

I. INTRODUCTION

1. Objectives

1. Increasingly, countries with widely varying economic and political systems are using privatization as a tool to improve the efficiency and lessen the burden of state-owned enterprises (SOEs). Countries as diverse as Argentina, France, Jamaica, Togo, New Zealand, the Philippines, Mexico, and the United Kingdom have implemented privatization programs, while others such as Sri Lanka, Laos, and much of Eastern and Central Europe are launching ambitious efforts to reduce state ownership. Privatization is an important component in Bank Group lending and policy dialogue. Currently, close to 150 Bank operations in 45 countries support reforms to privatize SOEs; approximately 30 IFC projects provide advisory support and/or investments in privatized firms; and 3 of MIGA's first 15 projects insure privatizations.

2. The objectives of the proposed policy paper are to examine the privatization experience in developed and developing countries, highlight key design and implementation issues, synthesize the lessons of experience, take stock of best available practice so as to provide guidance to Bank staff, and draw out policy implications for future Bank Group support for privatization. The paper will draw upon existing analyses and research, and a small set of specially commissioned analyses of country experiences and key practical and technical issues in privatization. The paper is primarily intended as a policy paper for the Board and senior management.

2. Scope and Methodology

3. The paper will concentrate on privatization through the transfer of ownership of SOEs to the private sector by means of partial or full sale of ongoing concerns, and sale of assets following liquidation. Since this has been the major form of privatization in developing countries to date, options involving the privatization of management but not ownership -- such as management contracts, leases, and contracting out of public services to the private sector -- are flagged and discussed as appropriate, but the paper will not analyze in detail these options.

4. The paper will focus on three major privatization themes: objectives and strategies; implementation issues; and the role and organization of the Bank Group in privatization (see below). The paper will also include a brief historical review of privatization experience. Data will be presented on the numbers and types of enterprises privatized, regional and sectoral trends over time, and outcomes vis-a-vis stated privatization objectives such as reduction in sector size, improvements in SOE performance, financial gains, capital market development, etc. Findings from the ongoing

PRE research project, examining in-depth the ex-post economic and financial impact of privatized firms, will be incorporated as they become available.

5. The analysis will cover both developed and developing countries. Examples include the U.K., France, Canada, and New Zealand among developed countries; Guinea, Togo, Nigeria, Ghana, Jamaica, Mexico, Argentina, Chile, the Philippines, Bangladesh, and Turkey among developing countries. Transforming socialist economies will be examined to the extent possible; in-depth treatment of such economies are found in separate Bank papers. The paper will attempt to present its findings and conclusions in a taxonomic form, paying close attention to two sets of variables that affect policy design: (i) country conditions; i.e., the macroeconomic environment, market size and structure, and level of capital market development; and (ii) enterprise characteristics; i.e. size in relation to factor markets, market structure, and profitability (both present and potential). Thus, for example, privatization strategy and design will be differentiated for countries with relatively well developed vs. weak capital markets, and those with highly distorted vs. liberalized macroeconomic environments. Differences in privatization approach will also be highlighted for firms operating in competitive vs. monopolistic markets.

II. PRIVATIZATION OBJECTIVES AND STRATEGIES

1. Delineating Objectives

6. Governments usually have a number of different objectives for privatizing SOEs, including: improving productive efficiency; raising revenues or removing a fiscal drain; developing capital markets; spreading ownership more widely; attracting new financing to key sectors; and, more broadly, increasing competition and efficiency in the overall economy. There are several trade-offs involved in pursuing these multiple and often conflicting objectives. For example: (i) there can be a trade-off between short-term financial gains and efficiency: selling an SOE may eliminate a fiscal drain in the short-run, but extending special concessions and protection against competition in order to maximize price and revenues may lead to costly inefficiencies in the long-run; (ii) there may be a trade-off between wide dispersion of ownership and managerial accountability: distributing ownership widely may prevent asset concentration, but a single investor with enough of an ownership stake may be needed to hold managers accountable for results; or (iii) there may be a trade-off between equity and efficiency: selling SOEs (for example, public utilities) can improve productive efficiency, but developing a competitive environment and an adequate regulatory framework is necessary to protect public interests and ensure affordability of basic services. The paper will explore these and other trade-offs, examine the extent to which objectives must be clarified and prioritized at the outset, and suggest strategies to minimize the costs of any trade-offs involved.

2. Strategy Formulation

7. Strategy formulation involves choices on scope, timing, and method of privatization. Some countries have formulated grand "master plans" to set the scope and pace of reform for the entire SOE sector before implementation. The paper will explore the view that such plans, while potentially useful, risk delaying implementation as they could end up generating substantial debate and become an end in themselves. The paper will also analyze strategies for the timing of SOEs for sale, including the approach of targeting smaller and easier firms for initial sale (as a way of obtaining quick demonstration effects and developing a learning curve) and then broadening the scope to include more complex candidates, as well as the market effects of privatizing a large number of firms at the same time.

8. Strategic choices between sale and non-sale privatization options such as management contracts and leases must also be made. While such decisions need not be mutually exclusive and are usually made on a case-by-case basis, the paper will consider the criteria for making these decisions (including affordability of basic services), flag the conditions and circumstances under which non-sale options can be alternatives to outright sale, and assess the extent to which ownership change may be needed to lock in performance gains resulting from non-sale options. The paper will also examine the commercial, financial, legal, and political dimensions involved in choosing different sale techniques. One view is that the techniques most likely to yield the highest financial and performance gains (outright sale to foreign investors, for example) may be those which are least acceptable politically; and, conversely, the most politically attractive modes (public share offerings, for instance) may be least likely to obtain such gains.

3. Sequencing

9. Experience shows the importance of seizing the right political moment for privatization. The paper will weigh this against evidence which shows that efficiency gains are likely to depend on coordinating sales with parallel measures to improve competition (removal of price and trade distortions, opening up of markets, for example) and develop an adequate regulatory framework. Such measures are particularly relevant in the case of large SOEs or monopolies, or countries with serious market distortions. The paper will analyze the complementary reforms necessary for successful privatization, and address the different sequencing approaches, taking into account variations in enterprise and country conditions.

III. IMPLEMENTATION ISSUES

10. This part of the paper will focus on major aspects of the sale process, and their impact on policy design and outcomes. The key issues to be tackled are:

1. Valuation and Pricing

11. Different methodologies can be used to value an SOE, depending on whether the sale is of an ongoing concern, sale of shares, or sale of piecemeal assets. A key question is how these methodologies can be applied to the pricing of SOEs for sale, including the extent to which technical appraisals can correctly estimate the market price of an asset that has never been traded; how government objectives such as wider distribution of ownership lead to deliberate underpricing of shares and assets; ways in which macroeconomic distortions affect sale price; and the extent to which valuations must account for social functions that the SOE was providing but which the Treasury must now pay for.

12. This section will briefly discuss the available valuation methodologies. It will focus primarily on the factors which affect pricing, including enterprise-specific factors, market conditions, government objectives, the net social value of the enterprise, and macroeconomic conditions. Issues of why pricing is important, and the potential financial and efficiency impact of pricing will also be addressed.

2. Prior Restructuring

13. The question of whether and how to restructure an enterprise prior to sale is an important aspect of implementation, particularly in the case of monopolies and large firms. One view is that efficiency and financial gains from the sale of large SOEs and monopolies are contingent upon prior rationalization of firms by government through break-ups, separation of competitive and non-competitive activities, liquidations of peripheral assets, employment reductions, and cleaning up of the balance sheet. However, new investments for modernization or rehabilitation may not be advisable as the costs may not be fully recoverable in the sale price and privatization may be delayed; such investments might best be handled by the new private investor. In the case of small SOEs, the gains to be had from any type of restructuring may be few; here, the objective may be to get them off the government's books as quickly as possible. The paper will consider the experiences with different types of restructuring (financial, legal, organizational, physical, sectoral), and analyze the conditions under which prior restructuring is most relevant.

3. Financing

14. Financing is a major constraint in countries with weak capital markets and embryonic local private sectors. Moreover, such constraints can often be exacerbated by ownership limitations and exclusion of certain groups of buyers for socio-political reasons. A number of options are available to minimize financing constraints, including: the combination of various sources of financing in a transaction through trade sales (foreign and domestic), share sales, and employee share ownership schemes; the creation of mutual funds or equity funds to facilitate broad-based participation; free give-away of shares to the local population; and sale of majority rather than full

ownership of large SOEs, while limiting remaining government ownership rights. These options, as well as the use of a "golden share" mechanism in SOEs where foreign investment could play a major role in bringing access to new capital, markets, and technology, will be studied in detail.[1]

15. The paper will also examine other commercial and financial aspects of privatization transactions, including the extent of desirable debt financing in the purchase of SOEs, role of debt/equity swaps, and treatment of financial liabilities. The role of financial markets and the government in financing post-privatization investments will also be considered, particularly in infrastructure-related projects where large investment programs are a critical element of the sales agreement.

4. Employee Issues

16. Resolving employee issues is a critical aspect of the privatization process. This is more difficult in countries where overstaffing and poor labor mobility lead to lay-offs and hardships. Nevertheless, innovative mechanisms such as attractive severance packages and redeployment schemes have been used to ease the transition; and employee share ownership schemes are being developed to elicit employee support. More in-depth assessments of such mechanisms are needed in view of some early findings: overly generous severance agreements (in relation to existing labor laws) and pension rights have become unaffordable in some cases; and, in others, wage distortions have continued in firms where employees became owners of the largest block of shares. This part of the paper will examine the employment effects of privatization in different circumstances, analyze mechanisms (including changes in labor laws) to mitigate social costs and increase employee incentives, and highlight those solutions which have worked best. It will point out that, as a precondition to privatization, reforming socialist economies may need to nationalize social safety net and social investment programs for which SOEs were previously responsible.

5. Managing Privatization

17. Governments must organize themselves to manage the implementation process. Experience shows that centralization of privatization responsibilities, minimal bureaucracy, and ready access to top decision-makers help maintain momentum and keep the process consistent and transparent. Sector ministries are usually slower to privatize, as vested interests are more salient. Related to the question of setting up an appropriate institutional structure is the question of developing an appropriate legal framework and obtaining the right technical and financial skills for privatization. These

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[1] In some cases, governments have adopted the practice of reserving a "golden share" in the privatized firm, giving them the right to veto changes in the firm's articles of agreement. The golden share mechanism has been used on an exceptional basis, primarily for large enterprises with strategic or national interest.

skills are often unavailable locally and may thus have to be imported. Where foreign private sector experts substitute for local skills, both the costs and nature of such advice, as well as government capacity to employ external advice and evaluate the public policy implications of technical recommendations need to be assessed. The paper will examine what legal and institutional arrangements work best under different circumstances, and propose ways to make skills more easily available to privatizing governments.

IV. ROLE AND ORGANIZATION OF THE BANK GROUP

1. Role of the Bank Group

18. The paper will provide a short history of the magnitude and nature of Bank Group lending for privatization, noting the significant changes that have taken place over the past ten years. An earlier review of Bank experience suggests, among others, the following operational issues for further analysis: (i) the fit between privatization and adjustment loans (so far the major vehicle for privatization lending), including the emphasis on speed and use of conditionality and quantitative sale targets; (ii) the appropriate design and financing of technical assistance components to support privatization in Bank loans; and (iii) the availability of necessary resources for designing, monitoring and evaluating privatization programs, particularly as countries graduate to more complex sales. In addition, the paper will examine the appropriate role of the Bank Group in the restructuring of SOEs prior to sale and financing of post-privatization investment programs.

Doesn't do well

2. Organization of the Bank Group

19. Privatization is an area where the Bank, IFC, and MIGA play complementary roles. The paper will examine implementation capacity and avenues for greater coordination by different Bank Group members. More specifically, the paper will: (i) summarize recent initiatives outlined in recent Board papers on private sector development; (ii) report on recent progress in increasing coordination between the Bank and IFC; and (iii) report on the role of relevant Bank units in privatization.

V. CONCLUSIONS AND KEY LESSONS

20. The major lessons and themes from the previous sections will be summarized here. The emphasis will be on highlighting the practical lessons of design and implementation for the Bank Group policy and for borrowers' strategies. The paper will conclude with an agenda for future research in privatization.

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The World Bank/IFC/MIGA
O F F I C E   M E M O R A N D U M

DATE: February 24, 1992 06:05pm

TO: John Nellis (JOHN NELLIS)

FROM: Parvez Hasan, ECAVP (PARVEZ HASAN)

EXT.: 32666

SUBJECT: **Privatization: Draft Paper on Lessons of Experience**

I enjoyed reading the above paper. It is clearly written, analyzes the issues and Bank experience well and suggests a pragmatic multi-track approach to the difficult and complex problems of privatization in the ex-socialist economies. I have two comments on the paper.

The first concerns the recommendation that where there exists an alternative between public and private provision of investment capital in infrastructure, preference should be given to the private source provided (i) that conditions of the private investment are structured to enhance efficiency and promote modernization and expansion and (ii) access of the poor to essential services is safeguarded. This recommendation stems from the analysis that despite years of Bank lending with strict project covenants and conditionality, performance improvements in the infrastructure SOEs have been modest and unenduring. The paper refers to recent reviews of lending to the power and telecommunications sectors which show deteriorating performance of many borrowers. I fully agree with the need to tighten conditionality for infrastructure lending and make it stick. I am not sure, however, that the specific recommendation has been fully thought through. One reaction I have is that the caveats are so broadly worded that no change may take place. In a typical borrower, the private alternative does not exist and may need to be created as a matter of deliberate government policy. I would therefore have liked to see more emphasis on creation of conditions for development of private sector alternatives in infrastructure. It would also be useful to look at the Bank lending in infrastructure during the last two years and to see what would have been different if the recommendation would have been in effect; the paper in fact does this for the other recommendation concerning SOEs, that the Bank should not lend directly to enterprises functioning in competitive or potentially competitive markets, except to facilitate a time bound program to privatize that enterprise. My more general point is that if we have serious problems with our infrastructure lending which remai we should confront them frontally and not as an aside to the privatization paper. In specific country situations, the answers to poor performing infrastructure SOEs may differ; reduction of total lending on performance grounds, re-direction of lending to other sectors as well as lending in support of private investment (assuming an appropriate Bank instrument is available) may be considered. A third point is that the proposed recommendation could penalize countries which have not used Bank resources to avoid reform and indeed have well functioning SOEs but more of a private sector alternative.

My second comment relates to the recommendation that the Bank directly finance severance costs, while applying safeguards against bidding up the price and "against revolving door practices". The inclustion of severance costs in selective cases of project financing for privatization may make sense. However, such financing will still have to meet the test of local currency financing on country grounds. The paper needs to deal with this issue. Again, a retrospective look at past Bank financing of privatization efforts may be useful to see how the additional flexibility that is being requested would have been used in specific country situations.

Finally, two minor points. First, foreign private investment could play a significant role in privatization in the ex-socialist economies. I would have, therefore, liked to see somewhere in the paper an exploration of links between large foreign private investment flows into Hungary and the privatization progress. Second, do we really want to say in Box 6 on efficiency consequences of regulation of monopolies "since virtually all real world regulatory effort falls short of perfection, the analysis suggests that under most circumstances, regulation will yield little, if any, efficiency gains". Is the case for regulation going to be made solely on needs of transparency or as a way of limiting actual or perceived inequities? I hope the analysis on which this is based is reasonably robust.

CC:	Larry Summers	(LARRY SUMMERS)
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THE WORLD BANK/IFC/MIGA

OFFICE MEMORANDUM

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92 FEB 18 PM 1:

DATE: February 14, 1992

TO: Distribution

FROM: Lawrence Summers, DECVP

SUBJECT: PRIVATIZATION: Draft paper on lessons of experience

You are invited to attend a meeting to review the attached paper, "Privatization: Lessons of Experience for Bank Group Lending." The paper is scheduled to be presented to the Board in late April. The review meeting will be held on Tuesday, February 25, 1992, at 9:30 a.m. in Room E-8042. I will be in the Chair. Written comments and suggestions may be sent to Sunita Kikeri (x37653) or John Nellis (x37482).

Attachment

Distribution:

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DRAFT

PRIVATIZATION: LESSONS OF EXPERIENCE FOR BANK GROUP LENDING

POLICY PAPER

Country Economics Department
Public Sector Management & Private
Sector Development Division
February 14, 1992

2/10/92

Kikeri/Nellis

PRIVATIZATION: LESSONS OF EXPERIENCE FOR BANK GROUP LENDING

EXECUTIVE SUMMARY

Introduction. More than 80 countries, with widely varying political and economic systems, have implemented or launched ambitious efforts to privatize some or all their state-owned enterprises (SOEs).[1] Since 1980, more than 7,000 SOEs have passed from majority public to majority private ownership. Accumulating evidence reveals that the results of privatization are generally positive, both in financial and economic terms.

The Bank Group has actively supported privatization. Over 180 Bank operations have privatization components, and 50 IFC projects provide advisory support and investments in privatized firms. This paper reviews the evidence and distills the salient themes and lessons emerging from case, country and Bank Group experience. It concludes with policy implications for Bank Group support for privatization.

Why Privatize? The primary objective should be to improve efficiency. On the whole, SOE performance has not lived up to expectations. Performance improvement measures short of ownership transfer have yielded limited results; more important, they have not endured. Changing ownership helps lock-in efficiency gains achieved by past, partial reforms of SOEs, and further improve efficiency. Both Bank research and independent academic analysis shows that privatization has significantly improved economic welfare and enterprise performance -- when properly done. Privately owned firms, unlike SOEs, are

[1] The paper concentrates on the transfer of ownership of SOEs. Ownership change is the most widely employed and debated aspect of privatization. Thus, options involving the privatization of management -- management contracts, leases, and contracting out of public services to the private sector -- are flagged and briefly discussed, but not analyzed in detail.

less subject to political interference, more subject to financial discipline, and more capable of offering competitive managerial incentives. Most importantly, private firms are supervised by shareholders with a direct stake in enterprise performance rather than by bureaucrats with a different agenda.

Governments privatize for more than efficiency reasons; they also want to raise short-term revenues, distribute ownership more widely, and develop capital markets. Experience indicates that stressing these goals at the expense of efficiency enhancement is a mistake. Special privileges, monopoly rights, and protection against competition should not be granted to maximize price and fiscal revenues; analysis reveals that the long-run economic sacrifices outweigh short term financial gains. Widespread dispersion of ownership should not be pursued at the expense of improving incentives to management, particularly in countries lacking the discipline of capital markets. In developing countries, core investors are usually needed to induce changes in managerial behavior and corporate governance. As for capital market development, most SOEs are poor performers and the goal should be to improve management before stock market sale. In addition, large privatization programs can swamp emerging capital markets and crowd out private share issues. It takes time to develop the appropriate regulations, and this can delay privatization; but privatizing in the absence of these institutions exploits small investors and invites pleas for government bail outs.

<u>What to Privatize</u>. Most divesting countries in both the developing world and Eastern Europe and Central Asia, have begun with relatively low risk, simple and quick sales of small firms in tradeable sectors. A growing number of developing countries are now choosing to give priority to large firms and monopolies in non-tradeable sectors, on the grounds that the greatest economic gains can be had by privatizing enterprises with the largest impact on the economy as a whole.

Gains can be had from privatizing monopolies into a well-regulated environment that safeguards consumers and provides clear rules-of-the-game to attract investor interest. The dilemma is that where SOEs have consistently performed poorly and proven resistant to reform (more likely to be the case in least-developed economies), the potential for regulatory failure is high. Yet, it can be argued that the costs of privatizing an unregulated monopoly would be less than the costs of retaining a very badly functioning public enterprise: private monopolies, even unregulated, would have a greater incentive to market output, improve services, and control costs. In the end, the choice of what to privatize, and when, should depend on which assets will attract investor interest, what the government has the capacity to manage, and which sectors most need new investment.

How to Privatize. There are many methods to transfer enterprise control -- and risk -- to the private sector. Outright or majority sales are the surest way, but these are not always financially or politically feasible, especially for large SOEs or countries with weak capital markets and embryonic private sectors. Partial sales can have positive effects, provided managerial control is transferred to private hands and limitations placed on government's voting rights. Performance gains can be obtained through management contracts, leases, and concessions; but only if government keeps an arms-length distance from management, and structures the arrangements to give managers incentives to improve operations, take risk, and maintain the long-term value of the assets (by incorporating an equity component into the contract, for example). Accumulating evidence shows that political authorities, while often willing to grant SOE managers the autonomy needed to turn around poorly performing SOEs, too frequently succumb to the temptation to re-interfere, particularly as SOE profits improve.

Preparing for Sale. Should SOEs be restructured prior to sale? The gains to be had from any type of restructuring have proved to be marginal in small- and medium- sized firms producing tradeables; here, the objective should be to sell quickly "as is," at the best price possible. Firms that do not meet the market test of viability should be closed down or liquidated. Attempts to sell non-viable firms as going concerns creates delays and invites special protection, subsidies, or subsequent government bailouts.

Large firms or monopolies often do need to be restructured prior to sale to obtain full efficiency gains and facilitate sale. Restructuring involves breaking-up monopolies before sale to separate competitive and non-competitive activities; or hiving off peripheral assets. Divesting governments have usually had to clean up the balance sheet and assume enterprise debts, since new investors are seldom willing to inherit past liabilities. Successful privatizers have often laid off redundant labor as part of a broader reform program preceding privatization. Labor issues tend best to be handled while the firm is still in government hands; this maximizes marketability and minimizes the burden of lay-offs on new private investors. Downsizing prior to privatization also pushes governments to develop social safety nets, such as severance packages and redeployment/retraining schemes; they help ease the transition (although overly generous agreements have become unaffordable in some countries). If redundancies are left to private investors, the new owners should be given full freedom to adjust the size and composition of the labor force according to their perception of need; otherwise, the new owners will demand protection or assistance to allow them to carry the excess workforce.

New investments for physical restructuring are best left to the new private owner. Private owners tend to make quite different choices, and pay different prices, from governments. Moreover, there is a risk that restructuring will divert scarce government resources from high priority social sectors, or delay privatization unnecessarily. For SOEs that are to be privatized in the medium to long-term, investments should be made only when it can be demonstrated that: (i) the firm is viable and privatizable within a specified time-frame (non-viable firms should be closed down); and (ii) there exists a market failure that justifies the investment by government.

Prices, Buyers and Financing. Once criteria have been established for the prequalification of buyers, the fastest and most transparent route is to let the market decide the sales price through competitive bidding. Asset valuation helps set a benchmark for market price (and is often politically valuable), but too much emphasis on valuation can prove unnecessary or problematic in small and medium sized competitive firms, where the market is the best judge. Valuing any firm -- public or private -- is difficult; in developing countries, all the more so since comparables are few, markets thin, and information on past performance poor. Excessively high valuations that bear no resemblance to current or future earnings have often become a stumbling block to sales. The lesson of experience is that valuation should be kept simple and regarded as indicative, not definitive.

Developing countries generally face financing constraints, and governments only heighten these by restricting the market for SOEs to citizens, certain ethnic groups, etc. (Furthermore, a surprising number of governments have crowded out their privatization programs by simultaneously offering high-yield, low-risk government bonds.) Foreign participation can be essential to finance the sale of large enterprises where local absorptive capacity is weak; it can also bring access to managerial skills, new markets, and technology. Some countries have successfully mitigated socio-political concerns by reserving a "golden share" for government (particularly for "strategic" enterprises), by giving concessionary prices to workers, and by promoting foreign/local consortiums.

There are good reasons to sell for cash. Excessively leveraged sales have led to bankruptcies and defaults, which then require slow and expensive repairs by government. In contrast, cash sales cleanly sever the relationship between government and enterprise, although they may lower the sale price. Realistically, some developing countries may have to sell on the installment plan; this has been the pattern where financial systems are weak, as in Africa or Bangladesh. Debt/equity swaps have eased financing constraints in several countries, and helped bring foreign commercial banks into transactions that would not have been concluded without their participation. The resulting reduction in foreign debt radically improves a country's investment climate.

Managing the Process. Institutional arrangements should aim for speed, transparency, and consistency in implementation. The requirements are heavy but they should not be overstated. A minimum amount of transparency through competitive bidding procedures, well-defined institutional responsibilities, and central oversight must obtain in every transaction. But worldwide experience reveals that light management and cursory review of transactions is often all that is needed to produce speedy sales of small and medium firms operating in competitive markets. In large transactions, a balance needs to be struck: lack of transparency results in political backlash, but too much dedication to transparency slows or even halts the process.

The developing countries which have privatized fast and well have centralized policy decisions and coordination in a specialized focal point. Many other countries have left policy responsibilities to cabinet committees or, worse yet, sector ministries, and this has delayed implementation. Few but high-quality staff, access to top decision-makers, and minimal bureaucracy are the characteristics of institutional success. Conversely, implementation responsibilities can be decentralized (to a technical secretariat, holding companies, and/or banks, but usually not to sector ministries), so long as clear implementation principles -- fair and equitable bidding procedures, criteria for valuation and ranking bids -- and time-tables are established *ex ante* to ensure transparency and accountability.

Ex-Socialist Economies. All of the successor governments in Eastern Europe and Central Asia have launched or are preparing privatization programs. Privatization in these countries is a more massive, complex, and more overtly political process than elsewhere. Many reformers in these economies (and some external analysts) see privatization's primary goal as the creation of a property-owning group that will support and sustain the transition to the market. Efficiency enhancement, the primary goal elsewhere in the world, is often regarded as important but secondary.

More than 100,000 small business units -- shops, restaurants, retail outlets -- have been privatized in ex-socialist countries in the last two years; this is a major success. Privatization of medium and large enterprises has moved comparatively slowly; excluding the former east Germany, "only" about 800 firms have changed hands. Nonetheless, governments in ex-socialist countries, with considerable external assistance, are busily devising a range of methods to overcome the obstacles to privatization (weak capital markets, inappropriate legal systems, illiquid populations, macroeconomic deficiencies, technical-financial inadequacies, and socio-political fears). Proposed measures include owner-assisted financing to facilitate sales; selling shares at concessionary prices, or giving other incentives, to workers; using financial intermediaries to actively turn around companies and spread risks; and creating privatization agencies to promote the process and protect the public interest.

The most innovative schemes aim at mass privatization through share give-away schemes, as a transitional or accompanying step to full-fledged privatization. The primary intention of these proposed schemes is to increase rapidly private ownership levels; but they should also avoid complex valuation exercises, solve the illiquidity problem, and diminish political problems associated with both foreign and nomenclatura ownership. Measures that hold out even a promise to accomplish all this are well worth examining and supporting. There are risks, since -- besides being difficult to devise and launch -- mass privatization would result in widespread dispersion or indirect holding of shares without a core owner, and foregone revenues. Thus, flexibility is called for; governments and the Bank should support a variety of approaches, including mass privatization.

The Role of the Bank Group. The dramatic growth in Bank Group support for privatization is fully documented in the paper. The Bank Group has long assisted borrowers to better enterprise performance under public ownership by subjecting SOEs to competition and by improving the institutional framework in which they operate. Gains, sometimes sizeable, have been recorded. Yet, over time it has become apparent that Bank lending to SOEs has not produced the anticipated results (and indeed, it has in some cases, inadvertently, contributed to market distortions and the delay of liberalization). This report cites growing and persuasive evidence that while privatization may not be necessary to improve efficiency -- though cases are noted where privatization did just that -- it is required in order to lock-in the gains of reforms so hard won under public ownership. In competitive markets, government ownership is associated with protection, subsidies, and other interventions that harm not only enterprise performance, but affect the basic nature of markets as well. Hence this reports recommends that the Bank should not lend directly to SOEs in competitive or potentially competitive markets except to facilitate an agreed-upon, time bound program of privatization.[2]

In infrastructure SOEs as well, despite years of Bank lending with strict project covenants and conditionality, performance improvements have also been modest and unenduring. Here too, it is hard to disprove the assertion that Bank-provided money has sometimes given governments the resources to avoid rather than undertake reform. If the Bank reduced or re-cast its lending to infrastructure SOEs, governments might more readily consider ending intervention and unrealistic pricing, and allow the private sector to play a more active management and/or financing role aimed at enhancing efficiency and expanding access.

The argument is not that the Bank should stop lending to infrastructure SOEs; the recommendation is that where there exists an alternative between public and private provision of investment capital in an infrastructure SOE, preference should be given to the private source -- provided that: (i) the conditions of the private investment are structured to enhance efficiency, and promote modernization and expansion, and (ii) access of the poor to essential services is safeguarded.

Bank Instruments for Supporting Privatization. It is not sufficient to assert that many public enterprises should be privatized; in developing and ex-socialist countries alike the process requires assistance and support. This is particularly likely to be the case in infrastructure sectors; large, "lumpy" investments may never attract adequate private sector financing. What can and should the Bank Group do to help, more than it is doing at present? One option would be to amend or re-interpret the Articles to allow direct Bank (and not just IFC) lending to private enterprises without a government guarantee; but this is seen as altering negatively the Bank's character and credit rating. Moreover, the IFC already lends directly without a government

[2]The Bank should and will continue to lend through financial intermediaries to tradeable-producing public -- and private -- enterprises, competing on a level playing field.

guarantee. A second option, government guarantees of direct Bank loans to the private sector, constitutes a serious distortion.

Yet another option would be greater use of the Bank's guarantee authority. Guarantee facilities could be used to diminish limited risks in order to encourage private investment in previously public activities. Bank guarantees can be structured to reduce or eliminate only the private sector's non-commercial risk in a project, placing them more on private lenders. Specifically, the Bank might guarantee foreign exchange convertibility in favor of third party lenders. The subject is large and intricate, and merits further study.

An inability to finance severance costs is often perceived as a major obstacle to privatization in developing countries. Attractive severance packages are essential to conclude sales and closures: they can limit opposition and help create a social safety net. The Bank's Articles of Agreement limit lending to "productive purposes," and the current interpretation is that direct Bank financing of severance pay in projects is not allowed. Evidence shows that severance costs can and should be viewed as economically productive investments; they have a high pay-back period over the short-run, and help increase efficiency. By directly financing severance costs, while applying safeguards against bidding up the price and against "revolving door practices," the Bank would facilitate beneficial privatization.

A final policy issue for the Bank Group relates to IFC bidding on Bank-financed projects. IFC is currently not allowed to compete for conflict of interest reasons. But least developed countries might be considered exceptional from a developmental perspective, since such markets are likely to be ill-served by private investment banks. One way to address this approximation of "market failure" would be by allowing IFC to bid on Bank-funded privatization projects only in IDA countries.

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PRIVATIZATION: LESSONS OF EXPERIENCE FOR BANK GROUP LENDING

I. INTRODUCTION

A. OBJECTIVES AND SCOPE

Governments around the world are privatizing in an effort to improve the efficiency and lessen the financial burden of state-owned enterprises (SOEs). On the whole, SOE performance has been persistently disappointing; and the results of previous, partial reform efforts, minimal or unenduring. Many governments today seek to privatize virtually all their SOEs, including public utilities and enterprises formerly classed as "strategic" (for example, airlines, ports, railways, petrochemicals, steel, and cement). Bank Group support for privatization has grown: over 180 Bank operations in 67 countries support reforms to privatize SOEs; and about 50 IFC projects provide advisory support and/or investments in privatized enterprises. Three of MIGA's 15 projects insure investments associated with privatization.

This paper: (i) examines the privatization experiences of developing and developed countries;[1] (ii) extracts lessons for the design and implementation of privatization; and (iii) draws out policy implications for future Bank Group support for the process. Privatization can be defined as the transfer of ownership of SOEs to the private sector by the sale -- full or partial -- of ongoing concerns, or sale of assets following liquidation. Sale of the

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[1] The paper is based on available analyses of individual country experiences (bibliography attached), as well as the experiences of the Bank and the IFC in privatization.

business or of its assets has been the most widely employed and debated form of privatization; this is the option that is analyzed in greatest detail.[2]

Recent trends (Section II) show that at least 7,000 enterprises have been privatized world-wide since the early 1980s. Experience from major privatizing countries such as Chile, Mexico, Jamaica, Argentina, Guinea, the Philippines, the U.K., France, New Zealand, and the former east Germany demonstrates that privatization has helped: create a conducive environment for private sector development; improve enterprise performance; reduce the fiscal burden and country debt; and improve consumer welfare. Clear privatization objectives and strategy have been essential for success (Section III). This involves identifying and resolving policy trade-offs; establishing the appropriate scope, pace, and sequencing of privatization; and choosing the right privatization methods. Speedy implementation (Section IV) has required pragmatic and flexible decisions on the restructuring of SOEs prior to sale, pricing of assets and shares, financing of sales, and the institutional set-up for managing privatization. Privatization issues differ in reforming socialist economies (Section V). The policy issues for the Bank Group's role are discussed in Section VI.

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[2] Methods of privatizing management but not ownership -- through management contracts, leases, and concessions -- are examined as alternatives to outright sale, but are not treated in equal depth. Privatization is sometimes more broadly defined to include deregulation and new private sector entry, or private sector financing through Build-Operate-Transfer (BOT) arrangements. The paper does not examine these mechanisms; it concentrates on lessons derived from ownership transfer.

B. WHY PRIVATIZE?

The decision to privatize is induced by both theoretical arguments[3] and empirical evidence supporting the contention that ownership matters in improving enterprise efficiency. The basic argument is that owners (principals) of private firms, unlike the state, are better motivated and equipped to improve corporate governance and productive efficiency. Private owners, having clearly defined property rights and profit incentives, are thought to be more likely than government bureaucrats to change the structure of incentives for managers (their agents) and hold them accountable for results. They should be less subject to political interference, more likely to be disciplined by commercial financial markets, better able to offer competitive managerial incentives, and more likely to increase dynamic efficiency through innovations, new technology, and capital investments.[4]

Privatization should also improve efficiency by increasing competition. In theory, a state-owned firm can operate as efficiently as a private firm, if both function in a competitive setting, according to the same rules and incentives. But evidence shows that the playing field is not often level;

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[3] These arguments are derived from the public choice and property rights schools. See Vickers and Yarrow, 1988, and Ott and Hartley, 1991 for a summary of the arguments.

[4] See Box 3. There is also considerable partial empirical evidence to support the notion that privately owned firms are more productive than SOEs. For example, rates of return on total assets employed in the private sector are higher than those in comparable SOEs. In Thailand, between 1983-87, the SOE rate of return was roughly 3%, while the private rate was 9%; a similar comparison can be made for India between the late 1960s to the mid-1980s; and in South Korea in the early 1980s, the public rate was close to 7% while the private rate was 27.5%. See Nellis and Kikeri, 1989.

governments support their enterprises, or discriminate against their private competitors, or both. They award SOEs monopoly status in competitive or potentially competitive markets; provide them with subsidies, cheap loans and loan guarantees, tax and duty exemptions; and fail to penalize them for unpaid taxes and utility bills. They allow them to run up large accounts with their suppliers, public or private. They are also often burdened with non-commercial objectives such as employment creation and regional development, best attained by direct government action. Despite the panoply of protection and advantages, many SOEs continue to lose money, and governments -- reluctant to let them go bankrupt -- respond by further limiting or preventing competition. Privatization, it is argued, will end the vicious circle; it thrusts SOEs into competitive markets and so creates pressures for enterprises to perform, or go under if they cannot compete.

As privatization improves productive efficiency and competition, it would also increase dynamic efficiency in the economy, as new investments and diversification of activities take place. And, by reducing the state's role in productive activities which could easily be carried out by the private sector, privatization affords government the opportunity to concentrate scarce managerial and financial resources on priority sectors such as education, health and nutrition, and transport infrastructure.

Privatization could also contribute to greater equity. Some argue that efficiency is not the primary reason why SOEs were created in the first place. In this view, SOEs serve social or political objectives which justify some sacrifice of performance. Yet numerous studies show that SOE inefficiencies undermine the very goals they were created to achieve and that the burden of their inefficiency falls disproportionately on the poor.[5] The poor may gain directly from privatization (in agriculture for example), and indirectly if their taxes finance subsidies to SOEs that pay an elite group of formal sector workers more than their marginal product. The latter are more likely to benefit from the rent-seeking and transfers associated with loss-making SOEs.

These arguments are most easily applied to enterprises producing tradeables in competitive or potentially competitive markets, where the benefits of private ownership and management are likely to exceed any short-term political or social welfare costs. But even for monopoly SOEs, recent evidence makes a strong case for privatization -- into an appropriate regulatory environment. Developed country experience shows that the technical and institutional aspects of regulation can be difficult; in developing countries the difficulties are greatly compounded by institutional weaknesses. In such cases, the choice will be between retaining and reforming the SOE, or divesting and initiating the development of a regulatory set-up. The evidence increasingly shows that the latter course of action may be the better choice, even where regulation is not yet fully in place.

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[5] Nellis and Shirley, 1991.

II. A HISTORY OF PRIVATIZATION

A. SOE SECTORS ARE LARGE AND POORLY PERFORMING

Developing countries created SOEs in the 1960s and 1970s to balance or replace a non-existent or ideologically unacceptable private sector; stimulate embryonic indigenous private sectors; transfer technology to "strategic" firms in mining, telecommunications, transport, and heavy industry; and produce higher investment ratios and yield a capital surplus for investment in the economy. By the early 1980s, SOEs accounted on average for 17% of GDP in sub-Saharan Africa[6], 12% in Latin America, and a modest 3% in Asia, compared to 10% of GDP in mixed economies worldwide. In Eastern Europe and Central Asia (see Section V), SOEs uniformly account for the bulk -- as high as 90% -- of all productive activities.

SOE achievements have rarely lived up to expectations. There are exceptional performers, but evidence from a wide range of countries shows that, for a variety of reasons, most SOEs have been economically inefficient and incurred heavy financial losses. Between 1989 and 1991, cumulative SOE losses as a percentage of GDP reached 9% in Argentina, 8% in Yugoslavia, and over 5% in sub-Saharan Africa. In 1991, close to 40% of all SOEs in China were loss-making. In many countries, SOEs have become an unsustainable burden on the budget and the banking system, and scarce public resources have been used for investments in activities that could be better done by the private

[6] In a thirteen country sample for which data were available. See Nellis, 1986.

sector, or for keeping loss-making, non-viable SOEs alive. Government transfers and subsidies to SOEs amounted to more than 3% of GDP in Mexico in 1982, 4% of GNP in Turkey in 1990, and 9% of GDP in Poland in 1989.

Overextended and poorly performing SOEs have helped impede the development of the private sector in borrower countries. Government regulations have tended to preclude the entry and formalization of private firms in potentially competitive sectors. Directed government credit to capital-intensive SOEs has crowded out private firms from credit markets; in Guinea, SOEs -- which contributed only 25% of GDP -- absorbed 90% of formal domestic Bank credit; while in Turkey, in 1990, SOEs received two and a half times more medium and long-term foreign credit than the private sector, despite a marginal efficiency of SOE capital half that of the private sector. Inefficient provision of critical inputs by badly-managed SOEs has increased the costs of business to the private sector and limited the potential for expansion, particularly in smaller firms.[7]

B. SOE REFORMS HAVE NOT ENDURED

In the past twenty years, virtually all developing countries adopted reform programs -- short of ownership transfer -- to remedy the causes of poor SOE performance, to the point where SOE reform became a widespread and nearly perpetual exercise. These reforms aimed at: (i) removing SOE protection from domestic and external competition and ending preferential treatment in order to create a level playing field; (ii) eliminating easy SOE access to credit from the budget and banking system, and instituting a "hard budget

[7] World Bank, 1991.

constraint;" (iii) increasing SOE autonomy and freeing managers from government interference in day-to-day operational decision-making and from non-commercial goals; and (iv) developing institutional mechanisms, such as contract plans and performance evaluation systems, to hold managers accountable.

Recent assessments reveal that some performance improvements have indeed taken place.[8] But they have tended to be relatively limited and, more important, difficult to sustain once the crisis that instigated reform measures dissipated. This holds true for developed (Boxes 1 and 2) and developing countries alike. In Senegal, for example, despite sector-wide SOE reforms dating back to 1977, overall performance has remained poor. Some improvements took place in the early 1980s, but total SOE losses continued to climb and reached CFAF 23 billion in 1986. Moreover, while SOEs with performance contracts performed better than those without such contracts, the mechanism failed to impose financial discipline.[9] Similar evidence can be cited for many other sub-Saharan African countries.

In many Asian countries, too, SOE reforms have not sustained. For some years after the introduction of a performance evaluation system[10] in Korea in

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[8] Nellis and Kikeri, 1989; Galal, 1990

[9] Nellis, 1988. Contract plans aim to clarify SOE goals and establish a clear set of targets between government and enterprise. While they have proved somewhat useful in establishing a dialogue between owner and enterprise, contract plans have been ineffective in enforcing the financial commitments between the government and SOE.

[10] See Shirley, 1989 for an assessment of the performance evaluation system in Korea. The system holds management accountable for achieving agreed objectives which have been calculated as annual targets. Performance

Box 1

OWNERSHIP MATTERS: THE CASE OF NEW ZEALAND

By the 1980s, the poor financial performance of New Zealand's state-owned trading activities had created an intolerable drain on state resources. To arrest the decline, government "corporatized" its SOEs in 1987, by adopting reforms that made these companies independent cost-conscious entities. This initiative was followed by the privatization of several SOEs, including telecomms, airlines, and petroleum. Yet for the remaining SOEs, the very success of these widely-heralded reforms could prove to be their undoing.

Significant improvements in SOE operating performance have already tempted government to interfere once again with their management. The legal framework for corporatization, for example, has already been watered down. Rules governing the appointments of Directors no longer require "persons who will assist the State Enterprise to achieve its principal objective: to be profitable and efficient." Many observers and officials involved in the process argue that unless the businesses are eventually sold, efficiency gains will fade as government reasserts itself.

The experience of New Zealand Post and the Electricity Corporation illustrates the short-term gains and long-term drawbacks of corporatization. Prior to the reforms, the postal service had consistently operated in the red, and government had used the Postmaster-General's department as an employment agency in recessionary periods. In the first year after corporatization, New Zealand Post generated an after-tax profit of US$ 72.1 million, and has operated profitably ever since. By a wide range of other indicators the company has registered excellent results (e.g., a 15% improvement in on-time delivery of high-priority mail between 1987 and 1990). Similarly, in just one year Electricity Corporation cut the real cost of electricity production by 11%, and increased power generation per employee by 19%.

Nevertheless, in both instances pressure for renewed government intervention is growing. Government has forbidden Electricity Corporation to diversify into areas that private electricity suppliers exploit, and restrictions on employment of top managers are re-emerging. And in spite of performance improvements, rates of return on capital at the SOEs remain below those in the private sector. Corporatized companies are not subject to take-overs, which can check bad management; government may fail to inject capital required for growth and diversification; and capital markets may poorly scrutinize borrowings under the presumption that they are guaranteed by the government. Corporatization as a reform strategy is a very good start but seemingly not an adequate substitute for privatization in the long run.

Draft

Box 2

JAPANESE RAILWAYS: REFORMS ON THE ROAD TO PRIVATIZATION

Between 1964 and 1986, Japanese National Railways (JNR) -- Japan's largest SOE -- recorded staggering losses. A recent study1/ by a group of Japanese economists shows that despite five separate, full-scale reorganizations, performance continuously deteriorated. JNR's annual losses exceeded US$ 7 billion in the mid-70s, and US$ 10 billion in the mid-80s. Over this period, JNR received subsidies of more than US$ 51 billion, and the company ran its long-term debt up to US$ 193 billion, or 10% of GDP. Past reforms had foundered largely because they did not insulate JNR against political interference. Management and labor had few incentives to cut costs, raise productivity and maximize profits. The company continued to invest in unprofitable, remote routes, and could not respond flexibly to rapid growth in competing modes of transport. More important, over 100,000 surplus employees remained on the payroll.

A high-level Supervisory Committee was established in 1983 to explore further reform options. In 1985, the Government firmly committed itself to privatizing the railway, and in 1987 JNR was broken-up into seven smaller, joint stock companies ("JRs") -- six regional passenger lines and one nation-wide freight line -- and a profit-centered corporate culture was introduced. Deep cuts were made in JNR's labor force, from 358,000 in FY 1983 to 191,000 in FY 1990 -- a 52% reduction. Legal restrictions that prevented JNR from diversifying into other businesses were also lifted, and Diet approval for the new JRs' budgets was no longer required.

The changes produced significant performance gains, even after allowing for the effects of economic growth and the removal of long-term debt from the JRs' balance sheets. Between 1986 and 1990, for example, passenger transport volume increased at an average annual rate of 5%; passenger railway operating costs fell by 11%; revenues per employee rose from US$ 118,000 to US$ 175,000; and annual operating profits for the JRs as a group increased from US$ 2.7 billion to $US 3.6 billion. And while JNR had raised its rates in every year but one since 1981, rates have been raised just once since 1987.

In the JNR case, corporatization and deregulation have clearly unleashed competitive pressures which helped improve efficiency. At the same time, the study forcefully argues that had government not made the sale of shares the final goal of the program, the reforms would have lost their bite. Public offerings of three of the JRs have been tentatively scheduled for the last quarter of FY 1992.

1/ Japan Economic Research Institute, 1991

1986, for example, no SOE in the system had recorded a loss. Losses have now reoccurred, despite the continuing use of the system, and in 1990 were 26,570 million won, the second highest recorded loss-making year. Government has proven unable to resist the wage demands by workers. Between 1981 and 1988, Bangladesh carried out a reform program for industrial SOEs, including increased managerial autonomy, financial restructuring of SOEs, and employment and wage changes. Despite these reforms, SOE performance deteriorated throughout the 1980s. The average operating deficit of SOEs grew, and net transfers from the state to SOEs increased from 0.8% of GDP in 1986 to 3.2% of GDP in 1989.

And in China, a restructuring program was launched in the 1980s to stem SOE losses and improve their efficiency (by fostering bankruptcy legislation and introducing competition from private enterprise). While the reforms led to a rapidly growing private sector (the share of SOEs in industrial production dropped from close to 70% in 1986 to only 53% in 1990), they failed to spur performance improvements in the state sector. Indeed, recent evidence shows that provinces with a higher share of industrial output privately produced show higher total factor productivity (Figure 1). Subsidies to unprofitable SOEs rose from US$ 8.4 billion in 1988 to US$ 10.9 billion in 1990. More than one-third of the government's revenues -- much more than is spent on education -- is now used to bail out the loss-makers. Such examples are numerous and can be found in countries in virtually every region. In

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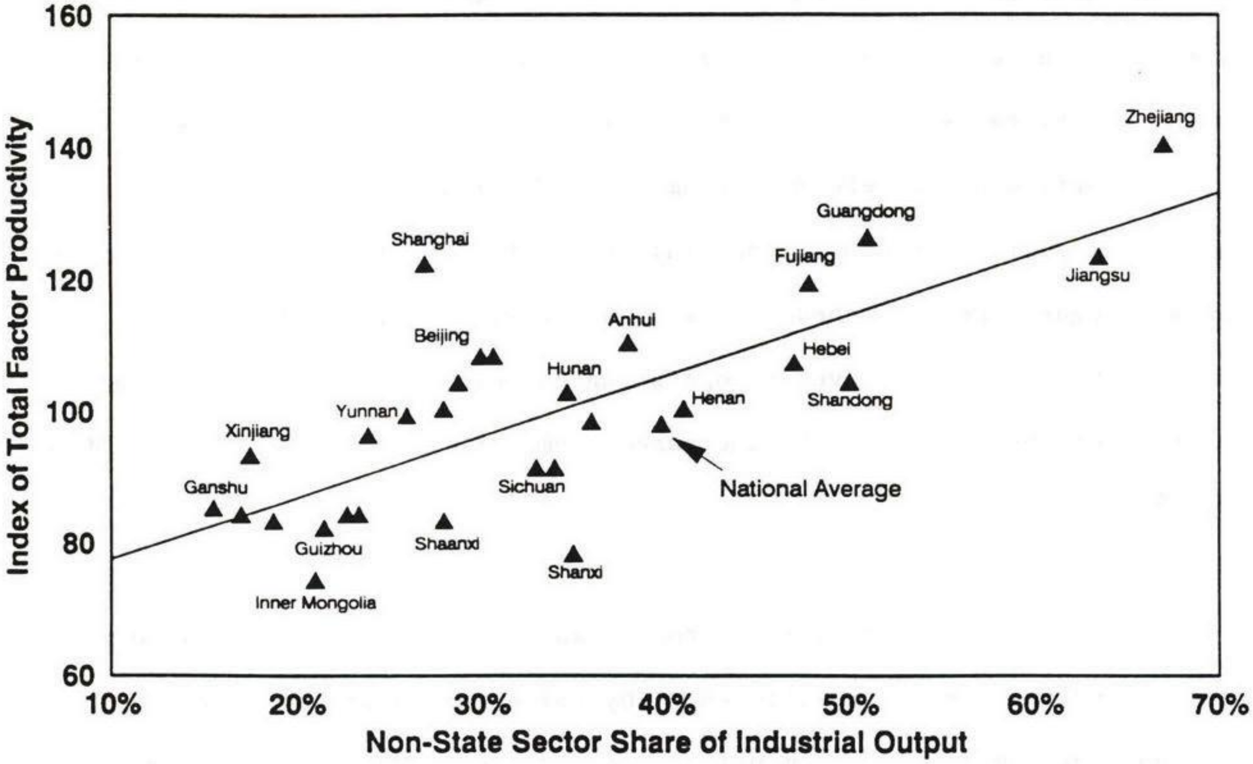
indicators were tailored to each SOE, and could include among others: general indicators relating operating expenses to sales; delivery of goods or services; and control of administrative expenses, management of funds, and research and development.

Figure 1

The Productivity-Ownership Link

1985-87 Chinese Provinces



Source: G. Xiao, China Economic Review, 1991.

short, evidence shows that SOE performance is difficult to improve, and even when progress is recorded, improvements tend to fade.

C. FACTORS MOTIVATING GOVERNMENTS TO PRIVATIZE

The recognition of the limited and unsustainable nature of past reforms fuelled the drive to privatization during the 1980s. In the early years, few developing country governments enthusiastically accepted privatization. Some even regarded it as an imposition of the international donor community.[11] Today, however, the pressures to privatize arise mainly from borrower governments themselves.

Developing country governments have been motivated less by theoretical arguments for efficiency and more by the urgent need to reduce the financial pressures created by wasteful SOEs, and concentrate scarce government resources on expenditures in social service sectors. Most governments are financially strapped and no longer able to finance modernization investments, particularly in infrastructure. They thus turn to privatization in the hope that new private owners -- in such diverse activities as hotels, iron and steel, textiles, and telecommunications -- can better tap commercial capital markets, allowing enterprises to modernize their facilities and expand production capacities.

[11] It must be admitted that in some cases the Bank is now recommending and supporting the privatization of public enterprises it had a hand in creating. While such support may have been justified at an early stage of economic development or in the case of natural monopolies, the Bank too underestimated the extent to which public ownership would create economic losses.

Governments have also used privatization as a tool to reduce national debt (in debt-ridden Latin America),[12] distribute ownership in the economy (Jamaica, Chile, and Nigeria), and develop fledgling capital markets. In ex-socialist economies in Eastern Europe and Central Asia, privatization is seen by many as an end in itself, central to the establishment of private property and the creation of a market economy (see Section V).

D. THE RECORD TO DATE

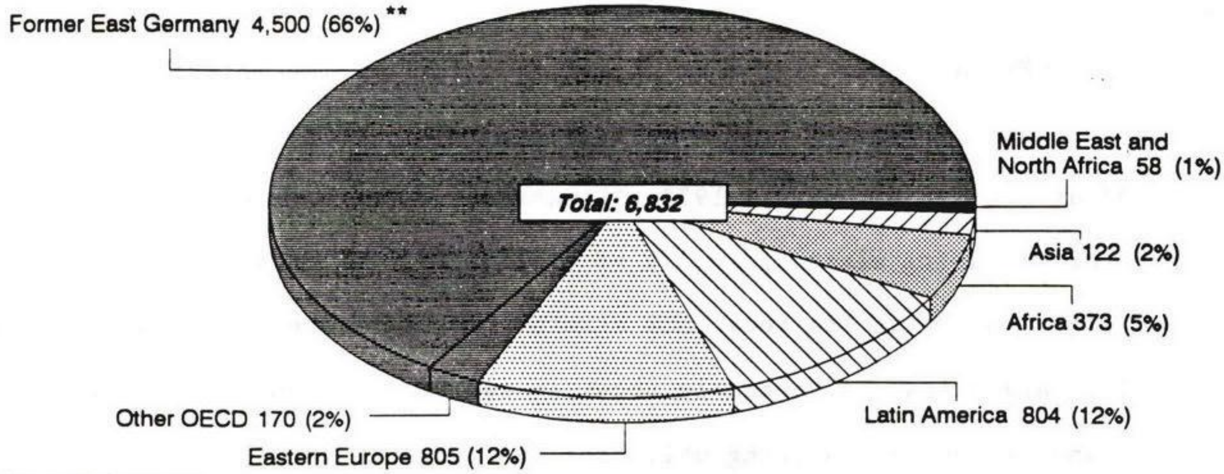
Privatization accomplishments are significant, widespread, and growing. Close to 7,000 SOEs have been majority privatized world-wide since 1980 (Figure 2). Approximately, 70% of total sales took place in developed countries, 66% of them over the past 18 months in the former east Germany alone. Among developing country sales (Figure 3), ex-socialist economies in Eastern Europe account for some 800 sales or liquidations of state-owned firms.[13] Latin America accounts for close to 40%, with Chile and Mexico making up the bulk of the activity. Sub-Saharan Africa accounts for 17% of developing country sales, with close to a fifth in Guinea alone.

In some countries, the size of the SOE sector has been substantially reduced. Starting in 1984, Mexico sold or liquidated approximately 400 of its

[12] In Argentina, debt/equity swaps in the sale of the telephone company and the airline reduced the US$ 38 billion commercial debt (at the time) by US$ 7 billion, or 18%.

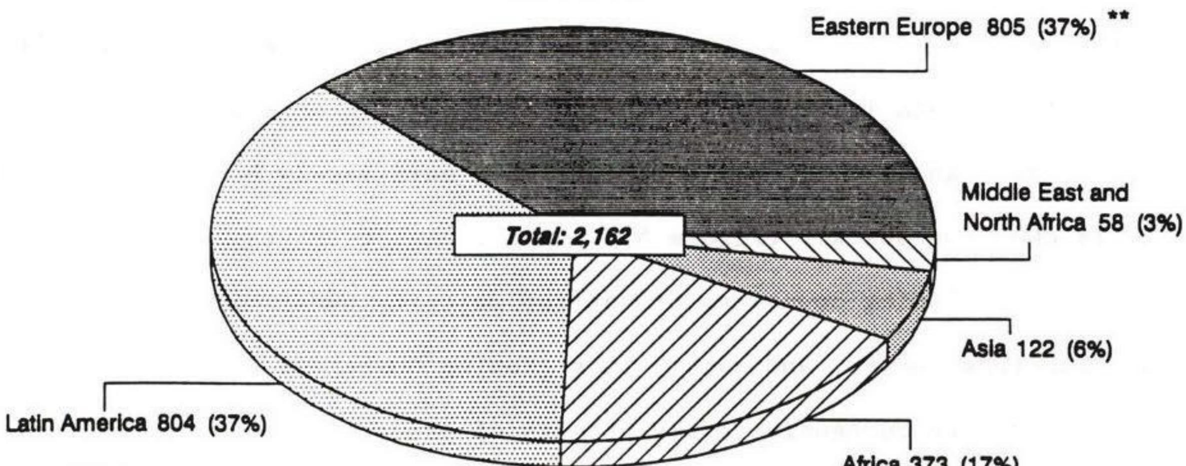
[13] These numbers would be much higher if one adds the very large number of completed "small" privatizations of shops, micro-enterprises, and kiosks in the retail and services sectors. An estimated 80,000 such firms have been privatized in Poland alone; 7,000 in Czechoslovakia, 1100 in Hungary, and 13,000 in east Germany. Other reforming ex-socialist countries, including the Russian Republic, have just recently announced ambitious "small" privatization programs.

Figure 2
Number of SOEs Privatized Worldwide, by Region*
(1980-1991)



Source: CECPS/World Bank
* Includes any sale which reduces government share below 50% and liquidations; excludes reprivatizations.
** May include partial (minority) sales.

Figure 3
Developing Countries: Number of Privatized SOEs by Region *
(1980-1991)



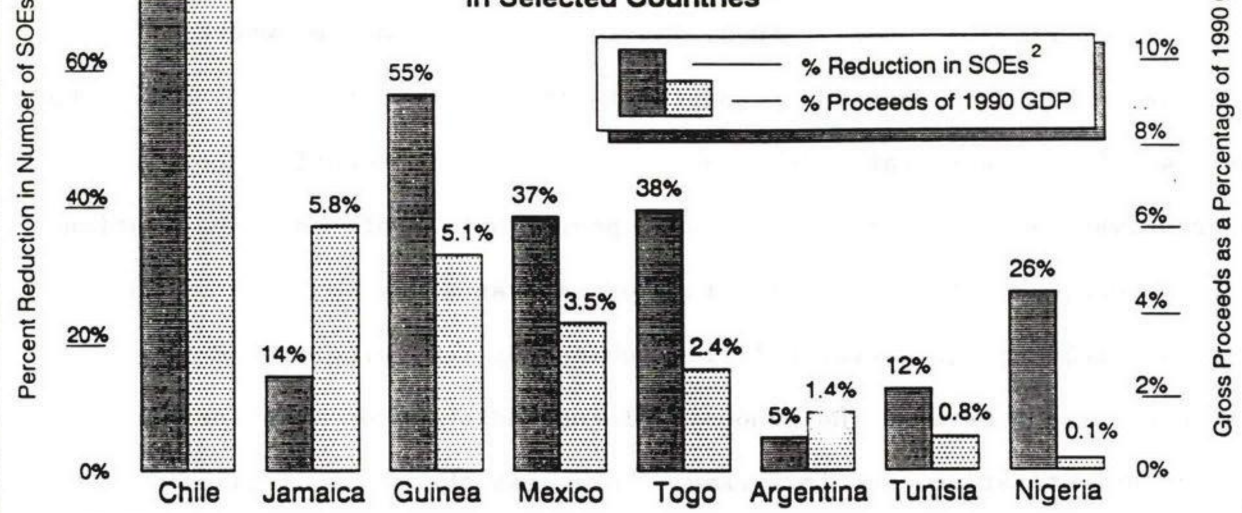
Source: CECPS/World Bank
* Includes any sale which reduces government share below 50% and liquidations; excludes reprivatizations.
** May include partial (minority) sales.

1,155 SOEs in a wide range of sectors, including telecomms, airlines, sugar, mining, manufacturing, and services (hotels and, more recently, banking); a further 400 SOEs have been merged or transferred to local municipalities. Sales have reduced total SOE assets by well over 20%. Chile has privatized all but 23 of its 524 SOEs since 1973. Privatization reduced government ownership of producing assets from 39% of GDP in 1973 to 12% in 1989. Jamaica divested close to 20% of its total SOE assets, including the telephone company and hotels. Argentina and Venezuela recently sold their phone companies and airlines, and are now privatizing utilities and large industrial SOEs.

In most developing countries, however, the aggregate effect of privatization on the relative size of the SOE sector has been modest thus far.[14] One indicator of the relatively small magnitude of change is that gross proceeds from asset sales normally amounts to a modest proportion of GDP in comparison to the numbers of SOEs sold (Figure 4). This is because small low-value firms in industry and services have most frequently been sold. In Guinea, for example, 70 of the 98 privatizations included the liquidation of virtually defunct retail outlets and small non-operating enterprises. Large SOEs in tradeable and non-tradeable sectors have more rarely been divested, but this is changing quickly (Figure 5). In the past five years alone, 14 developed and developing countries privatized majority ownership of 22 SOEs in telecommunications, power, and water; in a growing number of countries, SOEs in these sectors are currently in the process of privatization.

[14] However, if one contrasts the modest decline of SOE numbers to the very high rate of creation of SOEs of the period 1960-1982, the difference is more dramatic.

Figure 4
Indicators of the Magnitude of Privatization in Selected Countries[1]



Source: CECPS/World Bank
1) Includes any sale which reduces government share below 50% and liquidations; excludes reprivatizations.
2) Time period is 1980-1991, except for Chile (1973-1991).

Figure 5
Recent Privatization Transactions with Value Over US$100 million

Country	Enterprise	Date	Transaction Value (US$m)	Sale Technique (a)	Sector
Mexico	Bancomer	10/91	2,550	Private Offer	Banking
Mexico	Banamex	09/91	2,300	Private Offer	Banking
South Korea	Korea Electric Power	06/89	2,100	*Public Offer*	Power
Venezuela	CANTV	11/91	1,885	Private Offer	Telecommunications
Mexico	Temex	12/90	1,760	Private Offer	Telecommunications
Brazil	Usiminas	12/91	1,430	Private Offer	Steel
Mexico	Mexicana de Cobre	10/88	1,360	Private Offer	Mining
Argentina	ENTEL	11/90	1,244	Private Offer	Telecommunications
Malaysia	Telekom Malaysia	10/90	861	*Public Offer*	Telecommunications
Mexico	Cananea	09/90	475	Private Offer	Mining
Mexico	Aerovias de Mexico	11/88	339	Private Offer	Airline
Phillippines	Nonoc	10/90	325	Private Offer	Mining
Taiwan	China Steel	04/89	285	*Public Offer*	Steel
Mexico	Banca Cremi	06/91	248	Private Offer	Banking
Mexico	Multibanco de Mercantil	06/91	204	Private Offer	Banking
Mexico	Banpais	06/91	182	Private Offer	Banking
Mexico	Sicartsa 1	11/91	170	Private Offer	Steel
Chile	Compania de Telefonos	01/88	170	Private Offer	Telecommunications
Mexico	Sidermex North	11/91	145	Private Offer	Steel
Venezuela	VIASA	09/91	145	Private Offer	Airline
Mexico	Mexicana de Aviacion	06/89	140	Private Offer	Airline
Brazil	Aracruz	05/88	130	*Public Offer*	Pulp and paper
Turkey	Petkim	06/90	125	*Public Offer*	Petrochemical
Hungary	Tungsram	05/89	110	Private Offer	Electric Equipment
Mexico	Nikko Hotel	10/88	110	Private Offer	Hotel
Mexico	Tereftalos Mexicanos	11/88	106	Private Offer	Chemical
Colombia	Papelcol	08/90	100	Private Offer	Pulp and Paper

Source: Privatization International and CECPS/World Bank

(a) Does not include sales subsequent to first transaction (e.g., employee offers, international public offers, etc.) or debt-equity swap components.

There are also some developing countries where privatization has not gotten off the ground. Ghana, Kenya, and Turkey are countries where privatization has been debated or adopted in theory since the early 1980s, but where few sales have so far taken place (though Turkey recently announced another privatization effort). In Ghana, poor staffing of the privatization authority combined with lack of funding for severance pay contributed to significant delays; in Kenya, political obstacles revolving around the division of assets between indigenous Africans and those of Asian origin have postponed privatization; and in Turkey, where less than 0.5% of fixed SOE assets have been divested over seven years (and most of these were minority sales), an overemphasis on public offerings in a thin capital market, restrictions on foreign ownership, and overcentralization of implementation responsibilities were among the factors which stalled implementation.

In least developed countries, particularly Africa, privatization can be harder to start, and more likely to have but minimal effects. Thin capital markets, embryonic domestic private sectors, and limited interest on the part of foreign investors serious obstacles. Even when these initial hurdles can be overcome, there is concern that the factors that cause the acknowledged poor performance of SOEs will continue in effect when they become private: weak legal, regulatory and supervisory frameworks; frequent and intense political interference in operational decisions; and inappropriate macroeconomic and trade regimes that tend to keep private firms small, protected, uncompetitive -- and content to remain so.

These arguments carry weight. A number of African countries have privatization programs with very long gestation periods and few completed sales. Still, the difficulties are often over-estimated. In, Niger, one of the poorest African economies, the shift from public to private ownership revived a near-dead textile company, which now operates very profitably, at close to full capacity, exports much of its production, and has won a large domestic market share against imports. In Guinea, the leased water supply company provides the firm with skilled management and new investment capital. The IFC-supported privatization of a development finance corporation in Swaziland has been cited as a major success: closed down prior to restructuring and privatization, the firm's profits in its second year of private ownership were better than anticipated. Similarly, the 1986 privatization of an agro- industrial SOE in Mozambique led to profitability rates of over 55% of sales. These cases illustrate that there are gains to be had from privatization even in the most difficult settings; but they require patience and skill to bring into being.

The sections that follow analyze how successful privatizers have overcome these constraints; but first the paper considers whether privatization in fact yielded economic benefits.

E. THE IMPACT OF PRIVATIZATION

Economic Welfare. Many studies analyze why privatization was adopted, and how it has been done. Several examine the partial effects of divestiture;

these are summarized below. But these studies fall short of addressing the simultaneous effect of divestiture on all important economic actors in the long run, due to methodological difficulties.[15] A recent Bank-conducted research project, however, was able to control for these factors; the results show that privatization significantly improved domestic welfare in 10 of the 12 cases (Box 3). Contrary to conventional wisdom, labor, consumers and government all benefitted from privatization in the majority of the cases.

Enterprise Performance. Privatized firms tend to show higher profits, faster growth, and greater cost containment due to higher quality management, autonomy from political interference, and greater access to investment capital. In the U.K., for example, while it is true that many of the remaining public firms also did well in the time period under review, privatized industries were "faster growing and more profitable."[16] Privatized British Telecommunications, for example:[17] (i) increased investment rapidly; (ii) adopted a more efficient and profit-maximizing pricing formula, which

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[15] Methodological problems arise from difficulties in: (i) isolating the effect of privatization on firm behavior from concurrent changes (for instances, changes in macroeconomic policy, technology, demand structure, or the regulatory framework); (ii) answering the counterfactual -- what would have happened to performance in the absence of ownership change? -- which requires laborious extrapolation of pre-privatization performance trends, combined with measures to take exogenous changes into account; and (iii) the short-time horizon of post-divestiture history, which requires projecting the performance of the firm with and without divestiture.

[16] Bishop and Kay, 1988.

[17] Vogelsang, Jones, and Tandon, 1991.

Box 3

THE WELFARE CONSEQUENCES OF SELLING PUBLIC ENTERPRISES CASE STUDIES FROM CHILE, MALAYSIA, MEXICO AND THE U.K. DRAFT, January, 1992 1/

To date, much of the divestiture debate has been intuitive, theoretical, even ideological. Privatization's effect on welfare has not been rigorously analyzed. In response, the World Bank spent two years researching the welfare consequences of privatization of 12 firms in Chile, Malaysia, Mexico and the U.K. The cases cover telecommunication (three firms), airlines (four firms), electricity (two firms), a lottery company, a port, and a transport company. The research methodology captures the impact of divestiture on all important economic actors (i.e., government, consumers, buyers, workers, and competitors), and it reconciles divestiture trade-offs. Further, it takes a long term perspective and addresses the counter-factual question, i.e., what would have happened in the absence of divestiture?

What Are the Main Findings? 2/

In 11 out of the 12 cases analyzed, divestiture improved world (national plus international) welfare; the exception was one of the airlines. It also improved domestic welfare in 10 cases, the additional exception was one telecommunications transaction. The magnitudes of the welfare gains are substantial; in more than half the cases, the perpetual annual benefits to society in relation to pre-divestiture annual sales average 10 percent. 3/

Where Did the Changes Come From?

1. The most significant change brought about by divestiture was a dramatic increase in investment. A striking example is Chile, where the divestiture of the local telecommunication company (CTC) doubled its capacity in the five years after divestiture.

2. Somewhat surprisingly, less than half a dozen firms showed significant improvements in productivity. The productivity gains that did occur resulted mainly from improved labor-management relations and better performance-based compensation.

1/ Several of the cases are still in process; the conclusions presented are in some cases preliminary and subject to revision.

2/ For a full description of the methodology, analysis of the cases, and synthesis, see Galal, Jones, Tandon and Vogelsang, The Welfare Consequences of Selling Public Enterprises: Cases from Chile, Malaysia, Mexico, and the UK", (forthcoming).

3/ This is the annual component of the perpetuity equivalent of the gains (ACPE), which is calculated as the welfare gains times the discount factor divided by the annual sales of the previous year. For example, if the welfare gain was $100, the discount factor 10 percent and last year's sales $200, then the ACPE = 5 percent

Box 3

3. Unexpectedly, output prices did not change in half of the cases, and where prices did change, they overwhelmingly enhanced welfare--by moving towards efficiency prices.

4. Finally, divestiture often led to diversification of output into activities where there were economies of scope.

Who Were the Winners and Losers?

As in other policy realms, divestiture was not Pareto efficient, leaving no one worse off. The pattern of the winners and losers is interesting:

1. Foreigners versus Nationals: Where foreigners were involved, they did well for themselves, but they also contributed to national welfare. Only in one telecommunications case did they do so well that domestic actors were on balance considerably worse off. In contrast, foreigners did well in Chile telecom, but domestic actors did even better.

2. Consumers versus Buyers: In the telecommunications case where domestic welfare deteriorated (still to be verified), rising prices offset the advantages of improved service. This need not be the case: consumers of telecommunication services in the UK and Chile benefitted substantially from divestiture. In the remaining cases, consumers were either left unaffected--thanks to competition--or were only modestly worse off.

3. Government versus Buyers: Profit rose in 11 out of the 12 cases, but the distribution of the gains was not uniform. Buyers, both domestic and foreign, came out ahead in every case except one. Governments on the other hand lost in 4 cases (2 of them in Chile), but only by small amounts. In other words, in 8 out of 12 cases, total government receipts from the sale price plus taxes under private operation were more than government receipts from dividends and taxes under continued public ownership.

4. Workers: Contrary to conventional wisdom, in no case in the sample did divestiture make workers as a class worse off, even taking into account all lay offs or forced retirements. In three cases, workers made substantial gains (the U.K.'s National Freight, Mexico's Telecom and Chile's electricity distribution, ENERSIS).

Box 3

5. Competitors: Given the prevalence of near monopolies in the sample, divestiture had no significant effect on competitors. The two exceptions were in Chile and Malaysia. In the former, expansion of the divested CTC, the local carrier, benefited ENTEL, the long-distance carrier. But in Malaysia, the divested lottery company (Sports Toto) gained at the expense of its competitors, by acquiring greater market share.

In sum, contrary to the expectations of the research design, which was not biased toward success stories, divestiture enhanced domestic welfare consistently and substantially in all but two cases. Evidently, this finding strongly favors divestiture, especially since the sample includes several monopolies where the potential gains in efficiency could have been offset by losses to consumers. Yet, the two cases where divestiture caused domestic welfare to deteriorate remind us that careful attention should be given to the design and implementation of divestiture transactions.

would not have been possible under public ownership[18]; and (iii) improved productivity by eliciting greater output from a reduced workforce.

A recent study[19] of 41 firms fully or partially privatized by public share offerings between 1981 and 1989 in 15 countries (primarily developed but also including Chile, Mexico, Jamaica, and Singapore) shows substantial efficiency gains. Once privatized, the firms increased returns on sales, assets and equity; improved internal efficiency by better utilization of physical and human resources; improved their capital structure, thus becoming less leveraged; increased capital expenditures; and, contrary to expectations, marginally increased their workforce due to higher investments and faster growth.

In Mexico, 62 privatized petrochemical and autoparts firms increased investments up to 75% of gross sale revenues in a period of three years, improved financial management, upgraded technological processes -- and, in what is often a by-product of privatization in developed and developing countries alike, reduced management numbers but paid the remainder at more competitive rates. In Bangladesh, privatized textile companies were more profitable than public sector textile mills. This was partly due to debt write-offs, but greater attention to cost containment and more aggressive

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[18] After divestiture, prices changed more regularly than before. Prior to privatization, BT had no rate-of-return bands that would have automatically triggered price increases. Price changes were made only when achieved rates of return where substantially out of line with target rates. Also, prices of service elements where demand elasticity is low have been raised relative to those where the demand elasticity is higher, which probably would not have occurred under public ownership. See Vogelsang, et al, op. cit.

[19] Megginson, Nash, and Randenborgh, 1992.

marketing were also at work. Privatized mills adjusted their prices and production schedule daily or even hourly, while yarn prices of public mills were altered only twice a year.[20]

Privatization has in some cases led to the liquidation of non-viable firms previously kept alive by government protection and subsidies. In Guinea, for example, only five of 28 privatized firms continue to operate profitably. Nine of the remaining enterprises never resumed operations after sale and the rest are operating in difficulty due to procurement problems, limited export markets, lack of working capital and limited access to government subsidies and commercial credit.[21] Opponents of privatization argue that such bankruptcies and closures prove that the policy is misguided. This is not the lesson to be drawn from closures of privatized firms. Few developing countries can afford to subsidize, at the expense of the many, the relatively few workers and managers in unproductive SOE jobs that typically pay higher than average wages.[22] Moreover, the demise of loss-making firms, public or private, can free the assets for more productive use, eliminate a burden on the economy and allow more productive investment -- and job creation -- elsewhere.

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[20] Lorch, 1988.

[21] Suzuki, 1991.

[22] In most developing countries, SOE employees at lower skill levels are more highly paid than their private sector counterparts; SOE managers, on the other hand, are less remunerated than private sector managers. In Thailand, for example, SOE pay at the lower-skill level is almost double that of private enterprises, and 30-34% higher for middle-level professionals. Top executives, on the other hand, are underpaid in comparison to their counterparts in the private sector.

Fiscal Impact. Privatization revenues have been large in some developing countries (Figure 6). But in most cases, net revenues from SOE sales have been modest because most transactions have been small, the up-front costs associated with privatization (settlement of enterprise debt, unpaid taxes, and transaction fees) have been high and deals have often been on installment plans. In Guinea, for example, total assets sold amounted to GF 21 billion, of which only GF 2 billion had been paid (as of June 1991) due to lengthy repayment periods and defaults by purchasers. In Ghana, only 57% of total sale proceeds have been paid to date.

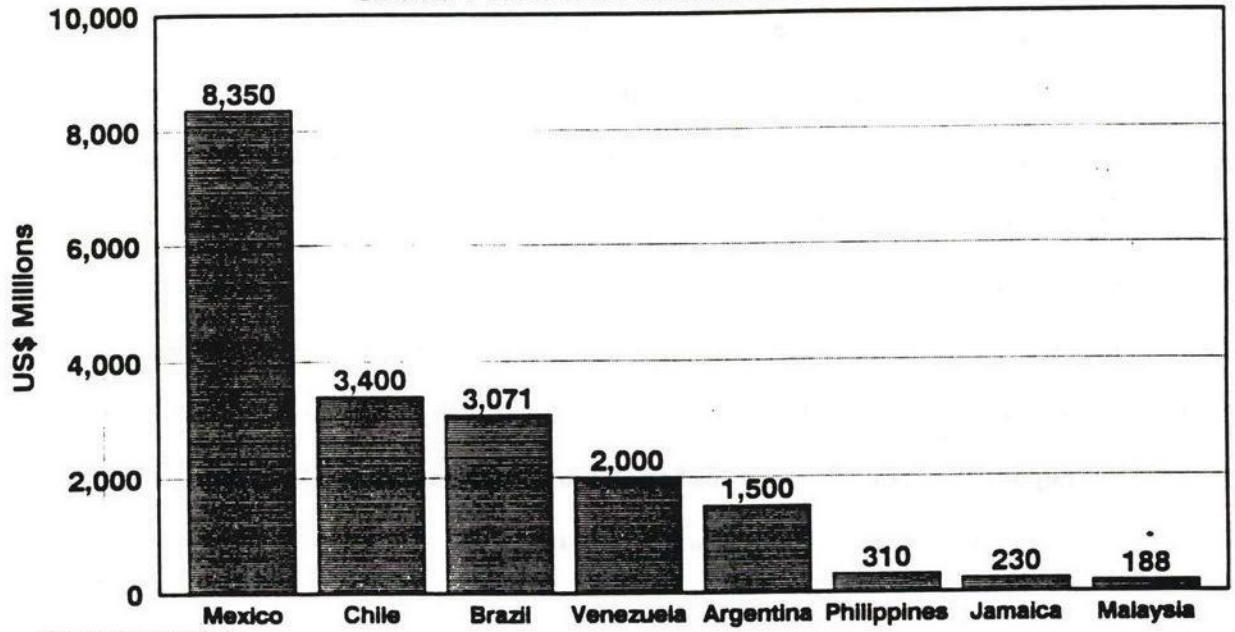
Net proceeds are only a small part of the story, however. More important, privatization has reduced the transfer of explicit and implicit government subsidies to SOEs, and increased transfers from privatized enterprises to the government. In Mexico, government transfers to SOEs at the end of 1988 were down 50%, a US$ 4 billion savings, from 1982, partly as a result of the hard budget constraint but also because of privatization (Figure 7). Freed up resources became available to fund social services.[23] In Chile, the net annual flow of funds from privatized ENERSIS (electricity distribution) declined following divestiture because government no longer received dividends; however, taxes increased as enterprise performance grew over time.[24] And Argentina's privatized Entel paid US$ 100 million more in taxes in the first year after sale.

[23] The Mexican Minister of Finance has noted that the US$10 billion losses of the state-owned steel complex (SIDERMEX) could have brought potable water, sewerage, hospitals and education to much of the poor in Southeastern Mexico. Much of SIDERMEX has now been privatized, and the funds formerly used to keep it alive are now available for tasks of a wider social impact.

[24] Galal, 1991.

Figure 6

Gross Proceeds from Privatization*

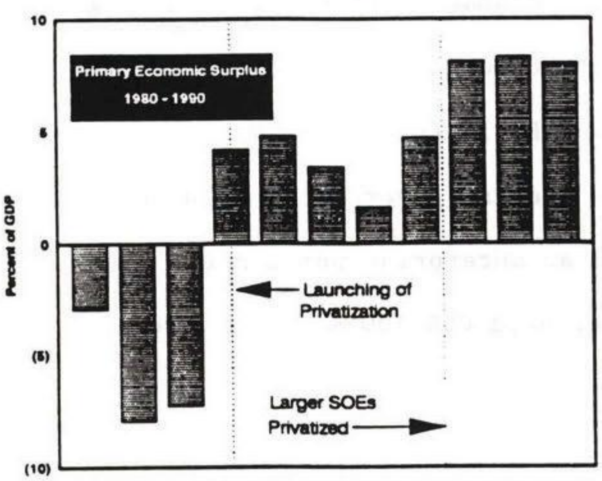


Source: CECPS/World Bank

* Includes any sale which reduces government share below 50% and liquidations; excludes reprivatizations.

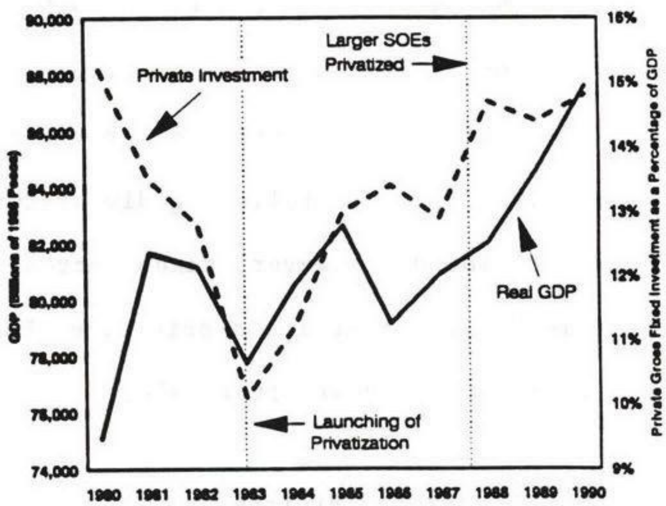
Figure 7

Privatization Contributes to Fiscal Relief in Mexico...



Source: "Economic Trends Report", August 1991, US Embassy, Mexico.

...and Spurs Investment and Growth



Source: "Mexico in Transition: Towards a New Role for the Public Sector", World Bank, 1991.

<u>Consumer Welfare</u>. Available data indicates that consumers have done well by privatization.[25] For example, product or service availability and quality have improved. In the U.K., telecommunication consumers in the aggregate have done better every year since the announcement of sale.[26] Consumers of long-distance service did considerably better in all years, while the position of consumers of local and other services remained more or less unchanged over the whole period. While factors such as increased competition and technological changes also played a role, new managers with full operational autonomy combined with an effective regulatory framework were critical in obtaining the gains. There was some deterioration in the quality of service in the early years after privatization (partly because of increased demand), but subsequent improvements now make the service better than before sale. In Chile, paying electricity consumers are better off, but those who used to be able to get electricity for free through illegal connections are worse off, since private management has cut electricity losses.[27]

Not all is positive; in Argentina, complaints after the sale of Entel and Aerolineas Argentinas that the country still had among the most expensive telephone and airline networks in the world led government to announce that future bidders would be selected partly on the basis of those offering to guarantee the lowest tariffs and strengthen the regulatory framework.

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[25] Only a handful of cases have been researched carefully; data for many large developing country privatizations are not available.

[26] Vogelsang et al., op cit.

[27] Galal, op cit.

Nonetheless, the newly privatized phone companies increased the percentage of completed calls from 70% to close to 100%, reduced the number of lines out of service, and have begun an ambitious program of expansion.

III. PRIVATIZATION OBJECTIVES AND STRATEGY

Privatization can produce a range of beneficial results, if properly designed and implemented. What should governments do to create the circumstances in which privatization will have these positive, enduring effects? Above all, there must be strong political commitment. Then, the essential first step is to formulate a privatization strategy with clear objectives and priorities. Privatization should be part of a broader macro-economic reform program that creates an enabling environment for efficient private enterprises, coupled with unambiguous statements outlining the scope and methods of reform. This does not mean that governments should attempt to plan the privatization process down to the last detail.[28] Still, there is a critical role for the state -- as the owner of SOEs -- in developing privatization principles.

A. OBJECTIVES AND TRADE-OFFS

Governments privatize SOEs for many reasons: the most often cited are efficiency enhancement, revenue generation, ownership dispersion, and capital

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[28] Privatization "master-plans" appeal to governments of an intervening bent, but the complexities and uncertainties of a major transaction -- much less a set of transactions -- strongly suggest that the divestiture process cannot be planned in intricate detail. What is required are straight-forward policy directives or guidelines. Overplanning ended up delaying rather than promoting privatization in, for example, Turkey and Malaysia.

market development. These goals may and often do conflict; attempts to accomplish numerous objectives can result in a failure to achieve any. Government's first strategic task is to choose between potentially conflicting objectives.

Make efficiency enhancement the number one goal. Privatization has its greatest impact on economic welfare when the efficiency objective is kept in the forefront. One way to accomplish this is to bring in private owners with the capabilities and means to improve efficiency (see below). Another way is use privatization to increase competition. Investors and governments argue that competition is often in jeopardy in privatization since the high risks and uncertainties in developing countries require special privileges and protection, else there would be no private investment. But this argument is wrong and can lead to perverse results. For example, a loss-making steel mill in Togo was leased to a private firm in 1984. The conditions of the lease agreement included a high level of nominal protection (40%), combined with import and export duty exemptions, a favorable pricing agreement, and a low lease fee -- with government servicing the substantial debt. This deal was plainly uneconomic.[29] Government could not face closing a loser, but this

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[29] Under private management, the steel mill became profitable for the first time since its creation and diversified into a new product line, pylon manufacturing, which was more labor intensive than the making of reinforcing bars, its main product. Taxes paid increased. Some jobs were preserved at higher salaries. The political embarrassment of liquidation was avoided. Some think that the operation opened the door to subsequent privatization -- which in the mid-1980s was significant in Togo. The inference is that even if the original deal was uneconomic, the net economic effect of private entry into the market might have been positive. This assertion has never been rigorously examined. But it is hard to believe that these secondary and intangible elements made up for the fact that the firm sold its prime product at 165,000 CFA a unit, when the FOB price of imported re-bar was 110,000 CFA a unit.

"solution" simply shifted the burden -- and even then only a part of it -- from the budget to consumers.

Opportunities for competition exist even in sectors once regarded as naturally monopolistic. For example, the U.K. water and electricity generation companies were broken up into smaller units prior to sale (into 10 and 16 different and independent units, respectively). The generation companies compete directly, while the performance of a water company in one geographical area can be compared to those in other regions to encourage yardstick competition. Contrast these sales with other UK privatizations where revenue maximization, not competition, was the primary objective. (Box 4).

Maximizing short-term government revenues should not be the primary consideration, because it can lead to deals which are bad for the economy (though perhaps good for the budget). Some governments have wrongly sold competitive or potentially competitive SOEs as monopolies in order to raise the selling price and thus revenues. In infrastructure SOEs, a monopoly concession may be unavoidable in some activities because of economies of scale. But the economy will be best off if governments first deregulate potentially competitive activities and establish adequate tariff regulation, and then privatize -- even if that means a lower sale price. Jamaica, for instance, privatized its telephone company with a 25-year concession on local and competitive international services, with a guaranteed rate of return arrangement that exceeded industry norms and provided few incentives to reduce costs. While the efficiency impact is yet to be judged, the underlying

Box 4

Competition and Privatization in Non-Tradeables

In any privatization, the greater the degree of competition produced, the greater the likelihood that efficiency will be enhanced. Critics of the early UK experience argue that privatization could have led to greater economic benefits had monopolies in potentially competitive sectors -- such as British Telecomms, British Airways, and British Gas -- been broken up into smaller competing and comparable units before sale. They were sold intact partly because by selling monopoly rights, government would maximize short-term revenues, and partly because senior management opposed deregulation and breakup.

Government did promote competition by licensing Mercury Communications to compete with British Telecomm and British Midlands to compete with British Airways; but these were small firms, thought likely to capture only small market shares, as has indeed been the case so far. To break up the monopolies now -- once they have already been granted -- is far more difficult, since that would affect the sales price of the remaining government shares. Nevertheless, British Telecomm's regulator (OFTEL) is considering a recommendation to the Monopolies and Mergers Commission that British Telecomm be broken into competitive parts.

objective in granting these sweeteners was to maximize selling price and short-term revenue to government. By contrast, in the recent telecomm sales in Argentina, Venezuela, and Mexico, non-basic services were opened up to varying levels of competition. Private purchasers obtained seven to ten-year concessions in local services, but the deals were combined with provisions encouraging expansion and incentives to reduce costs. For example, the privatized Telmex will pay a corporate tax rate of 10% if they meet their promised investment schedule; 29% if they do not. In this instance, as in many other infrastructure sales, greater weight was given to follow-on investments rather than price.

Privatization can help develop capital markets (and vice versa); but do not make this an objective of privatization. In many countries, privatization has helped develop and expand financial markets. Jamaica, Chile, Nigeria, the U.K., and France increased the number of shareholders and total market capitalization as a result of privatization (Figure 8). Yet, an overemphasis on stock market sales can cause problems in developing countries. One problem is weak absorptive capacity relative to the size of individual or total sales. The sale of 24% of Telekom Malaysia in September 1990, for example, aimed at raising M$2.35 billion, compared to M$3 billion raised in total on the Kuala Lumpur stock exchange in 1989. And in Nigeria, total new private offerings in 1989 were Naira 800 million, compared to Naira 3 billion expected to be raised from privatizations between 1990-91. Weak absorptive capacity risks creating delays and SOE sales can crowd out private share issues.

Figure 8

Privatization and Capital Market Development

Country	Number of Enterprises Sold Through Stock Exchange (a)	Proceeds of Sales Through Stock Exchange (US$ millions) (b)	Proceeds as a Percentage of Stock Market Capitalization (c)	Number of New Shareholders
Canada (d)	2	812.0	0.4%	n.a.
Chile (since 1985)	14	893.5	9.3%	63,316 (e)
France	14	5,148.1	3.0%	5,000,000
Jamaica	3	120.8	12.6%	30,000
Nigeria	16	27.0	2.0%	400,000
Trinidad & Tobago	2	6.8	2.5%	n.a.
Tunisia	2	8.6	n.a.	n.a.
United Kingdom	14	51,720.5	6.0%	7,400,000

(a) Source: Bouin and Michalet (1991); source for Nigeria, Tunisia, Trinidad/Tobago and Canada: CECPS

(b) Includes share auctions and public offerings.

(c) Market capitalization in year of last public offering.

(d) Includes only federal ("crown") enterprises.

(e) Does not include Endesa shareholders.

It also takes time to develop appropriate institutions and regulations in weak capital markets. Privatizing poorly performing enterprises without information and prudential regulation may exploit small first-time investors. If an improperly investigated sale goes bad, it can lead to pressure for government bail-outs or call into question the credibility of future sales. But developing the appropriate institutions can slow privatization down; in developing countries, an emphasis on stock market sales could greatly delay implementation since mutual funds and the domestic market for private placements are virtually non-existent.

The volatility of developing country stock markets can also set back privatization. In Korea, for example, a 1990 attempt to sell shares in three commercial banks attracted 3.5 million would-be investors. But the market fell 50% before payment came due, and only 200 investors actually paid. The damage to the overall privatization program was severe. Moreover, in most developing countries the majority of SOEs are poor performers and unsuitable for quick sale on the stock market. Preparing them for public offering involves time and resources that are better spent on infrastructure or human resource improvements benefitting a larger part of society. Finally, as discussed in Section IV, capital market transactions involve potentially large pricing discounts that can result in a political backlash to privatization.

Widely dispersed ownership should not interfere with improved corporate governance. A proven way to improve corporate governance is to turn SOEs over to private owners with enough of a stake to benefit from improved performance -- and the power to achieve it. But this runs into conflict with another frequently proposed objective of divestiture, the promotion of wide share ownership. And in any event, over time, efforts to expand share ownership widely tend to fall short of their goal.[30] When ownership of firms is widely dispersed, management performance tends to be sacrificed. In developed countries with mature stock markets, management discipline can be provided through the threat of corporate take-overs and bankruptcy, influential financial journalism, and the active participation of non-executive directors.[31] In developing countries lacking these conditions, strong private management and control are essential to achieve a turn-around of troubled SOEs.

One way to both improve corporate governance and spread ownership is to reserve core shareholdings (at least temporarily) for strategic investors committed to the company. This was a key strategy in Chile's second privatization phase. In France, prior to the public offering of shares, 15 to 30% of equity was offered to core investors at premium prices (2.5 to 10% above market price). In Venezuela, banks were sold to private investors with the provision that shares will be offered widely to the public and employees

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[30] Experience shows that share ownership tends to concentrate over time, despite the mechanisms used to attract and retain small shareholders (such as bonuses or matching shares, pricing discounts, and reduced taxes on dividends). In the UK, despite concerted efforts to spread shares widely in the privatization floatations, re-concentration of ownership quickly occurred. Similarly, at the time of the public issue of the Malaysian International Shipping Corporation, there were approximately 60,000 shareholders; this fell to less than 5,000 shareholders after a brief round of secondary trading. Similar patterns emerge in other countries divesting through their stock markets. See Adam and Cavendish, 1990.

[31] Even under these circumstances, however, the lack of managerial accountability is a problem. One explanation for the perceived slow rate of growth in returns to capital in US private firms is the separation of "principal" (owners) from "agents" (managers).

over a 3-5 year period. Another way is to involve institutional investors, such as life insurance, pension and provident funds. While they tend to be more passive than trade owners, often exerting limited influence or control in direct corporate governance, institutional investors can temporarily substitute where trade buyers are lacking (as is proposed in Eastern Europe and Central Asia; see below). They are preferable to a large number of dispersed shareholders, since they tend to watch dividends more carefully, and sell shares if income stagnates or falls. This exit can have a positive supervisory effect on management, or at least assist "hostile takeovers."

Summary. Overall, privatization should aim to provide enterprises with motivated owners and managers capable of improving efficiency and overall corporate governance. The efficiency goal should be kept in the forefront. Short-term revenue generation, capital market development, and ownership dispersion can be important secondary considerations, but they should not be the primary goals of privatization.

B. WHAT, HOW MUCH, AND HOW FAST TO SELL?

Once objectives are clarified, strategic decisions need to be made about the scope and pace of privatization. The early 1980s witnessed much debate about what should be sold. Airlines, beer factories, petrochemical plants, and cement and steel mills were often defined as "strategic," and thus unfit for privatization. Today, government thinking has changed and virtually all SOEs are being opened up to privatization.

Most divesting governments -- including Mexico, Chile, Jamaica, Poland, the Philippines, Togo, and the U.K. -- began by giving priority to small and medium-sized firms in competitive sectors. Such sales are simple and quick: they require little prior restructuring and institutional capacity, entail minimal political risk, and, since they are more easily absorbed by local private investors, reduce the thorny issue of foreign ownership. Speed is essential to help put assets to more productive use and remove the managerial and financial burden on government. Experience with small sales helps prepare privatizers for subsequent sales of larger, more complex SOEs.[32] To ensure credibility, close attention needs to be paid to the development of an announcement of privatization, clear procedures for bidding, and a timetable for sale.

Despite the proven utility of this approach, a growing number of governments, such as Argentina, are giving priority to the privatization of large SOEs in critical sectors such as public utilities. Such sales are complex and time-consuming, requiring development of a competitive environment and regulatory framework (see below), sophisticated financial engineering, and sensitive labor restructuring. But there can be compelling reasons for adopting this strategy. First, the window of political opportunity may be but briefly open, and the most important cases are best tackled before circumstances change. Second, large privatizations provide instant policy

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[32] The Mexicans see this as lesson number one of their successful experience. They recommend starting with the small firms to learn how to do it, to educate the public, and to minimize risks. "If one makes a mistake selling a night-club or a bicycle factory...it is not as tragic as if these mistakes are made while selling the largest commercial bank in the country, the telephone company or a major airline." Pedro Aspe (Secretary of Finance and Public Credit), 1991.

credibility and send clear signals of government commitment to financial markets and investors. Third, the potential economic and financial benefits may make it worth the risks. Privatizing badly-managed firms providing critical upstream goods and services (telecomms and power, for example) helps accelerate modernization and growth, and removes binding constraints on private sector development. Privatizing a few large loss-makers can have an enormous budgetary impact; in Argentina, for example, the three SOEs on which government focussed first (telephones, railways, and hydrocarbons) accounted for 50% of the SOE operating deficit.

Privatization priorities are country-specific. In the end, the choice depends on investor interest, government capacity, and on which sectors and enterprises are most in need of new investments and efficiency improvements. Contrary to conventional wisdom, selling loss-makers is not all that difficult. The majority of IFC's privatization transactions, for example, have featured SOEs that were either closed or making recurrent losses. Most of the companies required investments for modernization; privatization was a solution to this problem. In the meantime, attention should be paid to corporatizing large SOEs and putting them on a hard budget constraint in preparation for privatization.

C. SEQUENCING ISSUES

Create an Enabling Policy Environment. There are many conditions that have to apply for private ownership to produce its promised gains. Trade, price, and exchange rate reforms not only help attract private investors, they also ensure that privatization expands competition and productive efficiency, and does not simply transfer rents from SOEs to new private owners. Such reforms also facilitate the pricing of enterprises for sale (see below).

Successful privatizers such as Mexico and Chile began macroeconomic reforms well before privatization. In Mexico, trade and exchange rate reforms were critical in attracting private investors and a large amount of flight capital back to the country (an estimated US$ 2 billion as of September 1989), and in ensuring that privatized firms (particularly monopolies or oligopolies) were exposed to external competition. The absence of such reforms have made sales difficult in other countries. In Brazil the failure to relax price and wage controls combined with rampant inflation contributed to lack of investor interest in the first phase of the privatization program.

Legal and Regulatory Framework. A well-functioning legal framework is essential for success (Box 5). This entails developing important aspects of business legislation (such as property law, competition law, corporate law, dispute settlement, and environmental legislation), defining property rights, and modifying the legislation of SOEs to be divested. (A separate paper covers the issue of sequencing of legal reforms.[33])

Privatization of natural monopolies can be beneficial, if it is done right. To get the best results, sales should coincide with the development of a regulatory framework which separates out potentially competitive activities, sets out the pricing regime, establishes universal service goals, develops cost minimization targets, and creates a regulatory agency. Ideally, this

[33] See Guislain, 1991

Box 5

LEGAL ASPECTS OF PRIVATIZATION 1/

Legal issues permeate the whole privatization process from preparation to implementation and follow-up, and occur primarily at two levels: the systemic (laws, regulations and institutions) and the transaction level.

First, existing legislation, as well as the legal status of the SOE(s) to be divested, must be analyzed in order to determine whether they allow privatization and are compatible with the government's objectives, or need to be amended. Laws may need to be enacted to abolish a monopoly, regulate or deregulate the concerned sector, strengthen the country's capital markets, authorize the transfer of the concerned SOE(s) to the private sector, or organize the privatization process itself. Some SOEs may have a legal status that does not allow or facilitate divestiture, in which case a status change will be required (e.g., corporatization). The ownership of some SOEs or assets may be disputed, in which case the rights of contending parties must be clarified. In other countries, the existing legal framework may be adequate and no modifications are required. All these elements need to be addressed before privatization can start.

Lawyers remain critical actors at the implementation stage, responsible for drafting and advising buyer and seller on the negotiation of a wide range of agreements that may be needed to complete the transaction. These may include: recruitment and financing of lawyers to advise government; avoidance of conflicts of interest (or appearance thereof) for government officials and advisors; confidential agreements with bidders and other parties involved in the transaction; difficulty of carrying out due diligence in many developing countries; and treatment of SOE creditors' rights.

Following completion of the privatization transaction, legal safeguards are required to ensure that all parties comply with the terms of the privatization agreements and, if they do not, effective recourse mechanisms must be developed to enforce remedies. The regulatory framework may need to be fine-tuned to ensure that it is fulfilling expectations by allowing the private enterprise to develop, while protecting the legitimate interests of consumers, competitors and taxpayers.

The range and complexity of legal issues that could arise in privatization programs is almost endless. In each country, and for each transaction, privatizing governments should retain the services of qualified, experienced and independent lawyers to help them in identifying critical legal issues and promising solutions. This is a necessary condition for success, as law is at the core of the privatization process.

1/ See "Legal Aspects of Divestiture - An Introduction", Pierre Guislain, The World Bank, forthcoming.

framework would not only clarify the rules of the game, but also create a stable and predictable operating environment for private investors. It also helps overcome political opposition, as it allows decision-makers to point to mechanisms erected to defend transparency, competition, and the general interest. Chile had already a well-developed regulatory framework which assured that privatization led to increased efficiency without harming consumer interests.[34]

In developing countries where SOEs have consistently performed poorly, the potential for regulatory failure is probably very high as well. Nevertheless, privatization, may still be the best option, if the regulatory framework at least gives new investors the incentives to make the right investment decisions. The economic costs of privatizing an unregulated monopoly may be less than the costs of retaining a badly functioning public enterprise, because even unregulated private monopolies have a greater incentive to market aggressively and control costs. Some argue that the gains in X-efficiency could offset the social welfare losses stemming from higher monopoly prices. (Box 6). There are risks to this option; access to services and affordability could be severely curtailed. But in countries and cases where the alternative is poor and deteriorating service under state ownership, it may be a defensible route.

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[34] Tariffs are structured so that large consumers with high demand at peak periods, who cause the system to expand, pay a higher price than consumers not causing the system to expand; the latter group pays a price equivalent to the short-run marginal cost. Suppliers to large consumers have to compete in this segment of the market. See Galal, 1991.

Box 6

SIMULATION ANALYSIS OF THE EFFICIENCY CONSEQUENCES OF REGULATION

The conventional economic case for regulation of monopolies rests on the assertion that "deadweight losses" (DWL) -- the standard measure of the static efficiency losses from market failure -- are large in monopolistic markets. However, simulation analysis1/ suggests that these DWLs are small across a wide range of plausible empirical magnitudes.

The Table estimates the DWLs associated with moving from a competitive to a monopolistic equilibrium. This movement can be interpreted as a shift from a perfectly regulated to an unregulated private monopoly, with the DWLs representing the efficiency losses from deregulation -- or as a shift from a socially efficient public enterprise to an unregulated private monopoly. As Columns (A)-(C) summarize, the magnitude of the resultant price increases and associated deadweight losses vary with the price elasticity of demand: with an elasticity of 0.18, prices almost treble, and DWLs exceed 70% of output; by contrast, with an elasticity of 1.5, prices rise by only a third, and DWLs are less than 10% of output. The price elasticity of demand for electricity provides a useful empirical benchmark: estimates for the short-run range between 0.14 and 0.90, and for the long-run between 1.0 and 2.0. Column (D)'s estimates -- 40% above those of column (C)2/ -- are for a monopolist that produces an intermediate product, and hence affects output decisions downstream. Column (E) presumes that regulatory change is associated with an increase in technical efficiency of the monopolist -- likely empirically if the shift results from the privatization of an inefficient public

Table: Efficiency Losses from Monopoly as a Percentage of Sector Output

(A) price elasticity	(B) % change in price	(C) DWL as % output	(D) (C) adj. for pyramiding	(E) (D) adj 10% cost decline	(F) (E) adj. for non-linear pricing
0.18	283.3%	-70.8%	-99.2%	-90.6%	-22.7%
0.54	92.9	-23.2	-32.5	-23.8	- 6.0
1.0	50.0	-12.5	-17.5	- 8.9	- 2.2
1.5	33.3	- 8.3	-11.7	- 2.7	- 0.7

1/ The detailed calculations are in Ralph Bradburd, "Privatization of Natural Monopoly Public Enterprises: The Regulation Issue", CECPS, The World Bank, November 1991.

2/ Research suggests that 40% is an upper bound of the requisite correction.

contd.../2

Box 6

enterprise. Finally, Column (F) is for a monopolist that adopts two-part pricing (or some other nonlinear pricing scheme of a kind widely used by private firms), and thereby further reduces DWL.3/ Only with price elasticities less than about 0.5 and no non-linear pricing does the DWL of deregulation exceed one-third the value of industry output -- and, even then, only if regulation were properly implemented in the status quo ante. Since virtually all real world regulatory efforts fall short of perfection, the analysis suggests that under most circumstances regulation will yield little, if any, efficiency gains.

A plausible case for regulation can still be made. Sometimes a credible, transparent regulatory scheme may be necessary to persuade potential investors that the rules of the game will remain stable over time. And some countries may regulate monopolies as a way of limiting actual or perceived inequities. But the analysis suggests that the case for regulation based solely on the conventional logic of static efficiency is weak.

3/ The estimates in the table assume that nonlinear pricing facilitates an increase in output halfway from the monopoly to the socially optimal level

In some sectors, notably the financial sector, effective regulation is a must, however.[35] In 1974, the first phase of privatization in Chile took place in a newly deregulated financial system. Owners of banks were the main purchasers of privatized industries. The resulting situation -- interlocking ownership coupled with the lack of bank regulation -- has been blamed for the slipshod practices that led government to take over the banks, and the enterprises in the banks' portfolios, in 1984. The government in effect re-nationalized the firms it had sold. Chile subsequently re-sold the banks and industries, this time in a regulatory environment that guards against abuses.

D. PRIVATIZING OWNERSHIP VS. MANAGEMENT

Sales have a big advantage over non-ownership methods of privatization, since they transfer property rights to profit oriented owners who push their companies to perform better, at lower cost, and to pay more attention to the needs and demands of clients. The choice of sale technique depends on enterprise circumstances and government objectives (Box 7). But outright sales may not be financially or politically feasible in some countries, and alternative ways to improve SOE efficiency and bring in the private sector often need to be explored.

[35] This paper does not deal with the details of privatizing financial institutions. Because of the role of banks in the economy as fiduciary institutions and because of the great variability in the value of their loan portfolio, bank privatization raises additional issues. Prior to bank privatization, a prudential regulatory framework must be in place to ensure sound and prudent banking. Suitable owners are essential to ensure that banks are operated responsibly. And asset valuation is particularly difficult. These issues are covered separately in a paper currently under preparation in CECFP.

Box 7

TECHNIQUES OF SALE

In developed countries, 90% of all privatizations involved private sales or public share offerings, but in developing countries, most privatizations have been through liquidation followed by sale of assets This is because most of the affected enterprises so far have been small and unviable. Larger firms in need of reorganization are more likely to be sold through direct negotiations, competitive bidding, joint ventures or the sale of a core shareholding to a strategic investor.

Despite their political appeal, public share offerings have seldom been used in developing countries because capital markets are shallow and SOE conditions are so poor as to make them unfit for stock market floatation. There are exceptions. Shares of well-known and profitable SOEs (financial institutions and telecomm companies) have been successfully sold through the stock market in Jamaica, Chile, Nigeria, and the Philippines. Some larger SOEs badly in need of capital and restructuring have also issued shares to raise funds to modernize; this strategy was adopted in Tunisia (textiles), Pakistan (Gas pipeline), Mexico (airlines). The government receives no proceeds from the share issue, but its shares become more valuable thanks to the new investment and can be sold later at a higher price.

<u>Partial Sales</u>. Sales of minority shares can have positive effects, provided managerial control is transferred to private hands and limitations placed on government's voting rights to curtail day-to-day interference. Some countries have started out by selling minority shares. In Chile, shares of large and "sensitive" enterprises were sold gradually on the stock market until the state retained just over 50%. This was followed by an offer of 2 or 3%, which left the government in a minority position; and the remaining shares were then sold quickly.

Selling minority shares to small shareholders does not, however, improve enterprise management, and should not be considered privatization. In Bangladesh, for example, 49% of five industrial SOEs were sold via public offerings and employee ownership schemes, but performance gains were few both because of widespread dilution and continued government interference. Such sales can be beneficial if management has been strengthened; prior to the sale of 33% of shares of Nippon Telephone and Telegraph (NTT) to 1.5 million small shareholders in Japan, for example, the government corporatized NTT and appointed new management from the private sector.[36] A large government share overhang can also depress share price and make further privatization difficult.

<u>Private Management or Use of State-Owned Assets</u>. Significant gains can be had by bringing in aggressive private managers and allowing the SOE to operate like a private firm, even if ownership of assets is not transferred.

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[36] A recent study of NTT contains a great deal of useful information on how to corporatize on the road to privatization. See NTT International Corporation, 1991.

Management contracts, leases (or affermage), and concession arrangements are attractive alternatives to outright sale in cases where: (i) capital markets are weak and domestic private sectors embryonic; (ii) private investors are reluctant to take on ownership of large assets in need of modernization (railways, water, power); or (iii) upgrading under private management can facilitate later sale.

In management contracts, government pays a private company a fee for managing the SOE. Management contracts are common in hotels, airlines, and agriculture, where considerable experience has routinized contract negotiation and monitoring, and an ample supply of experienced managers makes it easier to employ contractors. They have been less frequent in the industrial sector, although Sri Lanka employed private management contractors to turn around three loss-making textile firms and prepare them for privatization; all three firms were recently sold.

Management contracts are usually less politically contentious than sales. They avoid the risk of asset concentration, and can enhance productivity. Governments nonetheless tend to prefer sales for a number of reasons. Typically, contractors do not assume risk; operating losses must be borne by the owner (the state) even though it has relinquished day-to-day control of the operation. Many standard management contracts are flat fee-for-service arrangements, payable regardless of profits, which provide little incentive to improve efficiency. Further, management contracts are time-consuming to develop and can be expensive to implement. Unless proper legal safeguards are developed, and enforced by monitoring, there is a risk that the contractor will run down the assets. Another drawback is that few management contractors provide adequate training for local counterparts.[37] These risks can be reduced with properly drawn-up contracts, but that requires strengthening government's capacity to negotiate, monitor and enforce contractual obligations.

Leases overcome some of the drawbacks to management contracts. The private party, which pays the government a fee to use the assets, assumes the commercial risk of operation and maintenance, and thus has greater incentives (and obligations) to reduce costs and maintain the long-term value of the assets. And fees are usually linked to performance and revenues. Lease arrangements have been widely used in Africa, particularly in sectors where it is difficult to attract private investors: examples include industries in Togo (steel, oil refinery, dairy, agricultural machinery), water supply in Guinea and Cote d'Ivoire, electricity in Cote d'Ivoire, road transport in Niger, port management in Nigeria, and mining operations in Guinea.[38] In each case, the contracted firm is a joint foreign/local enterprise, with the foreign partner bringing in essential technical and managerial expertise. Leases usually have built-in incentives to reduce costs; in Cote d'Ivoire, for example, the leased water company was motivated to reduce the number of high-paid expatriate staff from 40 to 12 to minimize costs. The technical efficiency, new connections, and billing and collection of receivables also improved dramatically (Box 8).

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[37] Hegstad and Newport, 1987

[38] Triche, 1990

Box 8

PRIVATE MANAGEMENT OF WATER SUPPLY IN CÔTE D'IVOIRE

Private management of Côte d'Ivoire's water supply has improved efficiency. But the experience also reveals the limitations of management contracts and leases as long-run substitutes for private ownership and good regulatory policies.

Thirty years ago, the third largest French water utility (SAUR) created an Ivorien subsidiary, the Côte d'Ivoire Water Distribution Company (SODECI). In 1960, SODECI won its first competitive bid to operate and maintain Abidjan's water supply system. Under a mix of "affermage" (lease) and management and concession contracts, it gradually added to its portfolio the management of sewerage and drainage systems and small urban and rural water supply systems throughout the country. In 1978, the company's shares began trading on the Ivorien stock market. Private Ivoriens now hold 46% of its share capital, with SAUR retaining 46%, employees 5% and the state 3%.

Thanks to the technical and managerial expertise of its foreign partner, and strong contractual incentives to cut costs, SODECI achieved remarkable results in the urban areas. By the late 1980s, water losses had been cut to 12% and the collection rate raised to 98% for private consumers. At 130 water connections per employee, the company's labor was twice as productive as the next best West African water utility. Moreover, expatriate staffing has declined from 40 to 12.

Despite SODECI's good record, overall water sector performance fared poorly, because of government investment and pricing policies. For example, it discriminated against urban industrial consumers to subsidize rural investments, and it insisted upon provision of free connections for low income urban groups. Tariffs were doubled for industrial consumers, curbing their production and thus reducing job opportunities. Over-investment led to under-utilized capacity -- 50% in Abidjan and 28% in other urban areas -- and a breakdown in sector finances. In the mid-1980s, the government attempted to sell SODECI the water supply infrastructure (and associated debts) that it manages, but the company lacked sufficient capital to purchase them. In 1988, the government granted SODECI a further concession for urban water supply; but unlike the previous "affermage" relationship, this contract for the first time makes the company responsible for financing future

Concessions go farther; the holder has responsibility for capital expenditures and investments (unlike a lessee). In general, concessions are more desirable but less feasible than leases. This is so because private financing (or willingness) tends to be weak in comparison to the size of the investment, particularly in sectors or countries where the political and economic risks are seen to be high. In such instances, the government might have to assume responsibility for planning and investment. Concessions have been successfully used in the recent privatizations of telecommunications and railways in Argentina. In Venezuela, private firms are to be granted concessions to operate and finance investments in ports and water supply.

Few systematic analyses of the experience with private management arrangements exist. What evidence there is shows the importance of using sales as the first option where investor interest exists; in Ghana, for example, despite the preference of a foreign-led consortium to purchase a glass manufacturing SOE, government agreed only to a lease partly because of disagreement over price, but also to maintain control over the company. This, in turn, reduced private investor interest in the overall program. Experience also underlines the importance of avoiding government interference in management, but holding managers accountable for results;[39] and giving managers incentives to improve operations and enhance the long-term value of the assets by linking fees to enterprise performance, encouraging managers or lessees to make an equity investment, or giving them the option to purchase

[39] There are a variety of ways to hold management accountable: business plans, properly staffed and empowered boards of directors, contract-plans and performance agreements, and performance evaluation and incentive systems. All are costly and difficult to install; none are fool-proof performance improvement methods.

some or all of the assets or shares upon expiry of the contract or lease. This last option must not link market value at the end of the lease period with purchase price, or the lessee would have an incentive to run down the value of the enterprise.

While private management arrangements have their utility, and can or should be used where privatization is seemingly impossible or but a long-term hope, it bears repeating that ownership change is eventually needed to lock-in performance gains. Political authorities often give private managers and contractors the power to turn around poorly performing enterprises, but over time, particularly as and if SOE earnings improve, the temptation to interfere reasserts itself. Furthermore, privatizing management does not bring the increased investment that can be a major accomplishment of ownership change (as in the cases in Box 3).

IV. IMPLEMENTATION ISSUES

A. WHAT TO DO TO PREPARE FOR SALE?

Should enterprises be fixed up prior to sale, and, if so, how and when? There is a significant difference between: (i) legal, organizational, managerial, financial, and labor restructuring measures which involve no new investments; and (ii) large new investments for plant modernization or rehabilitation. In general, the former, but not the latter, makes sense in the privatization of large enterprises and monopolies (see below). In small and medium-sized competitive SOEs which can be sold through competitive bidding, there are few financial or economic gains to be had from any type of restructuring. Such SOEs should be sold "as is," at the best price possible, as quickly as possible. The costs of delay are high, including potential deterioration of assets, loss of investor interest, and opportunities for opposition to coalesce. Mexico, Chile, and Jamaica successfully divested dozens -- and east Germany, Poland, and Czechoslovakia, thousands -- of small companies without any prior restructuring. Firms that do not meet the market test of viability should be closed down. Liquidation is not necessarily the complete death of the firm; it usually puts assets to productive use in private hands. Attempts to sell non-viable firms as going concerns can create delays, jeopardize the credibility of privatization, and lead to special protection and subsidies, or subsequent government bailouts.

Make Organizational and Managerial Changes. In many cases, changes in the legal status and structure of the SOE need to be effected prior to sale.[40] In other instances, restructuring might involve the break up of large firms and monopolies into viable and non-viable units, separation of competitive from non-competitive activities, and identification of peripheral assets (such as real estate holdings, sports teams, restaurants, etc.) that can be sold as separate concerns. The extreme case is in Eastern Europe: for example, in June 1990, the former east Germany had about 10,000 large and medium enterprises to divest; by November 1991 it had sold 4,500 -- but it still had about 8,000 firms to deal with, due to the break up of giant "conglomerates" into smaller units. Similarly, Argentine authorities are breaking up the

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[40] See Guislain, op.cit, for a detailed discussion of the different types of legal restructuring involved prior to privatization.

state railway company into more viable and marketable units, while Mexico did the same in the case of steel.

New managers -- most often from the private sector -- with different attitudes and approaches, increased autonomy, and a commitment to privatization are key. They were critical to successful privatizations in Chile (power), Mexico (telecomms), Venezuela (telecomms, airlines), the U.K. (telecomms, airlines), and New Zealand (telecomms). New managers launch the process of transition from government-run to business operation by identifying and cutting fat and waste, showing workers and managers what it will take to run the company commercially, and by demonstrating to buyers the potential of the undertaking.

Clean up Enterprise Liabilities.[41] SOEs are typically encumbered by large debts, particularly in developing countries; many are in a state of negative net worth. Private buyers have made it clear they do not want to take on these debts, even when the sale price is discounted by the amount of the debt. They seek immediate positive cash flow to reduce their risk and help finance new expenditures. Debt write-down is thus standard practice in divestiture, the world over.[42] The extent of the write-off varies from case to case, but, in principle, the aim should be to leave the new owner(s) with just enough capital (incentive) to protect and increase it. The governments of Argentina and Venezuela assumed debts of US$ 930 and US$ 471 million, respectively, prior to sale of their phone companies. In Ghana, government

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[41] Many SOEs have significant potential environmental liabilities that need to be addressed prior to sale. The clean-up of inappropriately disposed of waste can be undertaken prior to sale, or be undertaken by the purchaser as a condition of sale. On a related note, in Pakistan, a group of state-owned industrial enterprises has been judged to be far more polluting than private firms operating in roughly the same fields of production. There are two reasons for this. The first is that the SOEs use older, more polluting technology than the private firms. The second is that the SOEs receive exemptions from the pollution regulations from the government, their owner. Reason number two is obvious cause for concern; if allowing SOEs to evade pollution regulations and standards is a widespread practice, then there would be an environmental case against public ownership. At first glance reason number one does not seem to be related to public ownership; that is, in many developing countries public industrial enterprises predate private manufacturing firms, and older technology is generally more polluting, regardless of who owns it. However, one can argue that private owners might have opted or been forced to upgrade the technology at an earlier date. More important, given most developing country's inability to finance modernization investments, and in light of the considerable evidence that a common effect of ownership change is increased investment, then it is safe to assume that privatization will be associated with decreased pollution -- not because private owners are more altruistic or dedicated to protecting the environment, but simply because the new technology they install is likely to be cleaner.

[42] Debt relief should take place only when management changes hands, and not before, otherwise there is a real risk that arrears will simply reoccur. In addition, other measures, such as improvements in collection of outstanding accounts receivable, freezing of non-essential capital expenditure, and inventory reductions should also be taken to avoid reoccurrence of arrears.

assumed US$ 6.3 million in debts and unpaid taxes before divestiture. In Germany, government had assumed, as of November 1991, 70% of the old debts of the 4,500 companies sold.

In large SOEs with tangled financial histories, sale proceeds seldom cover all outstanding liabilities. Sorting out and settling who is owed what, and who will be repaid what (both prior to and after the transaction) is essential, but it can be complex, and often a major cause of delay in completing transactions. In Tunisia, for example, proceeds from divestiture covered about 45% of the liabilities of the companies sold. Priority was given by law to reimbursing payments to the Social Security Fund (workers' pensions). The claims of the Tunisian banking system on the enterprises greatly exceeded the remaining monies. However, government's senior tax claim on enterprise revenues allowed it to force the banks to accept a 50:50 split of the remaining proceeds (for any debt that was not government-guaranteed). All this was time consuming and arduous, but had to be done in order for the sales to go through.

Deal Directly and Quickly with Excess Labor. SOE workers are wary of privatization; they fear dismissal either before or after sale. They have reasons to be concerned: privatization often provides the impetus for making overdue employment reforms. Sales have been accompanied by downsizing of the labor force in Tunisia, Mexico, Argentina, New Zealand, and the U.K., among others. It is not surprising, therefore, that workers and labor unions are among the most vocal opponents of privatization, causing governments to delay or postpone privatization (as in Thailand, Sri Lanka, Bangladesh, and India).

Because of the sensitivities, and despite the potential delays involved, lay-offs are best done by the state prior to sale. In theory, the decision to retain or dismiss labor would appear to be best left to the new private investors: they, presumably, will know best what kind of skills the firm needs, and have the incentive to minimize severance costs. In practice, however, private investors are seldom willing to deal with potentially messy, highly visible labor disputes, and lay-offs are thus best handled by the state. This strategy is particularly applicable to large and visible firms, highly unionized activities, or mature industries such as steel. It is also applicable where liquidation precedes privatization. In Venezuela, for example, thousands of workers will be laid off prior to the liquidation of the national ports and water companies and the granting of regional concessions. (Some laid off employees are expected to be rehired by the private concessionaires.) Social safety nets need to be developed to ease the costs of lay-offs.

Some governments have sold large firms with their labor force intact in the interest of speed. This strategy has sometimes worked well, particularly in high-growth industries that are able to absorb presently excess labor (see below); but problems arise where new owners have not been given full flexibility in labor decisions. Labor restrictions not only reduce investor interest (as in Pakistan, where 12 month restrictions on lay-offs were in place) and invite demands for subsidies or concessions to cover costs (as in the case of the jute mills in Bangladesh), but they are also not easily enforced. In Turkey, for instance, the sale contract for a catering company included a provision against firings, the company reportedly did not comply, but went unpunished. In Germany, the Treuhand places employment maintenance clauses in the sales contracts, with stiff monetary penalties for failure to comply. But officials admit that enforcement is difficult, especially since the monitoring party -- the Treuhand itself -- plans to work its way out of existence as fast as possible. And in at least one case a purchaser laid off staff claiming that changes in market conditions excused him from honoring the contract -- and the claim was accepted.

The employment restructuring issue is important and sensitive; it generates much heated debate. Yet, several important points are often overlooked. First, redundancies are an inevitable part of <u>any</u> effort to improve SOE efficiency whether or not a change of ownership is involved.[43] Second, in growing sectors, surplus labor has been absorbed by new capital investments and more productive use of existing assets (telecommunication sales in Latin America, hotel sales in the Philippines and Tunisia). In many documented cases, employment levels have <u>risen</u> after privatization due to dynamic expansion (Megginson et al., op. cit; in the Mexican autoparts industry by 30%; and in Chile and the U.K.). This has been true even in least developed countries. Following sale, a formerly moribund textile firm in

[43] Many SOEs are severely overstaffed in comparison to estimates of personnel needed to complete the assigned tasks, and to private sector or industry wide norms. The extent of past overstaffing can be alarming. One regional railway in a borrower country had 4,500 personnel prior to sale. A consulting firm estimated that the company could operate well with 2,900 employees (a one third reduction). The new private owners, after a few months operation, now estimate that they can comfortably run the company with 700 to 1,000 employees -- and still have more employees per freight kilometer than many railways in the world.

Niger expanded its blue collar workforce, and hired many more Nigerien designers, foremen, accountants and managers.

Third, the private sector offers a potential for an increase in salary levels for those who remain employed since wages are more likely to be tied to productivity. In Malaysia, for example, the promise of performance-based pay led almost all of the 900 employees of the Port Kelang Container Terminal to accept employment with the privatized company rather than a generous severance package or an offer of employment with the Port Authority.[44]

Fourth, dismissed workers have benefitted from severance packages in excess of the benefits required by law in many countries. In some cases, generous severance packages have induced so many voluntary departures that there has been little need for outright dismissals. In Tunisia, for example, 90% of redundancies were voluntary departures or early retirements; only 10% were outright layoffs. In Pakistan, those opting for a golden hand-shake will get five months of their last-drawn basic salary for each year of service (in comparison to one month provided by law); this is expected to help garner labor support. Success, however, is contingent upon careful design. While in most instances costs are financed by sale proceeds, overly generous

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severance agreements and pension programs can become unaffordable and contribute to implementation delays (Box 9). Even where affordable, large separation allowances can cause the departure of the best and the brightest, as happened in cases in Bolivia and New Zealand.

Fifth, employee ownership schemes can be used to elicit support for privatization[45]; research shows they can also enhance productivity, although profit sharing and bonus schemes are more powerful incentives.[46] Many governments reserve a block of shares (ranging from 5% to 20%) for employees at reduced prices and easy credit terms.[47] Workers in Chile got 5 to 10% of shares at a discount; a special financing scheme allowed them to borrow up to 50% of their severance pay to purchase shares (with a promise to repurchase the shares if they were worth less than their severance pay at the time of retirement). In Nigeria, at least 10% of each SOE is reserved for employees; similar schemes exist in Poland, Venezuela, Jamaica, Pakistan, and Russia among others. Costs in lost revenue, usually low to begin with, are outweighed by the benefits of having such schemes.

Finally, labor opposition has been muted where employees understood that the alternative to privatization was liquidation, and the general public understood the costs of continued inaction. Public awareness campaigns were

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[45] In Chile, it has been argued that workers' shares raised the price paid for SOEs because the buyers regarded the workers' stake as reducing the risks of renationalization. See Luders, 1990.

[46] For a fuller discussion of the issues involved in employee ownership in privatization, see Lee, 1991.

[47] Excessive levels of employee ownership can lead to difficulties in employment and wage restructuring and make it difficult to attract investors.

Box 9

COSTLY END-OF-SERVICE BENEFITS SLOW DOWN PRIVATIZATION IN GHANA

Most of Ghana's SOEs are overstaffed. Either government must dismiss large numbers of employees before selling the SOEs, or allow new private owners to scale down the workforce to an appropriate level. A complicating factor is that the enterprises had previously agreed to overly-generous severance pay and retirement benefits in collective bargaining agreements. Between 1985 and 1991, liabilities for these end-of-service benefits (ESBs) grew 150%, reaching between 0.5 and 1 million cedis per employee (US$ 1423 - 2846; 4 to 7 times the GNP per capita). For the 150,000 employees in the SOE sector, liabilities for unfunded retirement benefits alone were estimated at 75 billion cedis (US$ 211 million) in December 1990. The government cannot afford these costly ESBs, and few private investors would be interested in purchasing the SOEs, if they have to honor these commitments.

Early in the privatization program, the government elected to pay off the ESBs from sale proceeds. With proceeds falling far short of liabilities, it arranged to supplement them with annual budgetary contributions -- under SAL III, for example, Ghana's 1991 budget will set aside 3.5 billion cedis for ESBs. These allocations have not been sufficient, and in the enterprises divested to date, the government has only paid out 20% of the benefits due employees.

The absence of a clear plan for settling ESB liabilities has delayed the privatization of the large SOEs and led to diminishing private sector interest. Roughly 22,000 redundant SOE employees remain on the government payroll, while some officials hope the state can transfer the heavy ESB burden to private investors. Vested interests have seized upon the ESB issue to stall the program. Breaking the logjam would require government to renegotiate affordable settlements with the unions, and to defer payments over several years.

To avoid future trouble, the government has established a national pension scheme to replace the system of negotiating separate enterprise pension plans, and is considering the creation of a national contributory unemployment scheme. It has also frozen the retirement gratuity portion of the ESBs at December 1990 levels, and called on SOE boards to renegotiate ESBs with their employees. As of December of 1991, the government had also drafted a proposal to standardize retroactive ESBs.

critical in explaining the costs and benefits of privatization -- and its alternatives -- in Tunisia, Venezuela, and New Zealand.

Avoid New Investments. Some argue that government will get a better price for SOEs if they are physically rehabilitated before sale. But there are many reasons why new investments for enterprises should be left to private owners once a privatization decision has been taken. (For enterprises that are likely to be privatized in the medium to long-term, see Section VI.) First, governments typically have a record of mismanagement and poor investment decisions; it is unlikely that they will now make the right decisions and recover investment costs. Second, governments lack the money to pay for rehabilitation and modernization investments; getting the private sector to finance and manage such improvements -- and take the risk --is a major reason for privatization in the first place. Third, the private investor is better able than a civil servant to judge future needs and markets. And fourth, uncommitted managers or governments can use restructuring to delay privatization.

B. PRICING AND VALUATION: RELY ON THE MARKET

Letting the market decide the sales price through competitive bidding procedures is critical for speed and transparency. At the same time, asset valuation can be essential for setting a benchmark for sales, and assuring a fair and "above board" process.[48] In small and medium enterprises operating

[48] Any company -- private or public -- can be valued on the basis of net asset value, net present value of discounted cash flow, earnings trends (P/E ratios), and/or dividend yields. Asset valuation is generally used for small loss-making enterprises that are to be sold on a piecemeal basis rather than as ongoing concerns. The discounted cash flow method is used when SOEs are

in competitive markets, little formal valuation might be required; Mexico, Chile, Tunisia, and the former east Germany more or less left asset valuation to the market in such cases. In large firms and monopolies, however, a baseline valuation is more important. But, even here, market-based pricing should be the preferred strategy provided there is: (i) a careful prequalification of bidders on the basis of proposed business plans, the experience and qualifications of the operating company, and the extent to which the sale would concentrate market power to the detriment of consumers' interests; and (ii) specification of a regulatory environment which provides incentives for modernization.

An overemphasis on valuation can prove problematic. Valuing SOEs for sale is as much art as science. Technical appraisals seldom estimate correctly the market price of assets that have never been traded before, even in countries with sophisticated capital markets. In developing countries, SOE valuations are all the more tricky: the macroeconomic and operating environment is changing rapidly (the number of bids over the asking price for one of Mexico's airlines went from 0 to 7 after the government signed a debt renegotiation agreement); financial data are of poor quality and reliability (Argentine telecomms was sold with poor financial statements for the preceding two years); existing accounts do not conform to acceptable commercial

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sold as going concerns. In this method, the present value of the projected stream of future cash earnings is calculated. Price/earnings ratios (where the share price is calculated as a multiple of the company's earnings) and dividend yields are used to price SOE shares for sale through a public offering. Since there is no one correct value, more than one method is usually used to derive a range of values. See Sasson, 1990.

standards (most acute in Eastern and Central European countries); comparables are also few, and the market thin.

Moreover, the dangers of overvaluation and unrealistic expectations on the part of government creates serious delays. Many divesting governments have chosen to set asking prices on the basis of historical book value -- on the seemingly reasonable grounds that they wish to recover at least what they put in -- but this has often led to valuations of eroded assets that bear no resemblance to what any buyer will offer. (In some cases, this might lead to undervaluation, since book values are not adjusted for inflation.) In the sale of the aluminum mill (Alumasa) in Costa Rica, for example, the company was valued on the basis of book value at US$ 52 million, despite persistent heavy losses. There were no takers at this price. Government then used a comparable mill in Venezuela, valued at about US$ 8 million, as a reference price. Alumasa was finally sold for US$ 4 million, about 7.5% of book value.[49] In Puerto Rico, a price of US$ 3 billion for the Telephone Authority was fixed in the legislation authorizing the sale. Government had no room to manoeuver during negotiations; the company was subsequently taken off the sale block after failing to obtain the asking price. And in Jamaica, overvaluation

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[49] Many find shocking sales prices that are less than 10% of book value. They conclude that privatizations at such prices constitute a serious loss to, if not a crime by, the state. But critics should direct their ire at the people who built uneconomic enterprises, or ran them so badly. The sad fact is that the rational economic solution for firms persistently making losses, or in a state of negative net worth, is to accept any positive price offered, to give them away, or even to induce someone to take them over. Economically, it makes sense for owners to pay someone to take a liability-ridden entity off their hands, and -- it is hoped -- put the assets back to productive use. The Treuhand has sold dozens of firms at the symbolic price of one mark. In these cases, according to Treuhand officials, "we are not selling companies; we are buying management and technology."

delayed privatization which led in the end to lower prices (20% of asking price in some cases) due to the physical and financial deterioration of assets during the protracted run up to sale.

Overpricing shares in a public offering is also a recipe for failure. In Sri Lanka, for example, 65% of the shares of United Motors remained with the underwriters, severely undermining small investor confidence in public issues. In Turkey, the share prices for two privatized enterprises declined in value in comparison to the stock exchange index by 50% in one and 38% in the other respectively since their initial offerings in 1990. The shares appear to have been overpriced to begin with: investors have lost a total of TL 450 billion (May 1991 prices) and have become wary of participating in future public offerings.[50] Instead, prices have to be low enough to foster demand, ensure a full subscription, and achieve the underlying objective of distributing ownership. Discounts on privatization sales have thus been much higher than the traditional after-market premium of 10 to 15% in other floatations (Figure 9). Gains to small investors should be seen as a measure of success rather than as a financial loss to governments, since in such sales distributing ownership is more important than raising revenues. (As noted, if raising revenues is the goal, another method should be used.)

To offset potential political and financial costs, some countries offer discounts to small investors and ask higher prices (either fixed or by tender)

[50] In the end, the Turkish government repurchased the shares to maintain the price, and then resold them at later dates in smaller tranches. This was costly and set a bad precedent for the remaining public offerings.

Figure 9
Pricing of Public Share Offers

Country	Enterprise	Date	Subscription Price	1st Day Closing Price	Premium/ Discount
France	CGE	05/87	FF 290	FF 323	11.4%
	Paribas	01/87	FF 405	FF 480	18.5%
	Saint–Gobain	11/86	FF 310	FF 369	19.0%
	Sogenal	03/87	FF125	FF225	80.0%
Jamaica	Nat'l Commercial Bank	12/86	J$2.95	J$4.94	67.5%
	Caribbean Cement Co.	06/87	J$2.00	J$1.55	–22.5%
Philippines	Philippine National Bank		P170	P255	50.0%
United Kingdom	British Airways	02/87	125p	169p	35.2%
	British Gas	12/86	135p	147.5p	9.3%
	British Petroleum	11/79	363p	367p	1.1%
	British Telecom	12/84	130p	173p	33.1%
	Rolls–Royce	05/87	170p	232p	36.5%

Source: France: Durupty, M., "Privatisation in France", 1991; UK: Vickers and Yarrow, "Privatization", 1988; Jamaica: Leeds, R., "Privatization in Jamaica: Two Case Studies", 1987; Philippines: World Bank.

from institutional investors.[51] Governments have also sold shares in tranches. France and the U.K. typically started with smaller share offerings and higher discounts; over time, as commitment was demonstrated and private sector confidence increased, larger percentages were offered and discounts declined. Thus, in the U.K., the first half of British Aerospace was sold in 1981 for Sterling 150 million; in 1985 the second half was sold for Sterling 275.3 million. "Clawback clauses" allow government to share in the gains that an enterprise might make through subsequent sale of under-valued property. This mechanism was used in the sale of the twelve regional electricity distribution companies in the U.K., where the government was entitled to a proportion of any gain in the subsequent disposal of land and buildings.

C. FINANCING

Poor timing of sales and weak financial systems pose constraints in financing privatization in developing countries. A number of governments (such as Argentina, the Philippines, and Jamaica) put SOEs on the market while simultaneously offering high-yield, low-risk, tax-free government bonds, which dampened the market for SOE shares. Ghana's agreement with the IMF limits unsecured private bank lending to 10% of a bank's net worth. Thus, the five major banks had a total of US$ 2.1 million for acquisition financing, while the estimated value of the SOEs up for sale in the first round exceeded US$ 25 million (more than the total net worth of the banks).

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[51] Tender methods are more appropriate for sales of shares to well-informed financial institutions and trade buyers than to small investors; the former are better able to assess bid strategy and price the investment opportunity. This method was extensively applied in the public offerings in the U.K.

Many governments exclude (or favor) certain ethnic groups from participating in privatization for political reasons. In Malaysia, government reserves shares for the Bumiputras (the Malay majority), but limits share acquisition by other, relatively wealthy groups of investors; in Kenya, and elsewhere in East Africa, citizens of Asian origin are sometimes excluded; in south Asia too, commercially oriented minorities are disfavored in the privatization process. Such restrictions and concessions can lead to costly delays and limit the entry of groups possessing the necessary capital, skills, and experience to provide jobs and opportunities for the majority. Mechanisms -- such as the reservation of a portion of shares for certain groups -- need to be developed to mitigate political concerns and safeguard the interests of the majority while, at the same time, tapping the money and expertise of the minorities.

Restrictions on foreigners have also narrowed the range of financing options, particularly in the sale of larger SOEs. Restrictions on foreign ownership exclude countries from an important source of new capital, markets, management, and technology. Prior restrictions on foreign involvement in many countries formerly averse to the concept, such as Mexico and India, have now been eased; in country after country, the rules are being relaxed, and competition to obtain foreign investment is growing intense. Success depends on having a stable economic and regulatory environment in place, as in Mexico and Chile. Nonetheless, many developing countries remain sensitive about foreign ownership. These concerns can be reduced by reserving a "golden share"[52] for government in exceptional circumstances, or by combining sale of a controlling interest to a foreign investor with widespread distribution of remaining shares to citizens and employees. In Indonesia, Togo, and New Zealand, for instance, SOEs have been sold to foreigners with the stipulation that a certain amount of shares be gradually floated to small investors through the stock market.

Government attempts to curb the participation of institutional investors and financial institutions also make it hard to finance privatization. Regulation of weak financial systems is clearly a legitimate function of government; but this should not preclude institutional investors from playing a positive catalytic role in privatization. (In turn, privatization can play a role in strengthening and diversifying financial markets.) After Chile cleaned up the mess created by poor banking practices during its first sales, it was naturally reluctant to allow banks or even private pension funds to invest in SOE shares. It solved the problem by creating a special commission to classify the risk of these investments -- very conservatively -- and by limiting the amount of high risk shares pension funds can hold.

Financial intermediaries should not be forced to buy, however. To soak up excess liquidity and provide equity to SOEs, Brazil compelled financial institutions and pension funds to convert a portion of their assets to "privatization certificates" (CPs) in order to purchase SOE shares. Not

[52] The term comes from the British privatization experience and refers to a stipulation, in a general privatization law or in a particular sales agreement, that government retains one non-voting special share, that gives it the power to reject subsequent sale, or major capital or physical restructuring of the firm. The power has not yet been exercised.

surprisingly, the financial institutions opposed this idea, and the forced conversion to privatization certificates is being challenged in the courts. Brazilian insurance companies and pension funds argue that they cannot invest in privatized firms because their regulations prevent them from investing in high-risk ventures. And banks have purchased only a small portion of the shares they were expected to buy in the preliminary auctions. Forced acquisition schemes run counter to the fiduciary obligations and sound business practices of these intermediaries; and they do nothing to improve management. Rather, financial discipline could be weakened by placing new funds in the hands of managers who have done nothing to raise them.

Debt vs. Cash. There are excellent reasons to sell for cash, even if this means selling at a lower price. Outright sale severs cleanly the ownership link between enterprise and state; "cutting the umbilical cord" was an important consideration in Mexico and Venezuela. The Mexican government insisted on all cash sales to assure that unpaid balances could not be used by the new owners to "blackmail" the state for future concessions. Cash sales also provide the liquidity to pay enterprise liabilities and severance pay. They should always be regarded as the preferred payment method.

Nevertheless, many developing countries have no alternative but to sell for debt, usually seller (government) financed. Easing the constraints on participation by foreigners and institutional investors will help, but many SOEs are simply not sufficiently attractive and many financial systems not deep enough to attract equity or bank financing. Selling on the "installment plan" is one option, but settling for a lower sale price, or selling in tranches (with control passing to the private sector), or simply giving small assets away might be better solutions in easing financing constraints than excessive use of debt.

Highly leveraged sales, regardless of whether the seller (government) or the banks are the source of credit, are risky. In Chile, the failure of privatized firms between 1974 and 1984 was partly due to the large debts owed to government. The initial terms were attractive. Buyers had to pay 10 to 20% down, with one year's grace. After that, however, they faced a short (5 to 7 years) repayment period, at a real interest rate of 8 to 12%. The firms had a very thin equity cushion when the recession hit in the early 1980's; seven of every ten privatized companies went into bankruptcy, and reverted back to state hands when their controlling banks were nationalized. In the second round of sales the chastened government gave no credit (except to the smallest investors and employees), and bidders had to prove their solvency. Numerous examples of the problems involved in granting and recovering debt could be cited.

Debt/Equity Swaps can ease financing constraints, and they offer an important additional advantage: reduced foreign debt radically improves a country's investment climate.[53] In a debt/equity swap the debt holder who wants to buy the enterprise swaps debt worth a fraction of its face value in the secondary market for equity, usually at a rate that is better than the secondary market price but still well below the face value. In Argentina, as

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[53] Sung, 1991.

noted, swaps in privatizations reduced the face value of outstanding commercial bank debt by 20%.

Critics of swaps argue with some justice that government may be better off selling the enterprise and using the proceeds of the sale to repay or repurchase the debt on the secondary market. It might that way capture more of the discount and expand the participation of local investors. Mexico, for example, sold most of its SOEs without swaps, and is using the proceeds to buy back debt. This approach is appealing, but it has its limits: a large debt overhang may deter any investor, foreign or domestic, from buying SOEs, particularly large companies that require new investment. And Mexico can be considered a special case since its debt reduction under the Brady plan put it in a better position to attract investors.

Swaps may be the only way for heavily indebted countries to bring foreign commercial banks into transactions, transactions that might not be done without their participation. This is important since a substantial proportion of the swaps under privatization are believed to have involved the original commercial bank lenders. A case in point is the Argentine telecom deal. Government sought a buyer who would bring in an experienced operating company, invest US $5 billion in capital improvements over 10 years, and maximize the amount of debt reduction (companies' bids were expressed in terms of external debt). Argentina sold the company in November, 1990, for $214 million in cash, and a $2 billion reduction in the face value of its debt. The advisors on this deal believe that it would never have materialized -- particularly with a pledge for new investment -- without the swap to induce the participation of the commercial banks. The approach used was to price the swaps through an auction; this allowed government to capture a larger share of the discount than case-by-case negotiation (as in Chile, Box 10).

Debt/equity swaps are not always suitable, however; they are only useful to countries which have a lot of foreign commercial debt and are selling enterprises that can interest foreign investors.[54] Countries may be able to increase their access to swaps by creating conversion funds for privatization. These have been successfully used in Argentina, Chile and Philippines. They pool eligible debt paper from commercial banks, multinational and individual investors to swap for enterprise assets. Such funds could even be active investors, taking a role in restructuring poorly managed enterprises.

D. MANAGING PRIVATIZATION

Privatization requires a managerial set-up that can ensure speed, transparency, and consistency in implementation. Improvised arrangements can derail the whole process: in the early phase of privatization in Togo, for example, speedy decision-making was hampered by lack of clarity in the roles and responsibilities of the various ministries.

Transparency vs. Speed. One of the most evident trade-offs in the privatization process is that between the rapidity of the transaction and the

[54] Paradoxically, the more successful are debt/equity swaps, the more their usefulness declines. As a country buys its debt back, it becomes a better credit risk; the secondary market discount on the debt drops, and this reduces the incentive for the investor. This was one reason why the volume of Chile's swaps dropped from US$ 1.9 billion in 1989 to US$ 0.7 billion in 1990.

First Draft

Box 10

DEBT/EQUITY SWAPS IN CHILE

Chile's debt swap program, which has been in operation since 1985, is considered one of the most successful. It aims to use discounts available on Chile's international commercial bank debt, to reduce external debt, to attract foreign investment, and to repatriate Chilean capital held abroad. Several factors contributed to the success of the Chilean program. The clear-cut swap rules are contained in Chapters XVIII and XIX of the Compendium of Rules on International Exchange. The former allows the conversion of foreign debt into a peso obligation and is aimed at Chilean investors who may have access to capital abroad. The latter is designed to accommodate equity investment by foreigners via debt cancellation. While seminar conversion programs in other countries were suspended or drastically modified from time to time, the Chilean program remained stable over the years. The consistency was important in inducing potential investors to make additional investments through debt swaps.

The definition of eligible debt under the program is broad and includes all commercial bank debt except short-term maturities. Swap proceeds are allowed to be used for broad investment activities or refinancing of local currency debt. Since use of Chapter XIX requires prior authorization of projects, the Central Bank could ration approvals to control the effects of swaps on inflation and exchange rates. Stringent limits were enforced on repatriation of profits and capital derived from the investment made. Careful design and implementation of the program reduced round-tripping (under which investors would have been encouraged to take funds abroad and bring them back through swaps). The effective implementation of the program by the authorities, as well as supportive macroeconomic environment and active privatization programs of Chile since the mid-80s helped build confidence in the system among potential investors and make the swap program a success.

During the six years(1985-91) that the Chilean program was operating, the two swap schemes retired about $7 billion in commercial bank debt, representing about 30% of the total. The conversion program contributed to a large and growing influx of foreign investment in the country. About 20% of Chapter XIX swap deals involved investments in public enterprises which were privatized in various economic sectors such as agribusiness, manufacturing, banks and other financial institutions. The pace of conversion under Chapter XIX fell off sharply in 1991 as the secondary market price of eligible debt rose to 90% of the face value and discounts on the declining debt stock became extremely limited.

extent to which the sale is conducted in an open manner -- which means one that permits potential bidders (and other interested parties) the time and resources to obtain and act on appropriate information. A first principle is that a minimum amount of transparency must obtain in every transaction. This can be ensured by having: clear and simple selection criteria for evaluating bids; clearly defined competitive bidding procedures; disclosure of purchase price and buyer; well-defined institutional responsibilities; and adequate monitoring and supervision of the program.

Experience shows, however, that speed should be the paramount objective for small industrial and commercial firms operating in competitive or potentially competitive markets. Such firms can and should be sold quickly so as to put the assets to productive use, decrease the administrative burden on the state, and avoid opportunities for vested interests to coalesce. All that is needed is light management and review of transactions; Mexico and east Germany, for example, divested hundreds of enterprises in this way. In large, highly visible, or market dominating transactions, a balance needs to be struck: lack of transparency can result in political backlash, but too much dedication to transparency can slow the process down. In some cases, insistence on the last full measure of transparency has brought divestiture to a complete halt. One way to accomplish a balance is to set up special commissions outside of the regular privatization machinery to handle the sale of large firms (as in the sale of telephone companies in Jamaica, Mexico, and Venezuela, for example). Foreign advisors have also been hired as a way of keeping the process both transparent and speedy (see below).

<u>Centralizing Policy Responsibilities</u>. Transparency and speed are best achieved by centralizing policy responsibilities for privatization in a strong focal point. A clear mandate, sufficient autonomy, minimal bureaucracy, ready access to top decision-makers, and quality staff are conditions for success. In Mexico, for example, a unit of seven people in the Ministry of Finance, reporting directly to an interministerial commission and freed of public sector rules and regulations, divested hundreds of enterprises over a few years. In the Philippines, the Asset Privatization Trust, headed by a qualified private sector businessman and staffed by a small group of experienced private sector individuals paid at private sector rates, disposed of more than 150 non-performing assets in 2 years. By contrast, in Ghana, where these conditions were not met, the process became lengthy and bureaucratic, the focal point lacked clout and authority over sector ministries, and recruitment of key staff was delayed because of non-competitive salaries.

Cabinet commissions and sector ministries do not function well as focal points. They tend to delay privatization because of strong vested interests, and make the process less transparent. Early privatization efforts in Brazil stalled because sector ministries were slow to privatize; implementation is expected to pick up speed following the creation of the Privatization Commission and its secretariat. Guinea also left early privatizations to the sector ministries; consequently, SOEs were closed and sales negotiated without proper legal authorization. Lack of transparency created a political backlash and many sales were subsequently stopped. Government is now considering the establishment of a focal point to expedite the process, protect the interests of the State, and increase transparency.

Decentralizing Implementation. Decision-making is thus best centralized, but excessive centralization of implementation can paralyze a program, particularly in countries with large SOE sectors. To accelerate the process and reduce the workload of the central unit, responsibility for implementation can be delegated to banks and financial institutions (as in Mexico, Nigeria, and France), international and local business consultancies (Argentina and Venezuela), holding companies (in the Philippines), sector ministries (Tunisia), and SOE managers themselves (Turkey and Hungary). The privatization authority must supervise these implementing agencies and have a clear mandate and timetable for privatization; otherwise, the risk of inaction is great. In Tunisia, sector ministers and managers, closely monitored by the privatization commission, moved quickly because they recognized that their careers were at stake. Clear implementation principles and standards of accountability are also necessary to minimize abuse and ensure transparency.

Employing the Right Skills for Privatization. Government capacity to handle the privatization process is scarce; time and money have to be spent obtaining the right technical, financial, and legal skills. Small privatizations can and should be handled locally to the extent possible (as in Mexico), but skills may need to be imported in least developed countries in sub-Saharan Africa (where institutional weakness has contributed to privatization delays) and for large transactions. Government capacity to employ external advice and assess the public policy implications of the advice needs to be strengthened almost everywhere, particularly since the short time-horizons and success-based fee structures of investment bankers can create perverse incentives.

V. PRIVATIZATION IN EASTERN EUROPE AND CENTRAL ASIA

A. A DIFFERENT PROBLEM

At their peak, the largest SOE sectors in industrialized and mixed economies were small in comparison to those in socialist Eastern Europe and Central Asia. In this region, at the beginning of the 1990s, enterprise numbers were much larger, and they contributed between two-thirds and nine-tenths of all productive economic activity.[55] Indeed, SOEs were not and are not a "sector;" they constitute, in effect, the bulk of the non-agricultural economy. And, because of their primary position in distributing housing, health and leisure services, they play central non-economic roles as well.

B. PAST PERFORMANCE

In the past, impressive production figures were reported for SOEs in most command economies. However, methods of production were inefficient, and the quality of goods produced was generally poor, usually incapable of competing in export markets. Despite persistent, repeated partial reform efforts from the 1960s onwards, SOEs in ex-socialist economies never sustained the efficiency and productivity expected of them, and their performance

[55]Poland started its transition to the market with 8,000 or more large industrial SOEs; Hungary, the Czech and Slovak Federal Republic (CSFR), Romania and Yugoslavia all had more than 2,500; before its demise, the USSR, at conservative estimate, possessed more than 47,000 very large industrial SOEs.

deteriorated sharply in the period 1970-1989. The dissatisfaction with the meager results of past partial reforms, and with the stagnating or even declining standards of living contributed to the political-economic upheaval of the past several years and to a widespread enthusiasm for privatization.

C. THE TURN TO PRIVATIZATION

All of the successor governments in the region have launched or are contemplating privatization reform. But the process in the ex-socialist countries differs greatly from privatization elsewhere. First, it is a more massive and thus more complex undertaking. For example, the governments of Poland, Hungary, the Czech Slovak Federal Republic (CSFR), and Romania have announced intentions to privatize between a third and a half of their SOEs within a three year period. At conservative estimate this amounts to more than 8,000 firms.[56] As noted, in the last eighteen months the Germans alone have privatized more enterprises (4,500) than the rest of the world in the last fifteen years. Second, the context is very different. In even the poorest or least market-oriented developing country there is a private sector of sorts; some prices bear a relation to scarcity values; and concepts of property, ownership, title, and contract are acknowledged (if not rigorously or regularly enforced). This has not been the case in the ex-socialist countries for at least 40 years -- and longer, in the case of the Republics of the Commonwealth of Independent States (CIS).

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[56]And probably many more, as they break up the many conglomerates and over-sized units into manageable, sellable units.

Third, the goals are different; that is, they are more overtly socio-political than elsewhere. In mixed economies, privatization is primarily seen as a tool to enhance efficiency and reduce budgetary burdens, and not as an end in itself. In many of these countries, privatization is seen as an end in itself, as a mechanism to transform society from communism to capitalism. Its primary purpose is to transfer property rights to owners who have incentives to defend the interests of the capital they own, and to respond to market signals. This will eventually increase efficiency, but many reformers see the creation of owners as equally if not more important. Why? Because private owners have an incentive to support with their votes and their actions the painful steps necessary to transit to the market. Proponents of this view thus argue that for the transition to succeed, privatization must be <u>massive</u>, in order to create a property owning group of sufficient size to carry economic and political weight. It must also be done <u>quickly</u>, since many key decisions that will determine the nature of the post-communist system are being taken now. They fear that if substantial privatization does not come quickly, years will pass before any substantial portion of assets was in private hands. And in the interim, a base could be constituted for those who see interventionist populism as the less painful alternative to communism. In sum, the purpose of privatization is to transform society as well as to put the previously wasted and underutilized assets to more productive use.

There is near universal agreement in the region on the goal of creating a large and influential group of property owners. But not everyone agrees that the property transfer must be accomplished immediately. Some respected reformers argue that since "the prime purpose of privatization is to nurture the <u>incentive force</u> private ownership provides," each transaction should be structured to yield the maximum possible amount of macro and microeconomic gain. In this view, "the sale of state property should <u>not</u> be governed by the guiding principle of speed."[57] In particular, countries that had a more evolutionary than revolutionary break with communism are less likely to regard massive/rapid privatization as essential, partly because their populations are somewhat less angered by the prospect of the <u>nomenclatura</u> ending up as property owners. (Contrast the Hungarian program in the Annex, where management buyouts are the main privatization method, to that of the CSFR, where the vast majority of firms will be privatized by a "voucher" or give-away method.[58])

D. <u>OBSTACLES TO PRIVATIZATION, AND WAYS AROUND THEM</u>

The pressures to privatize are intense. Nonetheless, actual sales or transfers have moved slowly in comparison to the established targets (except, once again, in the former east Germany). At the time of writing, just over 800 medium and large enterprises in the region have become private. Why this relatively slow pace? One reason is the normal complexity of the privatization process, made doubly difficult in ex-socialist countries, where:

* the legal basis for private ownership is unclear or embryonic, and the claimants to property rights numerous and competing;
* the elaborate auditing, consulting and financial apparatus for preparing a firm for sale must be built from scratch or imported (at high cost);

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[57] Kornai, 1990, p. 93.

[58] See the Annex for a more detailed review of the approaches adopted, and the results so far, in the three more advanced privatizing ex-socialist economies, Poland, Hungary and the CSFR.

* the domestic population is illiquid, capital markets virtually non-existent, the banking and credit system in desperate shape, and the only likely domestic buyers are members of the usually distrusted and discredited nomenclatura; and
* the vested interests arrayed against privatization are powerful.

Moreover, newly elected governments, struggling with democracy, fear that privatization -- and the attendant ending of subsidies to loss-makers, and the liberalization of prices, trade regime, interest and wage rates that normally accompany privatization -- would result in the collapse of much of the industrial base, a sky-rocketing of unemployment, inequities in the distribution of property, and grievous socio-political disruption.

These obstacles are real and formidable. Unemployment has risen from in effect zero to over 11% of the workforce in Poland in the last two years; reforms in other countries seem destined to produce similar figures. The collapse of CMEA trade has added to, but does not fully account for, the dramatic declines in industrial production in the region. Nascent democracies find it difficult to enforce painful reforms and win votes at the same time. Nonetheless, governments in ex-socialist countries, with external assistance, are devising a range of innovative methods to overcome the serious obstacles facing privatization.

* If enterprises cannot easily or quickly be sold, then perhaps they can be **given away**; as proposed or underway in Poland, the CSFR, Romania, and in several Republics of the CIS.
* If buyers are illiquid, then **owner-assisted financing** can be arranged; as in Slovenia, Hungary and a number of other countries.

* If workers fear and oppose privatization, then they can be provided with a "sweetener" in the form of **free or low-cost shares** in the newly privatized firms, as in Poland, Hungary, Russia and parts of Yugoslavia.
* If citizens do not (and cannot in the present economic circumstances) have adequate information about which enterprises to invest in, then **mutual funds/holding companies** can be built to bundle firms and diversify risk, as in Poland, the CSFR and Romania.
* If citizens fear that the nomenclatura are making off with the assets at unfair prices, then **reviewing agencies** can regulate the process in the public interest, as in Hungary, Russia, Poland and elsewhere.
* If excessive centralization of the process is causing delays, then **decentralized implementation** with overall central monitoring and control can be attempted, as in Hungary and the Republic of Russia.
* If overstaffing needs to be addressed, then **social safety nets and unemployment insurance schemes** must be devised.

Most of these mechanisms have yet to be implemented in any substantial way; in some instances, their use to solve a particular problem may cause another. For example, Poland and Romania have had problems setting up mutual fund-management company intermediaries; giving away enterprises can be as difficult as selling them. CSFR is experiencing difficulties in processing the masses of information necessary to launch the voucher scheme leading to a delay in the start date. Reviewing agencies that try to regulate privatization have sometimes brought it to a halt; striking a balance between supervision and strangulation is not easy. Elsewhere in the world, governments that have given credit to enterprise purchasers have often found either that repayment is a problem, or that purchasers with little of their own capital at risk are less then perfect owners, or both. This is quite likely to happen in the ex-socialist countries as well. Giving shares to workers could lead to excess wage bills, impede further and needed reform, and scare off other investors, or lenders. Finally, unemployment insurance schemes can be brought into existence fairly quickly, but improving the availability of other factors contributing to increased labor mobility, such as housing, is a longer term effort.

In sum, in ex-socialist countries, even more than elsewhere, one does not possess all the answers on what methods will and will not work; or on what will be the by-products of the corrective or facilitative mechanisms listed above. However, the usual counsel in this situation -- caution and delay -- would be exactly the wrong advice. A counsel of delay, or of devoting the bulk of efforts to a case-by-case method, might only reinforce the many who want to stop privatization altogether. Rather, the conclusion to be drawn is that the many uncertainties and obstacles should lead governments, and their external supporters, to experiment with all available privatization methods, including: enterprise-initiated (worker and/or management) buyouts; investor-initiated direct sales; public offerings on new or revived stock markets; give away schemes, and the innovative use of intermediary institutions such as combination portfolio managers/turnaround specialists.

E. MASS PRIVATIZATION

Mass privatization can take several forms: simply turning over ownership to the existing managers and/or workers; making all or some enterprises into joint stock companies and distributing a percentage of shares to the existing managers and/or workers; creating mutual funds-cum holding companies, and then distributing shares in these to the public; distributing to the public vouchers or coupons that entitle them to bid directly on shares in individual firms -- and several variations in between.

The advantages of these approaches are several. They avoid problems of absorptive capacity and purchasing power by rapidly giving at least some ownership in a firm or firms to a population that cannot -- or would not -- purchase it. They are equitable, since, under proposed schemes all or most of the population receives shares at no cost, or is given the chance to obtain shares at low cost. Mass privatization would delay, if not prevent, the nomenclatura from becoming property holders (though this can be a disadvantage, depending on how one perceives the managerial potential of the nomenclatura). Mass schemes should also reduce the need for government-funded or administered restructuring, and they would allow governments to focus funding on priority tasks such as social safety nets and infrastructure investments.

There are risks. Mass privatization is an untested approach; there is no empirical evidence on how these schemes will actually work. Mass privatization is an institutionally complex process that requires good administration by admittedly weak and over-burdened governments. Furthermore, widely dispersed ownership without an activist mutual fund does not solve the problem of "corporate governance;" it does not put "a living, breathing owner/investor" in charge of the assets.[59] Moreover, the forms of mass privatization that transfer large percentages of shares to workers may slow full privatization, deter private investors, foreign or domestic, or cause future difficulties for a lead or majority investor.

Nevertheless, the risks can be minimized. One of the virtues of private property is its flexibility. Widely disbursed shares can be acquired by investors intent on transforming an enterprise to shape it to new market opportunities.[60] Open markets create pressures to correct the defects of less than perfect sales. Financial intermediaries can be involved to encourage corporate governance. In sum, the situation in ex-socialist countries calls for some flexibility of approach, and governments and the Bank should actively support a variety of approaches, including experimental ones such as mass privatization.[61]

VI. ROLE AND ORGANIZATION OF THE BANK GROUP IN PRIVATIZATION

A. WHAT HAS THE BANK GROUP DONE IN PRIVATIZATION?

Role of the Bank. Two principal Bank objectives are the promotion of efficient economic development, and the reduction of poverty. Accordingly, the Bank's primary role in privatization is to help establish an appropriate policy environment in which ownership change will produce efficiency gains;

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[59] Kornai, op cit.

[60] Initial trading would need to be curtailed or the use of proceeds from sales of previously free shares would need to be restricted or taxed to reduce inflationary effects.

[61] As indeed it has in Romania and, to some extent in Poland.

these gains, in turn, will expand productive employment, and enhance welfare over the long run. Between FY81 and FY92, 182 Bank operations supported privatization in 67 countries, half of them sub-Saharan African (Figure 10). Bank lending for divestiture began in FY81. The number of operations escalated sharply in FY84, then rose steadily until FY92 (except for a slight dip in FY91).[62] Adjustment operations have been the most widely used instruments for supporting privatization, accounting for close to two-thirds of all Bank activities in this field. About 70% of all structural adjustment loans (SALs) and 40% of all sectoral adjustment loans (SECALs) (Figure 11) support privatization by helping to develop strategies, classify candidates for sale, establish time-bound implementation plans, and develop an appropriate supervisory/institutional framework (Figure 12). The Bank also supports privatization-related implementation measures, such as financial and managerial restructuring of enterprises prior to sale (21% of all operations), or the creation of special facilities and funds to help pay outstanding liabilities, or credit schemes to help finance privatization (13%). Many borrowers are still preparing for privatization, but in the next few years implementation assistance will grow.

In addition to adjustment loans, over sixty Bank operations finance technical assistance (TA) for privatization -- mostly in sub-Saharan Africa and LAC. A large part of this support (US$ 87 million to date) goes toward preparation and institutional strengthening. The rest (US$ 50 million) supports specific transactions through the financing of legal or financial advisors, asset valuators, and industry/technical specialists (Figure 13). A

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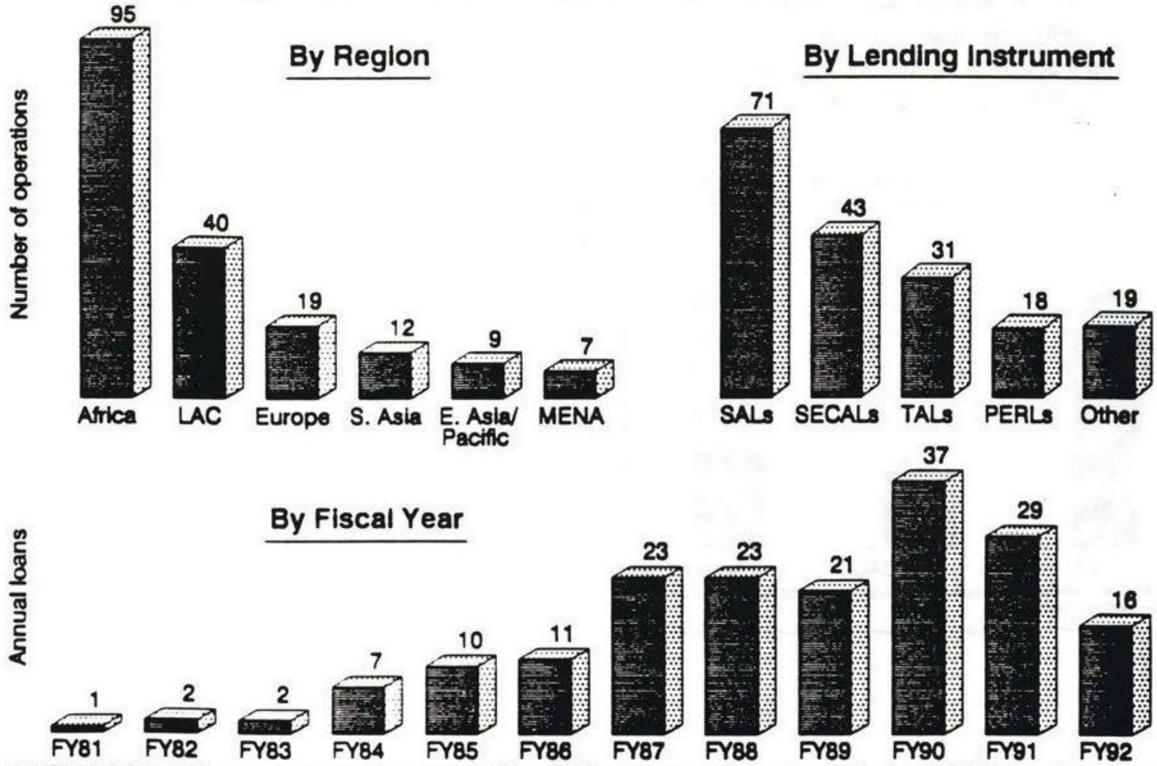
[62] Sixteen projects have already been approved in the first six months of FY92, compared with ten approved over the same period in the previous fiscal year.

Figure 10

Bank-Supported Privatization Operations, FY 1981 to December 1991



Note: SALs include economic recovery operations; TALs include both PE-specific TA and other sector TA operations; PERLs refer to PE SECALs, and PE and public sector reform operations; Other refers to hybrid and investment operations.

Source: CECPS/World Bank

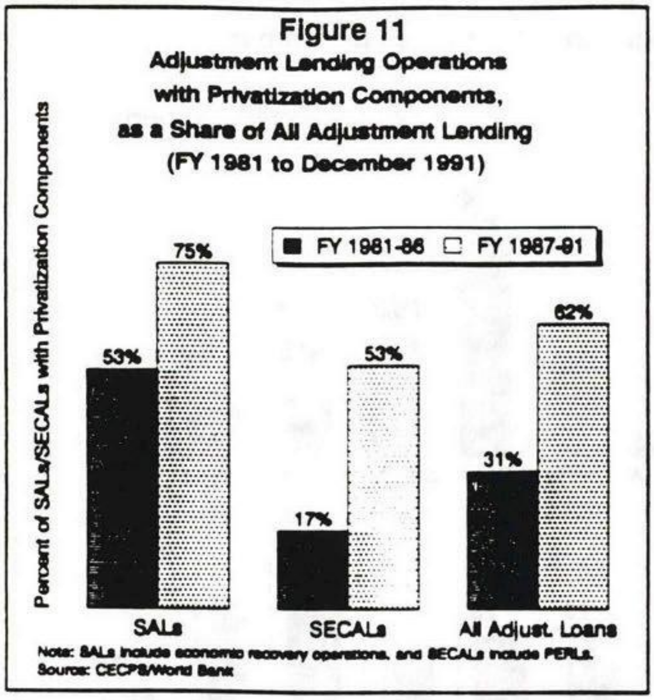


Figure 11
Adjustment Lending Operations
with Privatization Components,
as a Share of All Adjustment Lending
(FY 1981 to December 1991)
Percent of SALs/SECALs with Privatization Components
FY 1981-86
FY 1987-91
53%
75%
17%
53%
31%
62%
SALs
SECALs
All Adjust. Loans
Note: SALs include economic recovery operations, and SECALs include PERLs.
Source: CECPS/World Bank

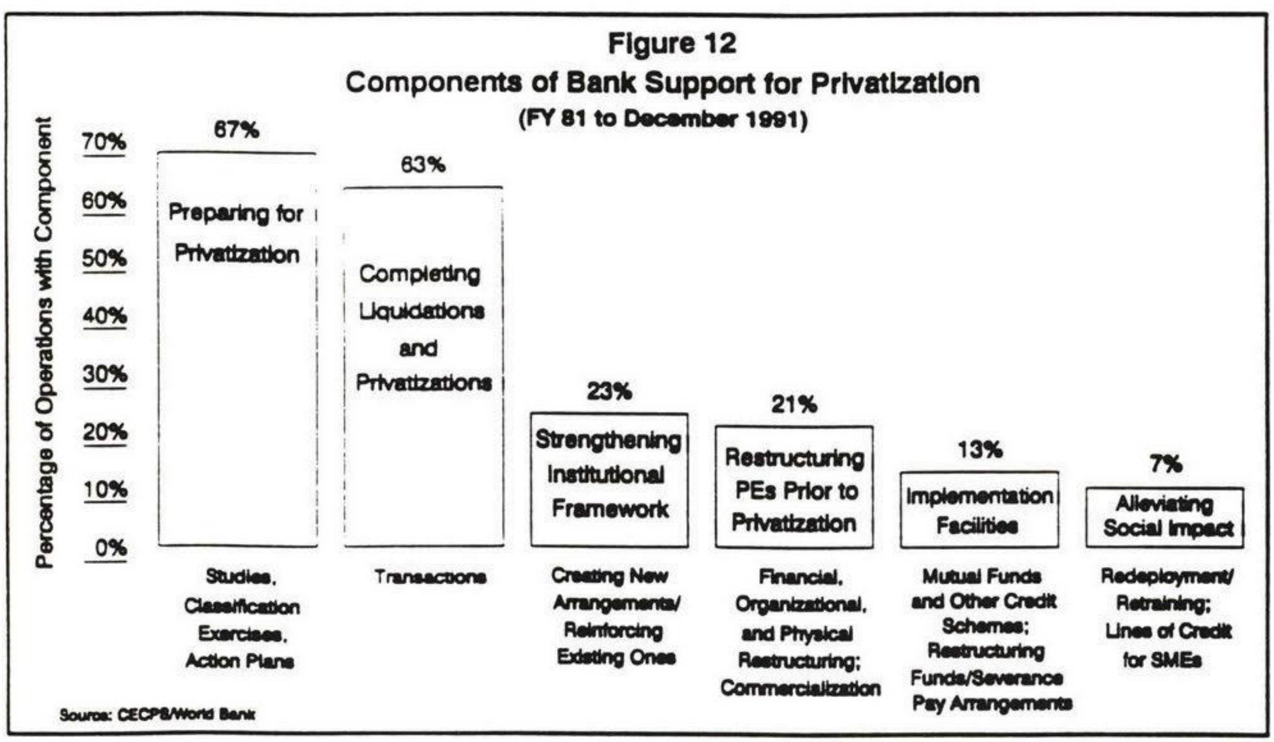
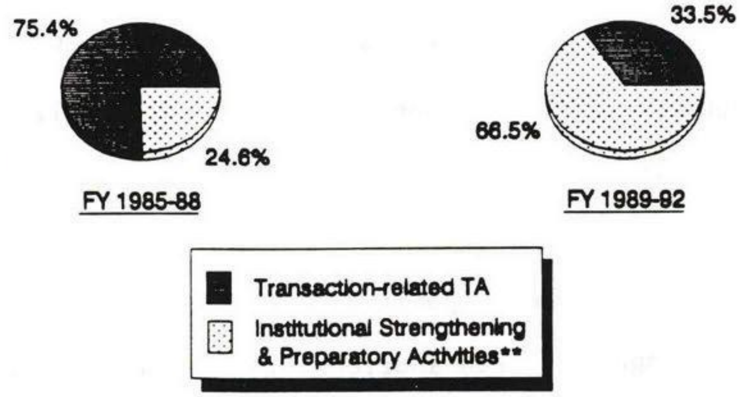


Figure 12
Components of Bank Support for Privatization
(FY 81 to December 1991)
Percentage of Operations with Component
70%
60%
50%
40%
30%
20%
10%
0%
67%
Preparing for Privatization
63%
Completing Liquidations and Privatizations
23%
Strengthening Institutional Framework
21%
Restructuring PEs Prior to Privatization
13%
Implementation Facilities
7%
Alleviating Social Impact
Studies, Classification Exercises, Action Plans
Transactions
Creating New Arrangements/ Reinforcing Existing Ones
Financial, Organizational, and Physical Restructuring; Commercialization
Mutual Funds and Other Credit Schemes; Restructuring Funds/Severance Pay Arrangements
Redeployment/ Retraining; Lines of Credit for SMEs
Source: CECPS/World Bank

Figure 13

Change in Privatization-Related TA Components*

(FY 1985-88 and FY 1989-92)



*Does not include 17 operations, whose privatization-related TA components could not be assessed in dollar terms, and 9 operations with TA components in which degree of transaction or other support could not be isolated.

**Includes studies, classification exercises, strategies & action plans.

Source: CECPS/World Bank

growing number of TA operations help governments intent on privatizing infrastructure develop the capacity to regulate privatized monopolies (particularly in LAC; for example, in Argentina, Venezuela and Mexico). The Bank also assists privatizing countries to build a social safety net, usually as part of the overall adjustment program.

Bank support for privatization has produced positive results, as documented in the previous sections. However, two shortcomings have also been observed:[63] (i) structural adjustment operations, because of their broad scope and short time horizons, are not optimal instruments to meet the resource-intensive needs of privatization programs. More in-depth lending instruments are needed to support privatization, including hybrid investment and policy loans, and technical assistance loans; and (ii) it is counterproductive for Bank operations to be overly specific concerning targets and deadlines for the completion of sales. Such deadlines provide investors with an unfair bargaining advantage, and can prompt hasty sales that rely too heavily on concessions and sweeteners. Both problems are being addressed, the first by operations focussing more narrowly -- but more deeply -- on privatization and enterprise reform issues; the second by the use of more flexible conditionality that tries to measure the seriousness of government commitment to privatization by noting passage of critical laws, bringing SOEs to the point of sale, creating the institutional framework, and privatizing some specified percentage of total SOE assets -- but not selling a particular enterprise by a particular date.

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[63] Nellis, 1989; Kikeri, 1990.

Role of the IFC. The developmental impact of IFC's privatization operations, as with its overall investment operations, is reflected not so much in the number or size of individual transactions as in their ability to strengthen investor confidence in the sectors/countries concerned. Though constituting a relatively small portion of the aggregate volume of business in the countries involved, these operations have been successful in catalyzing additional flows of risk capital, from foreign and local sponsors prepared to provide essential technical and management services. The focus has been on completing model privatization transactions, both to facilitate the supply response to macro reform and, in the process, to make IFC's transactional experience available to governments formulating privatization policy.

IFC's privatization transactions and fee-based advisory work, complements the Bank's policy and program support. Up to January 31, 1992, IFC invested in 20 completed privatization transactions, with another 10 approved by its management for appraisal during the fiscal year. The actual pace of these projects, the earliest of which dates back to 1986, continues to grow. Investments have been made in a variety of sectors, including development finance services, textiles, agro-industry, hotels, and iron & steel. Project size has varied from under US$5 million to over US$190 million; and IFC's own stake (equity and/or loan) from less than US$1 million to over US$60 million. The foreign sponsors in these projects viewed IFC's presence as an essential prerequisite to their own participation.

IFC's fee-based advisory services are a relatively more recent phenomenon. During the past two years or so, IFC has provided advice to a number of countries seeking to improve the efficiency of state-owned enterprises, through partial or complete privatization. East European countries, following the trend toward market-based economies, have been particularly important clients in recent years, though the list has included such diverse countries as Argentina, Philippines, Portugal, and Morocco. IFC's advice has also included the "buy" side of privatization transactions, on the operational and financial structuring of projects, and corporate sectoral development strategy.

An illustrative advisory assignment is the Skoda Plzen Advisory case. The company, Czechoslovakia's largest heavy industrial complex, with 18 production divisions in related but dissimilar activities, and employing some 38,000 persons, needed assistance in identifying and negotiating with an appropriate foreign joint-venture partner capable of transforming its energy and transport activities into internationally competitive business. IFC, which deployed considerable staff resources (around 100 sw) for this task, initially prepared a strategic review for the company, analyzing its strengths and weaknesses, and arriving at an action plan for the various product groups. The action plans were accepted and, for six product divisions, engaged the company in negotiations with prospective joint venture partners. IFC helped Skoda negotiate terms and conditions of foreign partner participation, and in structuring and drafting the definitive agreements. An agreement in principle has now been signed between Skoda and Siemens AG whereby Siemens will acquire a major equity stake on the basis of a set of firm commitments on financial contribution, capital investment, technology transfer, market access, management and training. The agreement will make Skoda a competitive producer and ensure continuing employment for much of its workforce.

B. MAJOR POLICY ISSUES FOR THE BANK GROUP

Let there be no mistake: improvements in public enterprise performance can be made without changing ownership. The Bank Group has long assisted its borrowers in finding ways "to subject public enterprises to as close as possible an approximation of the conditions and signals of a profit-maximizing firm, operating in a competitive market."[64] The amount of resources and time the Bank has spent on efforts to reform SOEs vastly exceeds those devoted to privatization. However, as repeatedly noted above, there are few cases in which reforms short of ownership change have led to a dramatic, and in particular an enduring, turnaround in performance. In a nutshell, performance improvements in SOEs have proven relatively easy to conceive, considerably harder to implement, and hardest of all to sustain. The lesson of experience is that privatization, though not always necessary to effect performance improvements, is necessary to lock in the gains and insulate the enterprise from continued political interference.

Bank Lending to SOEs. A considerable amount of Bank lending to SOEs operating in competitive or potentially competitive markets has not produced the anticipated performance improvements. Perhaps in recognition of this fact, Bank lending to such enterprises, particularly in the industrial sector, declined from 23 projects in CY 1989 to 12 in CY 1991. The principal reason for the decline has been the difficulties involved in attaining the stated

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[64] Country Economics Department, 1991, p. 23.

objectives of such projects. Moreover, the Bank strove to assure that lending to such enterprises would not provide governments with resources to keep persistent loss-makers alive, or delay private sector involvement in the solution to their poor performance problems, or tilt the level playing field toward the public sector.

But Bank lending to SOEs has sometimes -- inadvertently -- provided public firms with resources that allowed them to overwhelm their private competitors;[65] and it has sometimes caused governments to delay the opening of markets. That these outcomes were unintentional does not help. The fact is they occurred.

Does this mean that the Bank should not under any circumstances lend to public enterprises functioning in these markets? No: the Bank should and will continue to lend through financial intermediaries to enterprises producing tradeables -- public <u>and</u> private -- as long as they compete on a level playing field. The recommendation rather is that <u>the Bank should not lend directly to enterprises functioning in competitive or potentially competitive markets except where it can be shown that such lending will facilitate an agreed upon, time bound program to privatize that enterprise</u>. Adopting this policy would not appreciably affect the Bank's lending program,[66] but it would send

[65] In one African country, a well-intentioned loan to support a trucking SOE provided it with access to imported spare parts and fuel unavailable to several small, struggling private trucking firms. The SOE cut costs and the private firms folded.

[66] 54 of 228 (excluding SALs and social sector operations) Bank loans went to SOEs in calendar 1991. Only 12 of these went to enterprises functioning in what might reasonably be called competitive or potentially competitive markets. Of the 12, slight changes in the project formulation of 7

signals to borrower governments about the importance of assuring fair competition and the nature of needed reforms in SOEs producing tradeables.

Public monopolies in infrastructure and services constitute a somewhat different case. Bank lending is more easily justified to natural monopolies (though changing technology has altered the application of the term in sectors such as telecommunications). This is particularly so in economies where noncommercial risk is high, information is poor and costly to obtain, and capital markets are weak. Where these conditions prevail, privatization might be a longer-term solution. Large, "lumpy" investments may not be made by the private sector in the near-term, thereby delaying the development of infrastructure services essential for private sector development. This is the traditional justification both for government intervention and Bank involvement; the argument had, and retains, merit.

But here too Bank lending has in many cases not produced the desired or expected results. A recent review of lending to the power sector notes that, despite years of Bank lending and strict project covenants and conditionality, "performance and viability of many borrowers deteriorated steadily since the 1970s."[67] Other sectoral reviews in infrastructure reach much the same conclusion.[68] Although external factors are partly to blame, government

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could have brought the loan in line with the policy recommended in this paper, by altering vague allusions to eventual privatization to a time bound program of private sector involvement leading to divestiture.

[67]Power Sector Policy Paper, 1991

[68] For telecommunications see Nulty, 1987; Wellenius, Stern, Nulty, and Stern, 1989; and Ambrose, Hennemeyer, and Chapon, 1990.

intervention and management failure are also responsible. It is hard to disprove the assertion that Bank-provided money has sometimes given governments the resources to avoid rather than undertake reform. If the Bank reduced or re-cast its lending of this sort governments might well be pressured to adopt more appropriate policies of ending intervention and unrealistic pricing, and allow the private sector to play a more active financing and/or management role in these undertakings -- and that will in all likelihood increase efficiency and/or expand services. Moreover, many governments -- particularly in LAC and least-developed countries, perhaps less so in Asia -- have exhausted their capacity to finance modernization of infrastructure, and their track record on making past investments pay off is poor. Private investors have both greater access to capital markets, and a better record of management. Thus, <u>where there exists an alternative between public and private provision of investment capital, preference should be given to the private source -- provided that the conditions of the private investment are structured so as to enhance efficiency and promote modernization and expansion, and as long as access of the poor to essential services is safeguarded</u>. Where there is no private alternative, the Bank should actively try to seek and involve private investors.

<u>Bank Instruments for Supporting Privatization</u>. In many of the Bank's borrower countries it was the non-existence or embryonic nature of the indigenous private sector that led authorities to rely first on SOEs. In many of these same economies the local private sector has grown greatly, but there are still a good number of borrowers -- many of them in Africa -- in which the private sector lacks the size, experience, and access to capital to take on, unaided, formerly public roles. And even where foreign investors are welcome, their calculations of non-commercial risk may lead them to reject financially attractive investment opportunities. In sum, it is not enough simply to assert that many previously public activities should be turned over to private hands; in developing countries the process requires external assistance and support.

What can and should the Bank Group do to help?[69] One way would be to amend or reinterpret the Articles to allow direct Bank (and not just IFC) lending to private operations; that is, lending to the private sector without a government guarantee. Conversely, the Bank could lend to private operations, but those operations would be granted a government guarantee. The first option was examined by a Bank Working Group ; its conclusions are not yet available. Since the Bank Group already has, in the IFC, an instrument for lending directly to the private sector, one logical recommendation is that the IFC continue these activities, with expanded resources if need be. The second option -- government guarantees of private sector investments -- would constitute a serious distortion, and is rejected.

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[69] The Bank has long lent guaranteed funds to financial intermediaries, which then on-lent to purely private borrowers. These institutions have performed poorly (and steps have been taken to strengthen their capacity and apply more rigorous criteria for Bank support). Still, even if well-functioning, these intermediaries would not be able to take on the burden of supporting large, lumpy investments in newly privatized enterprises. Another mechanism in which the Bank has participated is leveraged cofinancing arrangements. However, there is some question as to whether they result in an appreciable reduction in a government's commercial risk. In any case, cofinancing and credits through intermediaries should be equally available to public and private projects alike; the issue is not specific to privatization.

Yet another option would be for MIGA to broaden its eligibility criteria for loan coverage and begin to insure against a wider variety of risks. This would require amending its Convention. But even an expanded MIGA would require some time to bring its activities up to speed. The interests of the borrower countries might therefore be advanced, at least on an interim basis, by greater use by the Bank of its guarantee authority. The major advantage of Bank guarantees over direct government-guaranteed Bank lending is that the former can be structured to reduce or eliminate only the private sector's non-commercial risk in a project, leaving all commercial risk to the private lenders -- who have a comparative advantage in this activity because they directly face the consequences.

The Bank recently approved the Enhanced Cofinancing Operation (ECO) facility, partially covering risks on project loans for new private sector projects extended by foreign and domestic commercial banks in borrower countries.[70] Similar guarantee facilities could be used to diminish limited risks in order to encourage private investment in previously public activities, particularly in large infrastructure projects.

Specifically, the Bank might guarantee foreign exchange convertibility in favor of third party lenders. In such an arrangement the Bank would not be liable, and the guarantee could not be called, for purely commercial shortcomings of the project. The guarantee would be called (and the Bank would be obliged to pay the private creditors) only in specialized

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[70] The Pakistan Hub River Project was recently approved. A guarantee facility is currently under consideration in the energy sector in Chile.

circumstances; for example, if the project generated adequate domestic currency for debt-service, but the government prohibited repatriation in foreign currencies. Other sovereign risks, determined on a project-specific basis, against which a Bank guarantee might be provided include those associated with expropriation or the tariff regime. Guaranteeing exchange rate convertibility has the added advantage that it can be clearly specified, reducing the chance that the Bank would become embroiled in disputes about the definition of non-commercial risk. The subject is large and intricate, and merits further study.

Bank Financing of Severance Costs. The most salient obstacle to privatization the world over has been concern with its impact on employment. Workers and unions fear that privatization will cost them their jobs. Governments fear that employee and public opposition will cost them politically. Treasury officials fear that the costs of previously negotiated severance packages are unaffordable. The fact that privatization has, in several instances, led to increased employment does little to allay the concerns of workers who see their livelihood at stake. Attractive severance packages are thus essential to conclude sales and closures: they can limit opposition and help create a social safety net. Recognizing the importance of this issue, Bank operations in Tunisia, Argentina, and Mali developed policy conditions to ensure that governments set-aside funds for severance pay (local counterpart funds were used). The Bank's Articles of Agreement limit lending to "productive purposes," and the current interpretation is that direct financing of severance pay in projects is not allowed.

But strong arguments have been advanced to show that severance costs can and should be viewed as economically productive investments.[71] When combined with institutional reform, they provide a measurable stream of benefits over a period of years.[72] These benefits arise from the reallocation of resources, both financial and physical, made possible by the reduction or elimination of redundant staff. Reducing the wage bill allows enterprises to increase investment, and reduces the demand (and the justification) for subsidy or protection. The reallocation of labor can increase efficiency in the enterprise and the economy as a whole. For these reasons, <u>it is recommended that the Bank directly finance severance costs, while applying safeguards against bidding up the price and against "revolving door practices</u>."[73]

<u>IFC Competition in Bank Projects</u>. As a general principle the IFC should <u>not</u> be allowed to compete in Bank-financed privatization projects and programs. The reason is simple; it would constitute -- or appear to constitute -- a conflict of interest, since it would be difficult to guarantee a fair and independent selection where one of the competitors is a part of the funding agency. But some markets, particularly the least-developed ones, are likely to be ill-served by private investment banks. The developmental role of the World Bank Group can be construed to justify a classification of such

[71] Galenson, 1988, 1990.

[72] A recent study of redundancy in the transport sector shows that the pay-back period for severance pay ranges from 4 months to seven years. The evidence shows that, most often, savings outweighed costs in a relatively short time, usually one to three years. See Svejnar and Terrell, 1991.

[73] Safeguards are needed to guard against the danger that Bank involvement might raise the levels of payoff and payout, and governments might allow retrenched staff to leave by the front door, with a healthy sum, and return to the public payroll by the back door.

markets as exceptional. The problem is that the administrative mechanisms one might devise to ensure that a market is "exceptional" -- for example, denoting the IFC as the investment bank of last resort, and allowing it to compete only in cases where no other investment bank shows interest -- would be costly and difficult to enforce, and would not solve the problem: in all likelihood, the IFC would not incur the costs of competing in a market where the unexpected arrival of another investment bank would force it to withdraw. A simpler, though more arbitrary method could be considered: <u>the IFC could be allowed to bid on privatization advisory services, funded by Bank credits, only in IDA countries</u>. (This section subject to revision to reflect the decision of the President's PSD Committee.)

Finally, and while not directly a privatization issue, the Bank Group and its borrowers should take special note of the important role of free entry by private operators as a means of shifting the public/private dividing line. The experience of Korea shows it is possible successfully to restrain the expansion of public enterprises, and at the same time encourage the rapid dominance of a dynamic private sector. Hungarian authorities, as well, are pinning their hopes for economic growth more on the burgeoning new entrant private sector than on privatization. The Bank Group should therefore be willing to support approaches to "marketization" that rely only partly on privatization -- but only where such an approach is accompanied by strong, sustained efforts to encourage the growth and primacy of competition.

ANNEX

The Privatization Experience of Poland, Hungary and the Czech and Slovak Federal Republic

The three most advanced privatization programs in ex-socialist countries (outside east Germany) are found in Poland, Hungary, and the CSFR.

Poland

Poland has successfully privatized about 80,000 small and micro enterprises. Through the end of September, 1991, 16 large firms have been sold through public offerings or "trade sales" -- direct sales to a purchaser, normally foreign, in the same line of production. Some 667 firms, of which 281 employ more than 200 workers, have been partly or fully sold after legal liquidation, the new owners usually being the managers and/or workers in these companies. The goal for 1992 is to privatize 30 or 40 more firms through direct sales, and another 1,000 enterprises by the liquidation-buy out method.

A "mass privatization" scheme is scheduled to come into effect in 1992; it will assign groups of large enterprises (200 in total) to between five and twenty financial intermediary institutions called National Investment Funds. The NIFs will actively manage some few companies in their portfolios, and passively hold shares in a number of other companies. The NIFs will be owned by the Polish people, who will receive, at low or no cost, shares in these holding companies-mutual funds. Difficulties in getting the mass privatization program off the ground have led Polish authorities to hire teams of investment bankers and consultants to review 35 branches or sectors of industry, and propose divestiture/workout plans for groups of firms. Activities are underway in several sectors, including detergents, cosmetics, brewing, pulp and paper, and power engineering. The idea is that the banker/consulting teams will rapidly prepare whole groups of firms for sale, find buyers, and arrange the transactions. The IFC is handling the cement sector.

Hungary

Of Hungary's 2,200 industrial SOEs, authorities estimate that 100 will remain state-owned, 400 will be liquidated, 800 of the medium to smaller sized firms should be sold (or have been sold) easily and rapidly, leaving a somewhat more manageable 900 medium and large enterprises as the problem group. As of end September, 1991, 339 "enterprise-initiated" privatizations have been approved by the State Property Agency;[1] this is a process whereby an SOE is transformed into a private firm in a combined management buyout-new foreign investment operation.

In 1989 and early 1990, an unsupervised form of this process, called "spontaneous privatization," resulted in managers, and their foreign partners, becoming owners; in most of these cases either the price paid for the assets was low, or the state was left with a small amount of low interest bonds, or both. Much of the Hungarian population regarded this as little more than theft. In mid-1990 the SPA was brought into being; it instigated financial and legal reviews of such privatization proposals. The theft stopped; but so did privatization. Critics then accused the SPA of obstructing divestiture because of its caution and bureaucratic procedures. The SPA has since attempted to

[1] The SPA is the government organization that owns and operates SOEs prior to their sale, and reviews -- and approves or rejects -- all proposals for their divestiture.

streamline and speed up the review process, and it has introduced simplified privatization procedures for firms with less than 300 total staff, and for enterprises in which a private investor has expressed a strong interest. These schemes have yet to produce substantial results.[2]

In its "active" privatization program, Hungarian authorities are attempting to sell through public offerings or negotiated sales some 20 large and generally well-performing enterprises. An open competition was held in 1990 to select privatization facilitators/advisors for each of the 20. These were chosen; they are at present in the process of readying the firms for sale, attracting foreign investors, and structuring the transactions. But after more than a year of preparation, none of the 20 have been sold; and a second wave following similar procedures remains in its early stages.

Despite the slow pace of sales, Hungary has no "mass privatization" or "voucher" scheme. Partly this is due to the more evolutionary nature of the transition from communism in Hungary; the notion of enterprise managers becoming owners is less objectionable there than in Poland, the CSFR or some other countries in the area. But the rejection of the mass approach is also due to the Hungarian government's emphasis on the goal of placing "a reliable and responsible owner; someone who represents capital and bears real risk"[3] in charge of the privatized firms. The Hungarian government intends to increase the speed

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[2] As everywhere in the region, Hungarian privatization is proceeding more slowly than planned. But Hungary has had remarkable success in generating new entrants into its private sector; new private businesses increased by 100 percent in 1990; and there has been a further 50 percent increase in the first half of 1991.

[3] As stated by Mr. Lajos Csepi, Managing Director, State Property Agency, Budapest, at the Second Annual CEEPN Conference on Privatization in Central and Eastern Europe, Vienna, November 30, 1991.

of privatization by further lightening or eliminating the SPA review procedures; it has no plans to introduce a mass privatization scheme.

More than 1,000 small shops have been privatized; most of these have been sold, and about 300 have been leased. In contrast to Poland, this small privatization process has proceeded more slowly than planned, due to disputes over which level of government owned the firms, and high floor prices that have discouraged bidders at auctions. The intention is to speed the process in 1992.

The CSFR

The CSFR started its transition and privatization processes at a later date, and results regarding large firms so far are more modest. However, as of November 1991 about 20,000 small and micro "business units" have been sold or leased, through auctions (out of a reported 100,000 total). In a first auction round, a floor price is set at 50 percent of book value; bidders are limited to citizens. If no buyer is found, the floor price drops to 20 percent of book, and the second round is opened to foreigners. Reportedly, 90 percent of completed sales (through August 1991) went for more than the floor price; divestitures to that date generated $190 million for governments. Proceeds are split 70-30 between the federal government and local authorities. CSFR authorities state that 40 percent of services and retail trade is now in private hands.[4]

By the end of 1991 authorities estimate that between 70 and 100 large SOEs will be privatized through direct sale to a foreign investor. A number of large, well publicized transactions have been concluded; Volkswagen purchased a

[4] Dusan Triska (Advisor on Privatization, Federal Ministry of Finance, Prague, CSFR), "Voucher Privatization: Czechoslovakia," paper presented to 2nd Annual CEEPN Conference, Vienna, November 1991.

controlling interest in SKODA automobiles; Siemens has purchased a SKODA electronics operation (with the involvement of the IFC; see above, section VI); Proctor and Gamble has acquired a large soap-detergent maker, and a number of other major acquisitions have been concluded.

The CSFR approach drawing the most attention is "voucher privatization," a scheme that gives CSFR citizens, at very low cost, the opportunity to invest in particular privatized firms, or in investment companies holding a portfolio of privatized firms. The proposed system is much larger than the roughly similar Polish mass privatization scheme, encompassing, in the Czech Republic alone, 1,703 SOEs in a first wave (and the entire remaining 1,250 in the second); it will also include in the first wave 634 firms controlled by local Czech governments (and 429 of these in the second wave). Reportedly, some 700 Slovakian firms will be divested in the first privatization wave. "144 enterprises will remain unprivatized in the coming five years."[5]

The CSFR voucher scheme is also far more complicated than the Polish proposal. The steps are as follows:

* Any citizen over 18 can buy, for 1,000 Crowns (one weeks pay), a voucher booklet containing 1,000 "investment points."
* Vouchers have to be registered before use.
* Voucher holders obtain information on the companies up for sale, as government will make available "information about the accounting value of

[5] Figures and quotation from Charles Jellinek-Francis and Eva Klvacova (Advisors to the Ministry of Privatization of the Czech Republic), "Country Privatization Report: Czechoslovakia," paper presented at 2nd Annual CEEPN Conference on Privatization in Central and Eastern Europe, Vienna, November, 1991, p.11.

the property...and the portion of their shares that will be privatized by the voucher method."[6]

* Holders can then exchange some or all of their investment points for shares in one or more newly created mutual funds.
* Or they can attempt to exchange some or all of their investment points for shares in a particular firm. Their bid for shares in a particular firm may not succeed, because the scheme contains an elaborate method to try and match supply and demand. That is,
* government supervisors set an initial "price" per share; the price is the number of investment points it will take to obtain a share.
* If voucher holders bid more investment points than there are shares available in a particular firm (at the initial "price"), all orders are cancelled.
* A second bidding round ensues, in which it takes an increased number of points to buy a share. Four or five rounds can take place in any one "privatization wave."
* On the other hand, too few investment points may be bid, in which case not all shares are sold. When this situation occurs, all those who bid receive their shares -- at the price they bid -- but a second round offers the remainder at a reduced price.
* Subsequent rounds reduce the price until the market is cleared.
* Finally, voucher holders can mix their bids, investing some in funds and some in individual companies.

The process began in earnest in the fall of 1991; all SOEs placed in the first wave submitted on 31 October "privatization projects" -- proposals stating

[6] Triska, op. cit.

whether they will be privatized by management or worker buy out, by private investor involvement, by the voucher scheme, or any combination thereof. (Firms cannot opt to remain public.) Republican ministries of privatization were originally given 60 days to approve or reject the proposals, but, recognizing the complexity of the task, the review period has been prolonged (and subsequent steps somewhat delayed). The first round of privatization bidding is scheduled for the spring or early summer of 1992. If it works, it will result in a very rapid transfer of perhaps 3,000 medium and large firms into private ownership.

Will It Work?

The architects of the CSFR program are at pains to state that the intention is not to distribute wealth; it is to parcel out the responsibility for running, indeed, cleaning up the economy. Nonetheless, it is likely that most citizens participating in the scheme view this as an opportunity to make money -- else why would they pay for the voucher booklet? Presumably, some citizens will feel that government, having "sold" them the vouchers, bears some responsibility for the future performance of the privatized firms. Another percentage -- larger, it is hoped -- may treat their voucher booklet as a lottery ticket; that is, as a relatively low cost chance to realize a substantial gain. Some may invest their points in round one and then find that not all shares were taken. This means that in subsequent rounds a smaller number of points will be sufficient to obtain a share; this may cause some problems among a population unaccustomed to exercising choice and judging risk. The most important potential problem is for those investing in individual firms; many inexperienced and information-short investors are bound to invest in enterprises that will not pay dividends, and that may not even survive. However, this may not be a large number. Hundreds of intermediary investment companies came into existence at the end of 1991 and early in 1992 (at least one "guaranteeing" a tenfold return on investment) and it seems that many millions of citizens are now obtaining vouchers, and that a good percentage of these will be invest in these intermediary firms.

CSFR authorities respond to all speculation by noting that the alternative to having citizens exercise choice and responsibility is for the government to try to do it for them -- and the past forty years demonstrate the futility of that approach. That people pay different prices for the same product, at different times, is a normal feature of the market. That people invest or spend their money with imperfect information is also the norm in capitalist economies. The point is that, for the CSFR authorities, the goal is not reform, it is "economic transformation;" and privatization "is the transformation itself."

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