PRIVATIZATION AND ECONOMIC REVIVAL

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Introduction

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This report covers the theme of Privatization and Economic Revival, which was discussed by a number of leading privatization experts at the Fourth London Conference on Privatization held in Westminster. The London Conference has now become a principal event in the international privatization calendar; and at the Fourth Conference we welcomed over 250 top-ranking delegates from 50 different countries and different territories.

London has become the natural home for such an important event. Nowhere does there exist a greater concentration of expertise in privatization than in the United Kingdom. The privatization programme in the UK started before those of other countries, and has included government companies and services that are larger and more diverse than those privatized anywhere in the world.

British merchant banks, marketing agencies, policy analysts, stockbrokers, management consultants, accountants, and other institutions now have so much knowledge about how to make privatization work that their advice is one of the UK's most thriving export industries.

It has become clear that professional advice is essential for any country embarking on a privatization programme. It s very easy to make mistakes and to jeopardise the entire strategy right at the outset. The experts we have assembled in this volume will admit to their share of mistakes; but from those occasional errors has come a wisdom that is all the more deep. And they know from experience that every country, indeed every industry or service within any one country, has its own special circumstances that must be understood and its own special problems that must be overcome.

The practical and world-wide experience of our contributors prompted us to concentrate this report onto the special features of privatization in developing countries. This resulting report provides policymaker in the developing world with a manual of great insight, which should help them press ahead towards the important political and economic benefits which privatization can bring.

PART 1 - PRIVATIZATION AND ECONOMIC REVIVAL

Chapter 1

PRIVATIZATION AND ECONOMIC REVIVAL

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Privatization is an important component of the structural changes which are sweeping the developing countries and will help determine whether their transition to more market-oriented strategies will be successful and sustainable.

I would like to discuss the following points from the perspective of the developing countries:

the role of privatization in the context of structural reform programmes;

the link between effective privatization and sustainable market-oriented development strategies; and

some of the basic elements for effective privatization.

Structural reform programmes

Structural reforms are being undertaken in many developing and Eastern European countries. Much of this work has been supported by the World Bank which, to date, has lent $26 billion of Bank and $6 billion of IDA resources in support of adjustment programmes. The success of these programmes varies widely, but the evidence is quite strong that in countries which persevere with their adjustment efforts, growth rates improve, investment levels and efficiency increase, and export capacity expands. The core aspects of the adjustment programmes are fundamental and common to most countries. They include:

1. Major trade liberalization, which involves both a reduction in the level of protection and a harmonization of that level across sectors, and where quantitive restrictions are replaced by tariffs.

The objectives of trade liberalization are to introduce competition for private and public enterprises alike; to terminate public sector distributional monopolies; to eliminate distortions between sectors which reflect governmental rather than market views of priorities; and to promote exports by making incentives to produce for the domestic and foreign markets more nearly equal.

2. Stabilization of the economy by reducing the fiscal deficit, establishing real effective interest rates, and decontrolling prices. The reduction of the fiscal deficit normally involves closing the special access of public enterprises to the Treasury or Central Bank to cover operating losses; pruning the investments of public enterprises unless financed by the commercial credit system; and reducing public subsidies.

The objectives of the stabilization programme are the obvious ones of restoring price stability and a sustainable balance between available resources and demand. But the objectives go beyond that, because embedded in the macro-economic imbalances, in fiscal policy, in the credit and tax systems, are structural distortions built up over the years which affect the operation of enterprises in two fundamental ways. On the one hand, they incorporate privileges, monopolies or oligopolies, and other restraints on competition which benefit both existing private and public corporations. On the other hand, they incorporate impediments to managerial discretion, innovation, entrepreneurial initiative and generally discriminate against the private sector by limiting new entrants. Both sets of factors create a far from level playing field for a competitive, market-oriented system. Stabilization programmes must, therefore, go beyond restoring a balance between savings and investment, government revenue and expenditure, and address directly the distortions which, of course, have immediate revenue and investment implications but have much longer term structural significance as well.

3. Reform of the public sector. This often is vital because the operation of the public sector often is at the core of macro- economic imbalances and distortions from market-based incentives.

The objectives of public sector reform are to eliminate special access to the budget to cover operating losses and place the public enterprises in a competitive framework and to reduce the extraordinarily large number of public corporations which usually exist. In addition, the administrative offices involved in the many control procedures -- prices, licences, import permits -- must be restructured since, without redeployment of such staff, the tendency to perpetuate 'oversight' is strong, as is the tendency to revert to controls in case of difficulty.

The role of privatization in reform

Privatization is a fundamental element in the restructuring of economies. As an objective, it is widely endorsed by those governments undertaking adjustment programmes.

To understand the objectives of privatization, and to form realistic expectations about progress, two kinds of information are crucial.

First, we need to know where the developing countries are coming from. Why and how did the public sector get so overgrown in the first place? It was not accidental. The concerns which led to the growth of the public sector have not disappeared, though the role models --- in the industrialized countries and in academia -- are themselves now supporting different approaches. But if privatization in developing countries is to be successful, and sustained, it will have to be sensitive to these issues.

Second, we need to know where the developing countries are trying to go. Privatization is not generally seen as an end in itself nor as an ideological conviction. It is a logical component of a much broader reform programme. The scope and sequencing of this broader reform effort will have a critical impact on the pace and the character of privatization and the prospects for success.

I am sure you are well aware that a policy which emphasizes reliance on private initiative and a reduction of the government's direct role in the provision of goods and services represents a significant departure from the past conventional wisdom of development policy.

The conventional wisdom

In the early postwar period, there was a widespread belief that private initiative in developing countries would not be sufficient to develop the industrial and agricultural base, provide adequate marketing and distribution channels, or foster an efficient allocation of financial resources. It was felt that relying on private development alone would mean that the necessary modernization of developing economies would progress too slowly. Furthermore -- and this was particularly sensitive in the early post-colonial period in many countries -- politicians and policymakers felt that critical sectors in the economy would not function in a socially acceptable fashion if they were not controlled by the state. This concern was complicated by nationality and ethnic concerns -- involving not only foreign ownership, but also minority dominance of the private sector.

The objectives of the policy of state intervention often were justified by the initial conditions. In many countries, the private entrepreneurial class was indeed small; managerial talent scarce; and the focus of private entrepreneurs was on trade rather than production; on monopoly rather than competition.

Policy failure

The basic policy of state intervention failed for two reasons. First, it did not allow for the political dynamics of the system that was created. The policy assumed that public enterprises would operate in a framework of market accountability, management autonomy and incentives for efficiency. But the political institutions were unable to deliver such a framework. Governments have many objectives, and the weaker the political system, the more intertwined these become. It simply turned out to be impractical for governments to manage their investments in public enterprises without these other concerns vitiating the efficiency objectives. The all-too-frequent response of turning to the budget was perhaps predictable and so were the results.

And second, the vested interests created made the system permanent, and expansionary, even though the private sector's capacities developed. What might have been an appropriate catalytic public sector role in the early stages of development turned into a long-term arrangement which then hampered the evolution of the private sector.

The net result was not only a failure to develop a competitive and efficient productive sector, but also a failure to meet the social objectives -- employment and poverty alleviation -- on a sustainable basis.

These two factors led to a third -- the high and ultimately unsustainable cost of a large, but generally inefficient, public sector. In developing countries, the costs of large-scale public sector involvement were greater than in the industrialized countries because state intervention involved not only nationalization of a developed industrial structure, or expansion within such a structure, but the development of new industries within a generally small modern sector. Thus, the investment decision, the choice of sector, product mix and technology was in the state domain and hence far removed from market discipline. As a result, today a number of developing countries are saddled with inefficient public sector enterprises which, because of their visibility and the public funds which have gone into financing and maintaining them, are an embarrassment to their governments.

The changing strategy

Developing countries have begun to change their approach to the public sector for very practical reasons. In many countries, the public sector had become a severe drain on budgetary resources, often generating a significant share of the fiscal deficit. To compensate for their inefficiency, public enterprises often obtained privileged treatment in the allocation of credit, were granted monopoly positions protected by trade restrictions and limitation on entry in their sector, and had their operating losses covered by the government -- which borrowed abroad to finance them. Also, particularly in the low-income developing countries, the large public enterprise sector placed demands on public administrations, often critically deficient in managerial skills, which simply could not be met.

The tangle of political interests that have long been served by the public sector enterprises makes it difficult either to improve their efficiency or to transfer ownership, though many developing countries are firmly resolved to do just that. Nonetheless, we would do well to remember that some of the initial concerns which justified a heavy reliance on the public sector -- the nature of ownership, the behaviour of private owners, and the broader social objectives -- still exist in many countries.

Policymakers in countries undertaking structural reform have concluded that the operations of public enterprises cannot be sustained and that reliance must be shifted to the private sector for investment and growth. What is less clear is the extent to which this commitment in principle also will involve a substantial disposition of existing assets; and if this is not done, what the implications are for the long-term sustainability of a market-oriented economic structure.

Some examples

The number of countries that have undertaken public enterprise reform programmes, including privatization, is quite large; but I would like to give just a few examples to highlight both the progress made and the operational difficulties encountered.

Mexico: In Mexico, public enterprises were spread throughout the economy. They represented an important legacy of the Revolution and were used liberally to maintain political consensus. Since the privatization process started in the early 1980s, about 700 of 1100 public enterprises have either been disposed of or the process is well underway. A large number have been privatized; others liquidated or merged. As such, it is one of the world's largest privatizations. The radical adjustments required to cope with the debt crisis made it easier to build political consensus for privatization and the dramatic economic liberalization that Mexico has undertaken created an environment suitable for increased reliance on the private sector.

But the Mexico experience is relevant precisely to the issue of asset transfers. As is the case in almost all countries undertaking privatization, those enterprises operating in competitive sectors where private enterprises already operate, with the lowest debt burden, smaller labour forces, and receiving relatively small budget transfers were the easiest to sell. The figures for the disposition of a subset of the portfolio of public enterprises, those operating under the Sector Ministry for Energy, Industry and Mining (SEMIP) are illustrative. This Ministry was responsible for about 400 enterprises in 1982. Slightly less than 100 have been kept. But while the remaining enterprises account for 25% of the **number** of enterprises they started with originally, they also account for 60% of the labour force, 70% of sales, 80% of total assets, and 85% of government transfers to enterprises in this ministry. I mention this not to detract from the progress in Mexico but to highlight how much there is yet to be done.

Turkey: It is interesting to contrast Mexico's programme with that of Turkey, since in both countries the public enterprises have deep historical roots. And both countries have made major progress toward a more market-oriented economy.

Although the government made the privatization programme a major objective in Turkey, and despite the fact that Turgut Ozal, Prime Minister for most of the 1980s, and now President, is strongly committed to it, there has been relatively little progress. It is difficult to determine precisely why this is so, but it seems fair to say that Turkey represents a case where it has not been possible to translate political commitment at the top into the consensus in the public at large that is needed to overcome the practical problems that all privatization programmes must face. In Turkey, the public sector is so closely linked to Kemal Ataturk's legacy and the national identity that dealing with divestiture on a large scale may simply be premature. But it is also important to note that the economic pressure for privatization in Turkey has been reduced by the very significant progress which has been made in reducing the burden of the public sector on the economy through the adjustment programme and through better management of their external debt problem. Budgetary transfers to public enterprises have been substantially reduced, most price controls on their products lifted, and preferential access to credit essentially abolished.

Africa: In sub-Saharan Africa, a number of countries are trying to implement privatization programmes. Some small countries such as Togo have made impressive progress. In many of these countries, the policy framework and past investment choices were particularly distorted, and governments have had to make courageous and painful decisions to liquidate a number of enterprises. In some cases, in order to consummate an agreement with private purchasers, concessions such as tariff protection and tax rebates on inputs have been provided. This is a dangerous precedent. Substituting private for public monopoly cannot be the objective of privatization. Indeed, such an approach will soon produce a backlash to the reform programme and is, in any event, inconsistent with progress toward a market- based economy.

Nigeria is undertaking a privatization programme now which has a number of interesting features. The stock market was already well developed when the programme started, and all of the thirty-odd companies privatized so far have been sold through stock market flotations. To build consensus for the programme, a special technical committee with broad representation from the private and public sector and all geographical regions of the country was established to fix the outlines of the programme and set priorities. To oversee and monitor implementation of the programme, the government appointed a very independent-minded private businessman, and gave him a strong and unambiguous mandate to get things done.

The above brief listing of privatization experience is intended only to highlight a number of different approaches, problems, and rates of progress. The rate rate of progress, even in countries with apparently similar conditions, can vary. They are background to the second question I raised at the outset. Where are the developing countries trying to go? What is a reasonable set of expectations about their future progress?

The constraints

We need to look at three different aspects in assessing what is feasible in a particular country. The first determinant is the set of social and economic objectives of the country. While these vary in range widely, no country aims for a full divestiture of public assets in the productive sectors. The divestiture of public assets is seen as a means toward two objectives -- a more efficiently functioning and productive economy, and a public sector which can discharge, on a sustainable basis, its responsibility for social services, physical infrastructure, a viable banking and financial sector, and for markets which can operate efficiently in a competitive environment. To achieve that with a limited financial and administrative resources, countries are prepared to shed a considerable portion of their investments and operations of producer companies.

A second determinant is the stage of development of the economy. A middle-income country with a substantial private sector, an important industrial base, a diversified agricultural sector and an existing capital market offers more scope for divestiture than a low-income country, with a monoculture agriculture and little private industrial capacity.

In the short term this latter set of countries is heavily dependent on foreign investment for privatization. Yet the interests of foreign investors in privatization in these countries is limited.

The third determinant is the institutional capacity for divestiture. Privatization is not, and cannot be, seen to be solely dependent on foreign investors; it must rely on a vigorous domestic private sector and the expansion of domestic ownership if it is to be sustainable in the long term.

Given the very different circumstances in the developing countries, it is not surprising that progress to date has been mixed. There is no doubt that the countries involved are committed to privatization as a central instrument of their economic restructuring, but much more can, and indeed must be done to expand privatization efforts and to deepen their effects. In commenting on some of the elements for successful privatization I also want to identify how the international community can assist the process.

The problems for investors

Even in the developing countries that have been the most successful in privatizing, the fact remains that all retain a sizeable public sector for a variety of reasons. A number of basic structural measures are needed to expand the scope for privatization and to expand the universe of enterprises that can be privatized. One major problem in achieving a major divestiture is the difficulty of effecting such a substantial transfer of assets. Private investors must wish to acquire assets which often represent a significant share of the total productive assets in the economy. It is frequently overlooked that such a massive portfolio shift is quite unrealistic over the short term if the link between ownership and management is not to be lost. Foreign investors can play an important role, but even aside from any political constraints to foreign ownership, a quick glance at the statistics for foreign capital inflows to developing countries suggests that it is unrealistic to expect them to purchase a substantial share of public assets.

In the long term, success of any large-scale privatization depends on the strength and capacity of the domestic private sector. Its evolution usually requires a significant improvement in the business climate and all that involves in terms of legislation of property rights, an improvement in the regulatory system, and an improvement in investor confidence.

Unfortunately, it is often the case that those countries which have decided to address the problems in their public sector are also suffering from macroeconomic instability and heavy external and internal indebtedness. And, private entrepreneurs may be reluctant to make major investments in the uncertain environment that this creates. Furthermore, as some of the examples I discussed indicate, and in contrast to most industrial country experience, privatization efforts may be costly to LDC governments in the short run. Therefore, a strong macroeconomic adjustment effort is often an essential prerequisite to large- scale privatization. In those countries where the World Bank has been involved in privatization programmes, developing a sound macroeconomic framework is typically part of the package of policy reforms that we recommend. But even if the stabilization programme is successful, it takes time to build the necessary investor confidence. History is not forgotten so quickly; and no investor can be sure that the new approach to development strategy is sufficiently institutionalized to survive the stresses which fluctuations in the world economy will impose.

The information gap

An important step in formulating and phasing any privatization effort is information. But one of the major obstacles often faced by policy makers in developing countries is the lack of accurate and useful information on public sector holdings.

In many countries, information on the number of public enterprises, their functions, the ministries to which they report, and the inter-relationships among firms in terms of stockholdings, indebtedness and special business arrangements, is not available centrally. Accurate financial information on specific firms is even more difficult to obtain, partly because public administration and oversight of the firm has been weak and partly because financial performance has often not been the focus of what oversight there has been. Also, in both the public and private sectors in developing countries, the state of accounting standards and application of the principle of accurate financial disclosure in enterprise accounts is very far behind what most investors expect and what is necessary to put these enterprises on a commercial basis. High inflation and rapid devaluations in many developing countries further aggravate the problem of accurately assessing the financial status of firms.

The lack of such information can undermine the credibility of the divestiture programme False starts with companies coming on and off the list of firms slated for privatization soon leads to the perception that there is no strategy and investors draw their conclusions about the likely business climate.

Technical barriers

Developing country officials have also met difficulties in managing the technical aspects of privatization transactions.

Valuation: One key barrier is valuation. It is always extremely sensitive for any public official to agree to a sale price which is below the presumed book valuation of the enterprise -- regardless of the reality. Yet, it is almost always as frequent that purchasers simply do not wish to buy at that price.

Some ingenuity is needed to devise measures of valuation that more appropriately approximate a marketable price and which still have enough rigour to convince observers that the transaction is fair and has been agreed at arm's length. The absence of stock exchanges that are perceived to function well enough to make such a valuation through flotation of shares narrows the options and increases the difficulty of effective sales transactions in a number of countries.

Terms of transfer: The mechanics of privatization transactions can easily become quite involved particularly when a large enterprise operating in a critical sector of the economy is involved. For example, when Malaysia leased its container terminal to a foreign-local joint venture, preparation of contractual documentation satisfactory to both sides proved quite difficult. Judicious use of technical advisors seems to have greatly facilitated the process. Government officials rarely have the requisite experience in this type of work and the agreements themselves must usually provide for unique and complex circumstances.

Control and restructuring: If the divestiture is to have the desired effect, private purchasers must take full responsibility for the assets transferred and have an interest in operating them successfully. Equally, governments must be prepared to accept the consequences of further restructuring, layoffs and failure of enterprises. Achieving this is not straightforward in developing countries, where government interference and special assistance to the private sector have a long history. A critical mass of equity participation by the new owners in the privatization transaction is important. Where a government must retain shares because the equity market is too small, it is important that it be a silent partner and leave management entirely to the private shareholders. Otherwise, neither party has sufficient incentive to operate in a truly private fashion.

Ownership and management: The link between ownership and management is crucial. National distribution of shares provides no serious control over management and no guidance to it. It is true that some argue that there is always the ultimate threat of letting an enterprise go bankrupt but that surely ought to be something that is used only in extreme circumstances and cannot be a common practice.

The denationalization of the textile industry in Bangladesh illustrates the difficulties that can arise when the purchase price is kept low and the lines of responsibility between government and the owners are not clearly drawn. Completion of the actual transaction was easy; the privatization was not. The private purchasers of the mills felt the government did not provide a policy framework which permitted them to operate the mills profitably. The government often felt put upon by continuing demands for assistance from the new owners.

Financial infrastructure: The financial infrastructure in many countries also requires attention since not only is it often too weak to support a large scale privatization effort, but its structure can lead to increased concentration of ownership and thus evoke political opposition early on. A first emphasis in many reform programmes must be to improve the banking system, to strengthen the capital market operations, and to try to ensure that the banking system, which is generally very limited in its own ownership distribution, does not become the source for creating a concentration of private ownership which will make the effort itself in the long term unsustainable.

It is important to make sure that appropriate regulatory frameworks covering capital markets and their relations between capital markets and commercial banking systems, is well developed. A great risk to the long term sustainability of the privatization effort is that it will end up through the absence of effective and efficient and well-regulated financial markets, with a structure which will not be socially acceptable in the long term in the country.

Social and political obstacles

The second set of issues which is very important for the developing countries and for us who are supporting them in their privatization effort, to keep in mind, is how to handle some of the concerns in the social sectors that led to the creation of public enterprises. These remain, even though relying on public ownership has been discredited as an instrument for dealing with them. In developing countries, the main economic issues that public sector intervention attempted to resolve relate to market imperfections such as natural monopolies, labour market rigidities and unemployment, and capital market imperfections leading to industrial concentration.

Employment: One of the most important causes for the inefficiency of public enterprises, and one of the major impediments to their eventual divestiture, is the employment objective which they have so often had to meet.

Constructive alternatives to addressing employment problems, through the expedient of public sector hiring, are essential if political support for a reduced public sector role is to be sustained. The basic approach must be to manage the social costs of unemployment centrally and to separate it from the operating decisions of individual firms. Treatment of employment issues at the national level permits a transparent assessment of the costs of dealing with employment concerns and helps to make choices explicit. Such mechanisms as 'safety nets' for the unemployed, labour legislation to facilitate the redeployment of redundant labour, pension entitlements which are transferable, and training programmes are in this category.

Designing these programmes requires difficult choices for governments as to the budgetary envelope that can be devoted to such activities and the options for financing them in the least distortionary fashion. It also requires a careful assessment of the type of intervention that will reach the target population, and can be administered effectively. Policymakers in the developing countries can benefit from the extensive experience of industrialized countries which have long been active in this area. Incidentally, this is quite likely to be a critical issue in the privatization process in Eastern Europe, as it will be in almost all countries that make serious attempts at divestiture.

Concentration of ownership: Governments also will have to address competitive policy. Concern over concentration of market power is one of the central factors that led governments to keep this power in the hands of the state. There is little doubt, particularly considering the constraints on financing of asset transfers, that there are substantial risks of at least temporary concentration of ownership in the private sector as a result of privatization. Therefore, mechanisms must be in place to ensure that this situation does not lead to monopolies and the attendant high prices and inefficiencies.

Trade and regulatory policies that allow, and even encourage, entry of both competing imports and alternative suppliers will play a crucial role in ensuring adequate competition. Sequencing is also of vital importance here. It is very common that precisely these policies have been distorted to accommodate the inefficiencies of public enterprises and reduce their direct demands on the budget. If these distortions are not dealt with before the enterprises are sold to the private sector, there may be strong resistance to their subsequent abolition. This will substantially reduce the efficiency benefits of privatization and engender political opposition to continuation of the programme.

Monopoly supply: The same requirement for an acceptable framework applies to such monopolies as water supply, communication and electricity. Constructive alternatives to full public control of these sectors exist in industrial countries and the experience has been broadened substantially.

'Best practice' in this area is evolving quite rapidly in the industrialized countries and will most likely continue to do so as technological innovation alters the boundaries of natural monopoly activities. However, they require resources that are usually scarce in developing countries -- skilled manpower, managerial capacity, and strong institutions -- as well as a monitoring system which blends public responsibility with profit. If developing countries are to move into privatization of firms operating in these sectors, they will need assistance to develop regulatory frameworks and the institutions capable of enforcing them effectively.

Conclusion

It should be clear from this discussion that it is unrealistic to expect that major privatizations will take place overnight in the developing countries. But the process is well underway. What is important is to sustain this process and to accelerate the momentum.

It is widely accepted that the large public sectors in developing countries can no longer be sustained, and many countries have already acted on this view. To broaden and deepen the privatization process, policymakers in developing countries must take on a heavy agenda of policy issues involving structural changes that are central to the functioning of their economies.

In this sense, their task is more arduous than that of their industrial country counterparts. They must create an environment which is receptive to privatization; in essence, they must privatize the private as well as the public sector. A framework must be established to ensure that efficiency is the critical factor for success, not whom you know in the critical ministries and government banks. And while establishing that level playing field, policymakers must also see that mechanisms are in place to ensure that critical social objectives are met.

This is a very tall order, even for some of the more advanced middle-income countries. Yet it is clear that without a sustained privatization programme, structural change towards market based economies will not be successful. Assistance from the industrialized countries, not only from governments but from private organizations, and from international organizations, can be instrumental in speeding the process; and their strong support can make a vital difference to its long term success.

QUESTIONS AND DISCUSSION

Mr A Herzog (Advisor to USAID in Western Central Africa): I was interested in your discussion on employment opportunities because this has been a problem I have been facing in discussion between aid agencies and governments. All governments wish to do something for employment generation. Yet the last five years I have seen almost nothing in this area succeed. Do you have any examples in your own experience where you have seen employment generation activities be successful?

Dr Ernest Stern: Unemployment opportunities is a very difficult problem particularly in Africa but more generally in countries where there is already very substantial unemployment and underemployment. There is a short term tendency for unemployment to increase following the general adjustment programmes and specifically the privatization measures. It is not possible, almost by definition, to provide alternative employment opportunities immediately, because such employment opportunities are going to have to be created by new investments and by growth. And, of course, part of the problem that has led to the laying off of people are the inefficiencies engendered by the distortions in the public sector in the first place.

This short-term impact on unemployment is there and is not going to go away. The efforts to deal with it vary tremendously: in the middle income countries in Eastern Europe the opportunities for a fairly quick response from the private sector in terms of new investment are very much greater than they are in some countries in Africa. They can absorb significant amounts of labour.

Two things have been successful in our experience. To help governments create a safety net is crucial because unrelieved large-scale underemployment is going to be one of the factors which can undermine adjustment programmes and privatization efforts. And it is, in fact, much cheaper in the long term to enable governments to provide some unemployment compensation systems than it is to finance ways to re-employ labour which are not sound in the long term. In Bolivia and a few other countries, we have helped governments to create those kind of social safety nets. They are difficult because donors do not like to fund them and governments often do not have the resources available.

The second (and again in the long term much cheaper) is to provide people who are laid off with some assets for investment; this is perhaps most relevant and more easily managed in less sophisticated economies. The need is for fairly small amounts of capital, and to introduce individuals into the service sectors -- transportation, distribution activities of various kinds. That is not going to work for everybody -- the entrepreneur talent, experience habit, is not always there -- but it is an effort that governments have to make.

Having said all that I cannot but agree with you that it is a problem and there are no easy solutions. Successes have been very mixed and it is something that governments have to stand firm on because you cannot simply believe that the excess employment on government payrolls can be shifted to somebody else's payroll in the short term.

Alfred Latham Koenig (Ernst and Young): It has been reported that the World Bank would gradually disengage from its operation in Eastern Europe and leave it all to the European Bank for Construction and Development. Would you tell us if and when this disengagement might take place?

Dr Ernest Stern: In Eastern Europe the World Bank has no plans to disengage. We have started a substantial lending programme in Poland which is our newest member there. Czechoslovakia and Bulgaria have applied for membership and we expect them to join us and become members at the annual meeting in September 1990. Yugoslavia has long been a member; now that it has started on its programme we have resumed a much larger level of lending. In all these countries the effort is very much focused on structural changes, and indeed on the privatization of public enterprises. Certainly our concept is not that the EBRD is going to take this over; the EBRD does not exist yet and will probably come into operation only in 1991. We look upon this relationship as we would a relationship with other regional banks. We look forward to a very collaborative relationship not a one-way relationship.

Mr Y Akturk (Interbank, Turkey): Would you comment on the role of The World Bank in expanding the non-productive public sector enterprises during the 1960s and 1970s, and your efforts in the structural adjustment programme in the early 1980s to bring to the fore this privatization process? We still do not see much active participation of the Bank in funding the latter. Will the Bank actively participate in this transition?

You have not touched upon the banking sector in public hands and the major inefficiencies caused by that. How would you envisage the transition there?

Dr Ernest Stern: The questions on the World Bank's role in financing public enterprises in the past: the World Bank did what everybody else did -- maybe a little better. Today we are swept up by a major intellectual reform. Countries today have begun to believe and be committed to an approach to development strategies which is fundamentally changed.

Not all public enterprises were bad at the outset or even afterwards. Not all public investment was a mistake. But there is no doubt that major donors, the World Bank included, provided a great deal of support for a development strategy which relied too heavily on public investment. And macroeconomic frameworks were simply not very sound -- the foreign private sector contributed to that by insisting on special advantages, tariff concessions, directed credit, tax holidays and so on; the official lending institutions bolstered it by not challenging soon enough the macroeconomic distortions which were gradually being aggravated by those policies.

The reform of the financial sector is absolutely crucial. You cannot have a long term sustainable privatization effort if the credit system remains in the hands of governments. The credit system has to be privatized and the role of government ought to become simply that of supervision through the central bank or ministry of finance. That is one of the most acute issues in Eastern Europe where many of these countries start without any history of commercial banking or private investment banking. It is also a problem in many developing countries where government financial intermediaries have grown very large and play a very large role. They need to be privatized as well.

Mr A Geerling (Ministry of Finance, The Netherlands): I wonder if Dr Stern would like to comment on the developments going on in the Soviet Union in the field of economic reform. He spoke about the conditions for privatization and I would like him to comment and say something about his ideas on how those developments should go further.

Dr Stern: The summit powers have decided they did not know the answers and were going to call on the IMF and the World Bank to do a six-month study.

It is clear that in the Soviet Union the process of liberalization is clearly a very partial one. What seems clear to me is that there is no national consensus about a different change in the management of that economy. There is no consensus that a market oriented system with profit as a legitimate objective is the way to go.

Also, the mechanics of implementation are very difficult in the Soviet Union because there are great political forces at work in various parts -- regional diversity and nationalism for example. The institutional systems do not exist and the distribution infrastructure does not work well.

And finally I would say that in the Soviet Union, unlike most of the countries of Eastern Europe and to some extent unlike middle- income development countries, you do not really have even a small private sector. In Brazil we talk about privatization but there is a large private sector; you do not have that in the Soviet Union. In Eastern Europe, in Czechoslovakia, in Poland, you have at least a *history* of a private sector; you do not have that in the Soviet Union.

So both the attitudinal changes, the conceptual changes, the managerial base from which you start, the existing infrastructure, all pose problems for the Soviet Union far outdistancing those in any other economy. And, I would say, far outdistancing the problems of liberalization in China which had at least some of those elements in place when it started its reforms.

Chapter 2

AID AND THE ENTERPRISE ECONOMY

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It is a pleasure for me to be here today to add my voice of pride in the energetic, intellectual leadership and work that is being done by the Adam Smith Institute. I think you deserve to be commended for it.

A changed world

Last night I flew in from Lisbon, where talk of privatization was in the air. There was a recognition that it is a public programme that attracts the interest of voters; and they are wrestling with familiar issues -- How fast? Which companies? What about housing, pricing, and unemployment? But still the political will is there. It is an immediate reminder that we are living through a world-wide economic shift and that privatization is essential in carrying out that shift. It becomes popular capitalism; a notion created here in Britain where large numbers of people have a stake in the system.

In the United States Agency for International Development we have just completed a survey of forty projects, and we found that strong and continuing political support was the only consistent factor that determines success. Political factors, in fact, were so important that it would determine whether or not privatization would even be tried. But if tried, then economic, legal, and regulatory reform, assistance with capital markets, and provision of credit facilities, must move along concurrently.

Privatization as an idea is changing the world. The English philosopher, Alfred North Whitehead, said that ideas will not keep; something must be done about them. And that is certainly true of privatization.

Last weekend my family and I were travelling in Massachusetts and we were caught up in the historical events of Lexington and Concord. In 1776 in America we were creating a new nation dedicated to life, liberty, and the pursuit of happiness; ideas born in England and carried out in America, that forever changed Western thought about democracy and about political freedom.

In 1776 meanwhile in England another idea was being put forward, an idea so profound and consequential in the course of human events; and to a degree far greater than the writer of *The Wealth of Nations* could have imagined. I think The Adam Smith Institute has taken after its namesake in terms of the world-wide impact of its ideas on privatization. But who in

Adam Smith's day could have foreseen that wars and revolutions would be waged over the thoughts put forth in his writing; that the fortunes of individuals as well as nations would hang on the success of these thoughts.

So as we passed through New England the force of the ideas of 1776 seemed very close. America's Declaration of Independence and Adam Smith's *Wealth of Nations* ultimately became inseparable in their destiny. For though America's Declaration of Independence called for a society dedicated to life, liberty, and the pursuit of happiness, it was Adam Smith in the *Wealth of Nations* that would explain how such a system could work.

The AID mission

Picking up our Anglo-American heritage, the United States Agency for International Development has just adopted a new mission statement in which it has set as its central role five foreign policy goals. The first is the supporting of free-market economies, which holds the promise of prosperity. The second is supporting democracies, which holds the promise of representation and of participation. The third is to build individual well being, offering the tools that countries need to help themselves cure poverty, malnutrition, and disease; for this holds the promise of self-reliance and dignity. Fourth, it is helping to solve global problems that transcend national borders, such as the environment, AIDS, and a response to natural disasters; for this holds the promise for future generations. And fifth is working with multilateral and multinational forums, which hold the promise of global peace and prosperity. Ultimately, however, the success of the ideas of Thomas Jefferson and Adam Smith remain the hinge upon which rests the success of individuals and nations alike.

The mission of my office, the Bureau for Private Enterprise, is to encourage market economies with access by all, and to encourage growth through private enterprise. Without going into too much detail, this Bureau is designed to provide expert technical services to client countries for economic development of their private sector. We offer a range from privatization and policy change to bank and housing loan portfolio guarantees; to specialized services for financial and stockmarket development; for informal economy analysis and microenterprise work; as well as a newly established office on trade and investment.

The importance of privatization

Although we work in all regions of the developing world we focus on those countries which have demonstrated a commitment to policy reform, and encourage private-sector-led economic growth. Of all the reforms needed, privatization has perhaps the greatest impact, for it sends the strongest message.

That is based on the fact that the private sector is the most appropriate mechanism for creating wealth. A healthy and independent private sector helps lead the way to expanded choice by individuals and the strengthening of democratic institutions. To quote the economist, Milton Friedman: 'History suggests that capitalism is a necessary condition for political freedom'. All of us in this room today are exploring how far capitalism and economic freedoms can and should lead or lag political freedoms.

Hence, AID continues to pursue its commitment to encouraging a global shift toward privatization and political freedoms. We are assisted in that pursuit by our world-wide privatization centre, which has garnered five years of invaluable experience in over seventy countries around the world. We have financed a long- term privatization adviser in Honduras where we have helped the government with seventeen companies that were worth $50 million in privatization. We are currently working with a Tunisian government to develop and implement a strategy for divestiture. In fact, we have help the Tunisians sell more than 19 state companies for a value of over $60 million. And we are working in Costa Rica.

We are meeting the new challenge of Eastern Europe and assisting the government of Hungary with a long-term adviser on the work of the Hungarian privatization mechanism, the State Property Agency. This is an interesting case for a country seeking to privatize large numbers of firms in a relatively short period of time, and we are fortunate today to have several participants from Hungary.

The lessons learned

At the same time we are reviewing the lessons we have learned over the past five years, and expect to make some significant strides forward in our policy in incorporating these lessons. Without going into all the lessons. I do want to briefly mention a few.

First, it's obvious how politically painful privatization can be for fledgling or transitioning democracies. Issues of unemployment and national patrimony, of speed and pricing, and thus of partisan politics will inevitably arise.

Also, privatization programmes will fail if objectives are no more than a collection of generalized precepts. Successful programmes have precise, carefully thought out, objectives, that interlock and support one another. Policy reform and privatization would be best if they can proceed simultaneously for each stimulates the other.

And lastly, any privatization programme needs a follow-up with an access to management services, to technology and to investment. We can no longer feel that once a privatization sale is completed that the programme is complete. The programme is a success only if it adds to the private economy, not merely once the transaction has been placed in the markets.

These are a few of the lessons we are learning, and form the basis for three objectives to our privatization approach. These three objectives are:

- to integrate the developing nations into the world economy;
- to foster growth with equity through competition; and
- to support democracies through increased voice and choice.

These objectives are in many ways a reaction for global trends. First, we are witnessing the greatest urban migration in the world's history. Global population is pressing at 8 billion people by the year 2000. In 1950 there were only 10 cities of 5 million or more people. In 10 short years there will be 48 cities of 5 million or more people, and 37 of these cities will be in developing nations.

Along with this rocketing population growth and rapid urbanization will come a flood of demands for social services, such as sanitation, medical and housing, as well as education and vocational training. The privatization of social services will be the best hope of meeting the demands of the urban migration.

At the same time, however, there is a second trend that exacerbates the problem for all of us; it is the scarcity of capital in the developing world in comparison to its needs. World credit markets are drawing back in the face of increasingly risky and problematic developing world investment environments.

Third, technology development and transfer. I am concerned that industrial countries are innovating technologies at an increasing rate and the technology gap between industrialized and developing countries is widening. Contributing to this is the concern (very legitimate) of developing countries, on how to ensure the productive use of the labour of their burgeoning populations. This remains a critical and constantly growing factor in developing nations and technology.

The fourth trend, and very important, is the decline of state control. As stagnant, centrally planned economies continue to fail there is increased opportunity for western-style economic freedoms, world peace, and expanded trade. And this is the world trend that is really helping all of us in privatization. Yet with that opportunity comes hightened pressure to deliver the services necessary to implement free market economies and see them through to success.

Encouraging competition

Let me turn to the very interesting subject of competition. I came from private industry and I know first-hand how difficult it is to bridge the concept of competition and putting it into practice. As a consumer I knew of competition and all of its beneficial effects in increasing variety and raising quality, and lowering costs. It was all very clear to me that when Japanese cars entered America, that our costs, our increased choice and quality had been improved. And I like having twenty different breakfast cereals and twenty different athletic shoes on the market to choose among. But as a business person I spent most of my waking hours trying to beat out, eliminate, or exclude competition. Individuals may espouse the virtues of competition but most companies are dreaming and planning of monopoly. Should we then be discouraged when developing country businesses react the same as our developed country businesses? The benefits of competition are overwhelming -- widespread ownership of resources and the growth of jobs and skills.

Thus, in my bureau we have set a goal for ourselves to press forward on creating regulatory and policy climates to encourage competition. And as an encouragement we are looking for ways to break down many of the large state-owned enterprises. Many are conglomerates and can be broken into smaller and more manageable businesses in which we can allow and encourage, and attract greater local participation in management, in financing, and in ownership -- and hopefully assure a greater chance for success.

The future of privatization

What does the future hold for privatization effort? Certainly old formulas and traditional methods of assistance simply will not work. Let me suggest a transaction that we might consider to cover environmental costs. Let us take an example from Eastern Europe.

Let us say we have a large state-owned enterprise, a heavy polluter that is to be privatized. Could we not consider a small additional transaction fee to be set aside as a clean-up account? If 2% were charged -- 1% from the buyer and 1% from the seller -- to cover air, water, and quality clean-up, and the on-going filtration of effluence for that company, covering the environmental costs of that state-owned enterprise, we would give benefits to the divesting country, to the government, to the employees, to the neighbourhood, and to the new buyer.

Let me address some other areas where we hope for future collaboration with you, our colleagues.

Let us try to create good climates for commercial businesses, from customs regulations to tax laws. A good business climate is good for indigenous as well as foreign investors. Let us promote trade and investment which will in turn encourage integration into the global marketplace. Let us stimulate competition, not just the transferring of large state-owned enterprises to large foreign-owned enterprises. Let us all try to work on simplifying the legal, fiscal, and regulatory procedures which often suffocate entrepreneurs and any desire for growth, capital investment or larger labour forces. Let us try to break down very large state-owned enterprises into smaller units, to assist in restructuring and divestment. And, let us offer technical and management services as a follow-on, after the privatization has taken affect.

What are our common challenges? Certainly one is to create the conditions and the framework that address the fear of foreign ownership, of selling the national patrimony; of being owned by Germany, Japan, or anyone else with money. Let us try to show client governments the real costs of state-owned enterprises. If many of the true costs are known -- and the true losses -- it would help buttress the political will so necessary in making the economic changes.

Another challenge is to think together on how to enlist flight capital, and to relieve some of the debt problems that are overhanging many countries: the development of the indigenous private sector is essential for this. And too, we can vividly see in Eastern Europe that we must try to integrate black markets and informal economies into the productive mainstream of a country's economic life.

Lastly, privatization is in the spotlight these days. You can pick up a paper in any country and there seems to be a reference to privatization. This creates high expectations -- probably too high. The public expects speed and success, we must convey the privatizations are most often slow and frustrating -- and sometimes they fail.

Privatization has many challenges and concurrently many benefits. US Agency for International Development is here to work with all of you, all over the world, to create market economies, better business and better government, and striving toward global prosperity. We are all working hand-in-hand in this idea of privatization. It is an idea that is truly changing the world.

QUESTIONS AND DISCUSSION

Question: The speaker made a point which the political economy approach would readily agree with, that the political factor has been found in their study to be critical to the privatization process. She did not give us further insights from this study and I wanted to ask about one or two points. I also think it is true that weak political systems fail to provide the appropriate framework for private enterprise functioning. Therefore, in terms of your study, what did you find, or what kinds of things have been put in place to strengthen weak political systems? We have the difficult situation that in most of the third world countries where the privatization is being accepted as desirable, the political systems are very weak indeed -- which is a complicating factor.

Henrietta Holsman: I think it is a very key issue about the appropriate framework for political and economic changes, both in the public sector and in the private sector. What our study showed was that low political sustainment was important, so that as the government changed it was important that the next group of people followed the same policies. How do you achieve that? It seemed that it was driven by the personalities, by a few key decision-makers, and it meant that we needed to get to enough of the leadership of the country.

Question: Political commitment at the highest level does not necessarily translate into public consensus within society. One of the problems that this is not an area of expertise of the World Bank. I would like to find out whether AID has studied this and have some insights of whether that problem can be solved or what can be done about it.

Henrietta Holsman: On how to translate this process into a public consensus, one of the keys seem to keep cropping up with us is the question of transparency. If you can begin with trying to tell the public what the process is, and approximately what the timeframe is, then the other pieces begin to follow through. Next comes that very important theme that was picked up in several areas which was: What is the valuation to be of the company? It is not just going to go from a state-owned enterprise into a foreign-owned enterprise. Transparency seems to be the best hope that we have on that one.

Charles Mensah (Ghana): It is quite obvious that privatization gives economic empower to private citizens which in turn undermines political dictatorship. Looking back we have noticed that many countries have stated the objective of privatizing. Some have firms on the market for the past three years without buyers. What incentives does the USAID provide to these dictators to privatize? Do you tie development and to reform?

Henrietta Holsman: We do tie aid to reform but I must say that leverage has been diminishing as our amount of money that the United States government is giving out diminishes. So we may no longer be able to make trades of that sort; I think it is better in any case to work by changing thought and mind. Having so many people here thinking about the same areas, hopefully will have its impact on some of the ruling elite in some other countries.

Question Privatizing requires a strong private sector that is sufficiently rich, or at least has access to credit, and capable to assume management. If not, foreign investors are the sole candidates to acquire shares for assets in the privatization process. Of course, the political sector reacts strongly against this possibility, particularly in certain key sectors or activities. What suggestions can you make to solve this contradiction? You talk about the enlistment of flight capital; that is a good idea, but how do we achieve that?

On the question of what to do in the enlistment of flight capital, we do not have the answer to that. One area that we are looking at is the question of maybe using bonds based with some good assets in either water or sewer, that directly affect people, so that there is some recourse and it can be got-ten to. If purchance the bond holder were to hold the asset, they indeed would have to run it as a private enterprise. We do not have the answers but I am clearly with you that we need to find some ways to bring back flight capital.

Dr Usman (Nigeria): Privatization is in the limelight; but to what extent have both USAID and the World Bank paid enough attention to that fact? In the 1960s it was import substitution and strategic development that was in the limelight. Then, in the 1970s it was user fees. And with the benefit of hindsight we now discover that a lot of mistakes were made in implementing those programmes. They did not work they way they were designed. Are you sure the policies that you are now expounding all over the world, especially structured adjustment and privatization, are the right policies? Or, are we just going around in circles?

Henrietta Holsman: I think you have touched on a very important point and we are struggling to see if we have indeed found the best answer now. I do not know; except that it seems that we are getting closer. Capitalism with a broader participation seems to be the best answer. A communist system does not seem have offered a better alternative and so the privatization process of putting capital into the hands of a greater number of people seems that it will being both democratic and economic participation. It is a very good point and one that all of us should be careful about.

Professor Njolwa (Burundi): I am Director of Operations in the Eastern & Southern African Trade & Development Bank, Burundi, this is a bank which covers 20 countries in Eastern and Southern Africa. I have been very impressed by this presentation and therefore I am going to pose a few things by way of questions and also comments.

The first one, the speaker put it very well to say that as a consumer she has been actually looking for a variety of goods, which means competition, but then as a business person companies want to eliminate competition. I think that message should be driven home, particularly to LDCs, so that privatization does not appear as a question of substituting the current state-owned companies with operations which would in the end actually get rid of what we are all calling for here -- that is an increased degree of competition. And that contradiction should be made quite clear.

Secondly, the speaker made a very good point that privatization is a slow process. That message should be made quite clear, as should the factors that are required to sustain the process.

Then, privatization for whom? Last week I was in a similar forum in Zimbabwe discussing the possible role of privatization. The question that keeps on cropping up is: for whom? Here you are trying to entice non-market economies, the majority of which are LDCs to actually follow the privatization process. What you are saying is: Can you hand over the reins of the economy -- economic power -- to multinationals?

Henrietta Holsman: The gentleman from Burundi made some very good points and we will take note in everything that we can on what you mentioned. I think it is very important about being sure that we do not lead electorates into concluding that we cannot deliver the goods in their expectation timeframe.

Privatizing and for whom? This is a question that we were hoping to address -- or at least a little corner of it with the breaking down of state-owned enterprises into smaller parts -- because we feel that it need domestic ownership, and management, and investment; and not just large, single, foreign, ownership. We cannot pass over one block of power to another person and feel that we have achieved much. So we all need to look and search a bit on that question.

Chapter 3

LEARNING FROM THE UK PRIVATIZATION EXPERIENCE

Sir Geoffrey Howe MP

UK Deputy Prime Minister
Former Chancellor and Foreign Secretary

The recent celebrations surrounding Adam Smith's bicentenary have confirmed the foresight of this Institute in choosing as its mentor the world's greatest political economist. We salute him, in this bicentennial year.

And the continuing advance of privatization worldwide has confirmed the equal insight of the Institute in appreciating, from a very early state, the enormous practical significance and potential of the UK privatization experience as a model for liberalizing governments around the world. As the Chancellor who launched the British Government's privatization strategy, I am very happy indeed to see that experience spreading and deepening in so many countries.

Privatization has, within ten years, become a truly global phenomenon. From Turkey to Argentina, from New Zealand to Israel, from Mexico to South Africa, there is barely a finance minister alive today who does not preach the virtues of denationalization and liberalization of state industries. Here in Britain we are proud to have played a seminal role in the privatization process, and confident that if it is sensibly and responsibly applied, privatization can bear fruit as fully and as richly as it has done in the United Kingdom.

The title of my remarks suggests a rather insular perspective. I will complement it by some reflections on the lessons to be drawn for other countries embarking on the same route, both in advanced democracies and the third world. And I will finish with an assessment of the role privatization can play in easing the path towards the market economy, in the countries of Eastern Europe -- the next and the most important 'new frontier' of denationalization in the world today.

THE UK EXPERIENCE

It is difficult now to remember what life was like before the bursting of the bubble of one of the most costly and tragic illusions in modern British history. By that I mean the so- called vanguard role of the public corporation as guardian of the national interest and purveyor of monopoly services in huge areas of our economic life. For almost four decades -- from the mid 1940s to the late 1970s -- its intellectual stranglehold was almost complete.

Birth of the illusion

In his book *Socialization of Transport* in 1933, Herbert Morrison set out what he saw as the potential benefits of nationalization, via his chosen route of the public corporation. Fifteen years later the postwar Labour government applied these principles to major sectors of the British economy -- coal, steel, gas, electricity, the railways, the airlines.

Today, Morrison's words seem almost unutterably naive:

'The industry will be more efficiently and economically conducted.'

'The quality of service will tend to advance and the price charged will tend to fall.'

'The board and its officers must regard themselves as the high custodian of the public interest.'

At the time, these propositions were treated seriously. The only economic criteria imposed on firms would be to break even after full depreciation 'taking one year with another'. 'Arms-length' control -- whereby ministers would concern themselves with grand questions of policy but not without commercial decisions -- would, it was supposed, allow adequate political control to be mixed with economic success. A beneficient State would provide the resources to enlightened managers, who together would somehow miraculously maximize the public good.

The outcome in practice was sadly predictable and depressing. The evidence built up over time: growing losses, rising prices, low productivity, feather-bedded managers who too often saw their corporations less as businesses and more as administrations. Political control was both intrusive and spasmodic, both disruptive and immobilizing at the same time. Reliance on the state for funding resulted in too little investment directed too often at the wrong targets. Monopoly supply tended to limit choice, lower standards, raise prices, and offer automatic profits that were frittered away in higher unit labour costs and pervasive underperformance of every kind.

By the mid to late 1970s, the developing failure of the nationalized industries had become endemic. Successive attempts to improve their performance had failed. Constantly second- guessed by politicians and bureaucrats, and with as little incentive to succeed as there was little practical risk of bankruptcy accompanying failure, they became less and less profitable as the pressures of the decade wore on. Zero returns on capital, or less, became the norm. The financial burden to the state became intolerable.

The last Labour government (from 1974-1979), far from liberalizing the state sector, burdened it with new acquisitions -- through the National Enterprise Board on the one hand, and the enforced nationalization of aerospace and shipbuilding on the other. Incredible as it may now seem, even the supposedly 'moderate' government of Jim Callaghan entered the 1979 election with plans for *further* nationalization. The Labour party *Campaign Handbook*, stated: 'We need to extend public ownership into profitable and dynamic manufacturing industry if we are to regenerate British industry.'

The change in direction

Fortunately, the Conservatives, not Labour, won the 1979 election and we embarked on a very different route -- what was to prove in time to be the most systematic dismantling of the state's role in ownership and production ever known in a Western democracy.

It is interesting to note, in retrospect, that the Conservative Party's commitment in 1979 to privatization was fairly circumspect. Mass-scale denationalization was a hope more than either a firm commitment or a safe prediction. We knew we wanted to reverse Labour's work, but never in our wildest dreams could we then have expected to have come so far, so fast, even a decade later.

Back in 1979 we were still battling to win acceptance of the notion that private ownership mattered. In the centre-ground of British politics there was a technocratic kind of assumption -- rooted in the writings of people like, at home, Michael Shanks and, abroad, John Kenneth Galbraith -- that public and private corporations were pretty much alike, with a general presumption in favour of the former. (To be fair to the memory of Michael Shanks, it should be said that he had changed position significantly before his sadly early death.)

In addition to that intellectual battle, we faced a massive series of more immediate practical problems which all needed even more urgent attention than denationalization. I am thinking of rising inflation, the necessity for monetary discipline, and the strangulating effect of pay, price, dividend, and exchange controls on the economy. Overlaying all that was the continuing strength of the trade unions -- which itself had ruined the Callaghan, as well as the Heath government -- and the huge and growing budget deficit, to which admittedly the nationalized industries contributed. Either of these could have blown economic policy massively off course at any moment.

Against this backdrop, we can perhaps be forgiven for having approached privatization with some caution. We adopted what one might call the Deng principle -- after Deng Xiao Ping's famous phrase: 'We must move forward boldly with careful steps'.

Our 1977 prospectus *The Right Approach to the Economy* had limited itself to the general assertion that: 'The long-term aim must be to reduce the preponderance of state ownership and to widen the base of ownership in our community. Ownership by the state is not the same as ownership by the people'. The 1979 manifesto, for its part, pledged to return to the private sector only the recently nationalized aerospace and shipbuilding industries, together with NEB holdings and the relatively small National Freight Corporation. None of the major postwar Labour Government's nationalizations were mentioned.

In a speech to the Selsdon Group in July 1981 I commented thus:

'It is only since the election that the issue of privatization has moved to the very forefront of politics. Our experience since we have been in government has convinced us of two things:

'First, that the need for privatization, competition or, at least, private sector financial disciplines in the nationalized industries is even greater than we imagined in opposition; and

'Second, that progress in the direction of privatization is often more difficult than it may have appeared to some of its armchair advocates.'

I spoke of 'experience reinforcing belief in the need for privatization', which year by year gathered pace with rising momentum.

The new policy in practice

A decade or so later, we can boast having privatized 29 major former state-sector firms, raised funds in excess of 30 billion and transferred around 800,000 jobs from the public to the private sector. That represents a reduction of over half in the share of the state's ownership of industry. Whereas the nationalized industries represented approximately 10% of UK GDP in 1979, today it is 5%.

Of the postwar Labour nationalizations, air, transport, gas and steel, have been privatized. Electricity will follow soon. In addition to those, as well as aerospace and shipping and the NEB holdings, we have privatized telecommunications, the airports and water, as well as BP, Rolls-Royce, the National Bus Corporation, the National Freight Corporation, Cable and Wireless, and a number of other firms. Soon the only remaining parts of British industry in public hands will be the postal service, the coal industry and the railways. And at least in the case of the last two, further progress towards private ownership is on the cards.

The benefits of privatization

Privatization in the UK has brought several substantial benefits. There is no inherent reason why these should not be replicated in comparable countries abroad.

First, privatization has relieved the state of what was the huge and growing burden of financing the investment needs and operating deficits of the public corporations. In 1979 the nationalized industries were costing British taxpayers over £ 50 million a week. Today the remaining ones have a negative external finance limit -- they are repaying money to the state.

Second, privatization has raised substantial proceeds which have helped finance tax cuts, priority public spending, and a reduction in budget deficits. Not only has the drain on public finances been removed, it has become a positive bonus. This has been compounded as subsidy-soaking deficits have been replaced by tax-yielding profits.

Third, privatization has massively expanded personal share ownership. We now have 9 million shareholders in Britain -- three times as many as in 1979. 13% of British adults own privatization shares. During the British Telecom privatization in 1984, some 2.3 million individuals bought a total of £3.9 billion of shares, then a world record for any single offering. 2.7 million people applied to buy shares in last year's water privatization. 4.6 million applications were received for British Gas.

Fourth, by freeing formerly state-owned firms of reliance on the government for finance, privatization has allowed higher investment in the firms concerned. The dead hand of Treasury control has been replaced by the hand which is as stimulating as it is invisible. The figures speak for themselves: British Gas's investment up by a quarter; BAA's investment up nearly half; BT's by over half.

Fifth, by freeing such firms from political interference in management, privatization has improved the internal efficiency of these firms -- allowing them to liberalize purchasing and rationalize labour practices -- and so increased massively their profitability. An improvement in the allocative efficiency of the economy as a whole has been the result. The profitability of British Telecom has almost trebled, that of British Aerospace more than quadrupled, that of Cable and Wireless more than quintupled.

Sixth, where privatization of former monopolies has been accompanied by liberalization, as in telecoms, it has increased choice, reduced prices, and greatly empowered the consumer. In British Telecom's case, for example, the question which no traditional leftist can find an answer to is: 'Why did telephones have to be privatized before we could expect to find call-boxes that actually worked?'

Seventh, where privatization has coexisted with the continuation of monopoly, as in the water industry or gas, it has permitted increasingly rigorous regulatory regimes to either improve standards or restrain prices, or both.

Lastly, and more generally, by increasing efficiency, improving competition and extending market disciplines, privatization has played a crucial part in cementing the foundation of an enterprise culture in Britain. For the individual firms concerned this has meant a new confidence and capacity for risk- taking, with growing success in export markets. Companies like British Aerospace, British Airways and Cable and Wireless have been converted from introverted sleeping giants into competitive, market-seeking extroverts.

More generally, when backed by reductions in personal and corporate taxation, as well as a generalized liberalization of markets, privatization has helped create a climate of optimism about the possibilities of markets and confidence about the benefits of the capitalist system.

UK LESSONS FOR PRIVATIZERS ABROAD

If this is the UK experience of privatization -- and by all accounts it has been the most successful of any undertaken so far -- what lessons can we draw for other nations treading the same path?

Start small

First, don't be afraid to start small, and move on to bigger and more complex privatizations later, as you gain experience and confidence.

Most of our early privatizations were straightforward sales of commercial business, which were already in direct competition with the UK private sector or suppliers abroad. This was the case with British Aerospace, Associated British Ports, Britoil, Amersham International, Cable and Wireless and Enterprise Oil.

When I spoke to the Selsdon Group in 1981 we were at the stage where the case for privatizing utility monopolies still had to be made. I spoke then of new issues like regulation or regionalised break-ups as important possible complements to any decision to transfer ownership to the private sector.

It was in fact only in 1984 -- five years after we entered power -- that we started to privatize major utilities. The first was British Telecom. Later examples have included British Gas, the water industry and now electricity. As we found, these are much more complex and difficult privatizations, requiring clear policy decisions about the structure of the industry to result, and the modalities of selling them.

Privatizing monopolies requires specific decisions about the degree of liberalization and the form of regulation to be applied by the state. These choices are likely to be controversial in themselves. Pricing policies need to be defined for gas or water or electricity in a way that simply doesn't apply to steel or oil. In the process of divesting itself of ownership, the state acquires, at least to a point, the alternative role of regulation: less problematic certainly, but necessary nonetheless.

Build on success

The second lesson I would draw, which follows from the first, is that you should organize your privatizations into some sort of flexible programme, so that the successful completion of one sale already foresees the flotation of the next. Provided one builds up gradually to the most difficult, a record of success can be established this way, with a bandwagon effect whereby each privatization is greeted more warmly than the last.

Make firms succeed

The third lesson I would draw is that the specific objective of maximizing government revenue from sale proceeds should certainly not be a prime purpose of privatization -- but should be a happy bonus. The removal of the financing burden to the state should be a sufficient objective in itself. The important thing is to ensure that the conditions are laid for the long-term success of the enterprises sold, not least in the context of increased choice for the consumer. Our privatization of the National Bus Corporation is a good example in point. We chose to break it up into 70 separate units, in order to increase competition in the industry, rather than raise what was expected to be more revenue by selling it as a whole.

PRIVATIZATION IN EASTERN EUROPE AND THE THIRD WORLD

Lessons such as these are of potential value to privatizers in like-minded democracies in the West. Can they be of much use in the third world or the newly-opening markets of Eastern Europe?

Key factors

Underpinning the success of privatization in the UK have been three factors which I believe are necessary corollaries of any effective long term, denationalization campaign. The existence of these factors in any country, rich or poor, can make a substantial difference to the sustainability of privatization campaigns.

Determination: The first is political will. The government in question must be thoroughly determined to pursue privatization, which is fundamentally a political process driven by economic problems, which may not ultimately be capable of resolution in any other way. And it must be prepared to continue the process even if isolated, individual asset sales attract a certain amount of criticism. The latter is likely to occur if they are seriously undersubscribed or, alternatively, if they are so successful that the share price is deemed to have been set far too low. The important thing is to persevere, rather than regard the credibility and attractiveness of privatization as depending on any one individual flotation.

Continuity: The second factor is political continuity. In order to develop a long-term strategy, building up gradually towards generalized acceptance, it is necessary to have the opportunity to pursue the privatization campaign over time. The longer-term the perspective and the less rushed the process, the more successful privatization is likely to be.

The very different political climates in New Zealand, Israel, Chile and South Africa -- ranging from liberal democracy to racial dictatorship -- have all seen privatizations over several terms of government, in a context of either broad interparty political support (Israel and New Zealand) or party stability in power (Chile and South Africa). Whether one likes the regime or not, it is important to note that in either case, political continuity has been a key criterion for developing and implementing a coherent and sustainable privatization campaign.

Context: The third factor is the complementarity of privatization with other policies of economic liberalization and reform. Privatization should occur in parallel with market opening, monetary discipline, fiscal rectitude, external free trade and other conservative economic policies. These are mutually reinforcing. They strengthen the framework of market disciplines which make privatization more likely to succeed, just as privatization itself makes it easier to sustain market systems in the remainder of the economy. Successful privatization in a climate of rampant inflation or widespread labour unrest is difficult to imagine.

These three factors -- political will, political continuity and complementarity of policies -- apply whether the country in question is Britain, Portugal, Turkey, Zimbabwe, or Malaysia. It applies to first and third world alike.

The market environment

A fourth factor comes into play, however, for the least developed countries -- whether in the third world or Eastern Europe. It is the existence of basic market mechanism in the form of a price system, a banking system, a labour market, a land market, accounting standards, property rights, and the other preconditions of rudimentary capitalism. It is not reasonable to expect privatization to yield serious benefits if these arrangements are not firmly in place.

The problem in Eastern Europe is that many of these arrangements simply do not exist. The result is that both the economic and political risks of privatization are formidable. Simply selling off state firms to the highest bidder risks souring public opinion through either huge increases in foreign ownership at knock-down prices, or giving assets to the existing ex-Communist managers of those very firms. As *The Economist* has put it, there is little point in giving capitalism a bad name just when Eastern Europe needs it most.

The basic difficulty is absence of adequate domestic capital to finance the purchase of privatized firms from within the country -- something well-known in the third world. That problem will not be resolved until at the very minimum laws are in place to safeguard profits and allow the full convertibility of the currency. It may take some time to achieve, especially in countries that are already overburdened with foreign debt, and where enforced savings have given investment a bad name.

The industries in question are often well and truly bankrupt. They are the legacy of years of mismanagement and insulation from anything remotely approaching competition. Lax financial constraints on state enterprise has led to an apparently insatiable demand for government subsidy, correspondingly poor productivity, and price levels that bear little relation to scarcity. When combined with environmental failure in many large-scale industries, it is clear that huge areas of state industry in Eastern Europe have only minimal economic potential, and minimal market value as a consequence.

What is equally clear, however, is that only private-sector disciplines -- supported of course by Western aid in the form of management advice, trading openings and well-targeted cash -- can free the economies in question from economic stagnation. Private ownership and control offers the only escape route from the Marxist impasse which history has bequeathed them.

If Eastern Europe is to right its public finances, contain inflation, reduce wage costs, constrain borrowing and correct current account deficits -- a very challenging agenda indeed -- the private sector will need to grow, from the 3%-15% that it constitutes in Eastern Europe today, to become predominant.

Extending private ownership is not only a matter of privatization -- useful though that should be. it is also about market access and 'demonopolization'. Creative energies are less likely to come from former or current state monoliths, than new enterprises and foreign enterprises that start afresh. Marx talked about the withering away of the state. That is what we should hope for in Eastern Europe -- the withering on the vine of those state firms that were once so dominant.

Imagine in Britain what the result would have been if privatization had been the unique engine of liberalization -- without tax cuts, trade union reforms and the abolition of pay, price, profits and capital controls. The result would have been a very partial success indeed. It is difficult to imagine that even the privatized firms would have flourished, let alone any other.

The need for imagination

So too today in Eastern Europe we must see privatization as having a place -- but far from the unique or central place -- in the liberalization process.

In Britain we experimented with the enterprise zones -- economic areas free of local and corporate taxes with liberalized planning regimes. Eastern Europe might do well to study the merits of such zones of economic freedom -- they can act as beacons for private investment and offer a demonstration effect of how capitalism can work.

Equally, like enterprise zones, 'magnet firms' might be designated which are freed of tax and other burdens for a limited period to get private-sector activity up and running in certain parts of the economy. There are other possibilities too. We need to toy with the notion of the 'licensed brigand' as a way to infusing the enterprise culture in areas once so barren to capitalism.

The limited liability company -- with the notion that firms can legitimately go bankrupt -- has been a mainstay of our capitalism. In Eastern Europe there is a need for what one might call the 'very limited liability company', where economic experimentation can occur with minimum risk to the entrepreneurs involved.

CONCLUSION

I have strayed somewhat from my original theme -- the UK experience of privatization. But I hope my remarks have helped place it in the wider context of what one can expect from privatization and how best to achieve it around the world.

Privatization is not a catch-all remedy in all situations in all times. It is an instrument of liberalization -- one among many. We have turned it to good advantage in Britain. Adam Smith, I am sure, would have commended our work.

But looking across the Elbe and even to the Bug, he would see it as only a part of the long-haul of economic reconstruction that faces the East. In recommending it to them, we are barking up the right tree, but not the only tree. The hidden hand can take many forms. We wish to give a helping hand to them all in the years ahead.

QUESTIONS AND DISCUSSION

Mr Chadman (Saudi Arabia): I would like to ask Sir Geoffrey what is the reason for limiting foreign ownership to 15% in privatized industry in the UK?

Sir Geoffrey Howe: Provided it is not a concept that is abused or taken too far (that is why I commended a limited duration for it) it is a way of sustaining investor confidence and political confidence as well. It depends on the industry you are concerned with or the country you are concerned with, because clearly if you are seeking to encourage inward investment that must limit the extent to which you can impose the restriction I have suggested.

Question (Sri Lanka): I would like to ask Sir Geoffrey about the employment aspect of the industries that were privatized. Were there any problems about the large-scale lay-offs of labour and how did you get the cooperation of the labour force in this venture?

Sir Geoffrey Howe: You put your finger on a very important point, that almost by definition many publicly-owned industries are very substantially overmanned and you are bound to face that problem as you go through the process of reorganization, whether in private hands or not. But as long as they remain in public hands the mobilization of the necessary managerial will is much more difficult.

We have experienced in the steel industry for example, a substantial reduction in manpower: We went through a substantial and prolonged steel strike on the issue in 1980-1981; but you have to be ready to accept that as a part of the reform process if necessary. But, of course, it is better still to be expounding the case for what you are doing by securing the consent of an increasingly well-informed workforce and by achieving success.

My home town in South Wales is Port Talbot, the home of the Abbey Steel Works of British Steel Corporation, and in 1979 that works was employing some 11,000 people. The industry was losing some £800 million per year and that works, like everything else in industry, had no prospect of survival whatsoever. It is now employing some 4,500 people, the industry is making profits of .50 billion per year, and that steel works is probably one of the most competitive works in Europe. So we had to go through a period of major social change in the community. We accompanied that, therefore, by a very consciously deployed policy to attract investment by the use of concepts like enterprise zones and by the encouragement of new more modern industries in the area. You will find in Wales today that there are now some

100,000 people employed in the financial services industry alone, in addition to the employment of ten years back. So that the jobs lost in steel and in coal have been very largely replaced by new investment in new industries. And a large number in addition have been replaced by expanding investment from (notably Japanese investors) overseas. So all these things go together and once you begin seeing the pattern of success taking place alongside the hardships of change, then you are on a much better wicket.

Question: There seems to be inflation in England and certain economic troubles and problems. Would this in any way affect the policy of the Conservative government towards privatization and liberalization?

Sir Geoffrey Howe: The re- emergence of inflation as a factor in our economy here in the UK is clearly a matter for regret and it is a most important political problem to re-establish our conquest of inflation. It doesn't in any sense diminish our commitment to privatization and economic liberalism, as being at the heart of our programme. But it does remind one that every political problem is made more difficult by inflation, and every political opportunity is more stunted by inflation. It is of fundamental importance, therefore, to re-establish control of inflation, and that means going through the present period of high interest rates and monetary constraint, and recovering the ground that we lost following 'Black Monday': it does not in any sense erode our commitment to the propositions I have talked about.

Charles Mensah (Ghana): One of the conditions you mentioned for privatization is the political will. In what way is the UK encouraging developing countries that do not have the political will, to liberalize?

Sir Geoffrey Howe: On political will and continuity, I think that there are obvious difficulties in achieving that in any society where a change of government is a possibility, whether through the ballot box or in any other way. I think that the way to establish continuity is through the method that Sir Keith Joseph commended when he was pioneering some of the thinking in this field: when he drew attention to the need to redefine the political common ground. I think we have to some extent succeeded in doing that.

For many years the political common ground in this country was that public ownership was a good thing; it had to prove itself a disastrous thing over a long period before we were able to begin redefining in terms of the political agenda. But the fact that we are now able to point to such success as we have had through privatization, has persuaded our opponents to retreat, not decisively or completely (we must not be complacent about it), but as they have looked around the world and as they have seen socialists governments in other countries actually espousing the proposals which they once regarded as heretical and dangerous in our hands, so that has become part of the common ground.

Mr O A Kuye (Nigeria): I think Sir Geoffrey listed one of the major conditions for success in privatization as political continuity, which is not necessarily the continuity of the political party in power. But the condition critical to the success of privatization in the developing countries, perhaps also in the Eastern bloc, is yet to come, because that kind of continuity is not found in those places. What continuity will there be under a military government that is there for an unknown and undefined date? It may be in power only one or two months. So that continuity is non-existent in most of the countries we come from.

Sir Geoffrey Howe: My own belief would be that in any society, whether moving from military government to civil government or not, it should be possible to achieve that kind of consolidation of intellectual and popular thinking. I do not doubt that it is easier to secure the acceptance of politically difficult policies in a democratic than a non-democratic society: but I do not think that should imply any discontinuity if right policies are handled in the right way by different forms of government. Essentially the case is that if privatization is closely linked with economic success, if it is seen to work, then it should be saleable in any circumstances. If you can find some quick examples of success that prove themselves then that is an enormous help.

One of the earliest privatizations in this country was the establishment of commercial television in the late 1950s, and everyone said that commercial television was going to be an affront to all our household gods of integrity and liberalism. But we established commercial television and it was so immediately popular and successful that within two years no government dared to suggest that it should be displaced. I think the same kind of technique is what somehow must be groped for in the massively over-regulated economies of Eastern Europe. One of their problems is that they have no surviving effective system of government and command which enables them to liberalize. When the Conservative government came into this country in 1951 the nation was oppressed by a pervasive restrictive food rationing schemes, but we were at least able to say we were going to deregulate the egg market. Even that caused a tremendous affront because everyone thought rationing was marvelous, we all had one egg per week and that would be endangered if we deregulated the egg. The newspapers said: 'beware the one shilling egg' that the Tories are going to introduce. We deregulated the egg market and eggs began pouring out of the beneficient hens and the countryside was flooded with a liberalized distribution system for eggs. We did it then with sweet rationing; sweets were rationed on an extraordinary points system and we said we did not think this was a good idea. Our opponents rose in anger -- it was not clear whether they were angry because we were going to starve the children of sweets altogether or destroy their teeth by a surfeit of sweets, but either way it was a bad thing -- but we deregulated that market too. In every case the results were positive and popular.

If anyone can identify similar things that can be done in some of the centrally controlled markets of Eastern Europe, just to prove success, then I think you get the better chance of a little continuity in politics.

PART 2 - COMMERCIALIZATION OF STATE ENTERPRISES

Chapter 4

COMMERCIALIZATION OF THE UK ELECTRICITY INDUSTRY

Neil Lerner

Partner, KPMG Peat Marwick McLintock

Why commercialize?

Let us first start with a definition of 'commercialization'. I think one can say that to commercialize means to make an enterprise act in a way which enables it to compete in a competitive environment, or to act as if it was in a competitive environment. That alternative is particularly important it means the principle can apply either to enterprises remaining in the public sector or those who are transferring to the private sector through privatization.

Let us look at some of the typical problems of state run enterprises. Of course I would not for one moment suggest these apply to all state run enterprises in every country in the world, but they are a fairly general application.

State industries tend not to be market orientated and not to be customer orientated. There is a lack of the commercial pressure which is needed to yield cost efficiencies. There is often political influence on decision making; I am sure that we can all think of examples where decisions are made for political rather than on strictly economic grounds. As a consequence of all this, such enterprises tend to be bureaucratic, with the management and staff tending to be resistant to change. Costs tend to run steadily upwards (particularly because they may operate in a cost plus environment) and it is often difficult to get any meaningful cost or management accounting information out of the enterprises. They have a tendency to proceed with uneconomic projects as a result of their ignorance of costs or the political pressures upon them. With some honorable exceptions the quality of service may be poor, and the management often shies away from the difficult decisions needed to improve it.

In the case of enterprises that are in the public sector and are going to remain in the public sector, commercialization will reduce the burden on state finances, and ensure better service delivery for lower cost. For monopoly enterprises which are intended to become private competitive firms, commercialization is essential to survive to meet what ought to be their tough regulatory targets, and when we talk about the Electricity industry where there are certainly monopoly suppliers left within the industry, we will reflect on that: and they also need to commercialize in order to ensure adequate shareholder returns.

The issues

Let us look at some of the issues surrounding commercialization, in general.

Should you commercialize before or after you are privatized? Obviously if you commercialize before privatization the vendor, that is the government, should be able to reap the benefits of that commercialization in terms of higher sales proceeds. In addition, it may be difficult to float at any price if some element of commercialization is not proceeded with. However, particularly when you are selling the enterprise to a single purchaser rather than a flotation on the stock exchange, there may be reasons for putting off the painful decisions that are always associated with commercialization until after the sale. We can particularly see examples of that in the UK, in the case of Royal Ordinance and Rover, which were sold by private treaty to, in each case, British Aerospace, leaving British Aerospace to take the difficult decisions regarding manning levels.

Commercialization means that enterprises must become more responsive to the market and therefore they must strengthen their marketing functions. Often you may find a complete absence of marketing expertise in government state-run monopolies. You need new accounting systems to provide the commercial managers with the information that they need to run an enterprise on a commercial basis. You need to introduce profit centre concepts so that managers become more aware of the resources that they are consuming.

Often state enterprises tend to do everything in-house and not concentrate on what their core business is, what they actually ought to be good at. Nor do they buy in services from outside. Part of the process of commercialization will be to review the activities of the enterprise and ensure that those which can be contracted out are so contracted out, and even where you decide to retain some in-house for strategic reasons, you insist on proper pricing between the supplier of the non-core service and the core business. You need better business planning, and more flexible business planning. You need to review your personnel practices and ensure that you have flexibility to hire and fire, and flexibility to pay those people whose skills are in greatest demand a market salary.

Commercialization in electricity supply

After that overview of commercialization in general terms, I would like to talk in more detail about the electricity supply industry: perhaps the largest and most complex privatization attempted anywhere in the world.

Prior to the 1st April 1990, we had one monopoly generator, the Central Electricity Generating Board (a monopoly in England and Wales), supplying to twelve area boards, each of which had a monopoly of the rights of distribution in their own particular geographical area. The CEGB had an obligation to supply, and its pricing arrangements with the distribution companies were basically cost-plus, with some refinements introduced by government to attempt to exert downward pressure on prices.

The service ethic was far more important in the CEGB than was the profit ethic; and despite attempts by previous administrations to enable other people to move into the generation business, there was effectively little competition, or no competition, in generation.

An important feature of the generation business is that 70% of the costs of the generation business are fuel costs. Of those fuel costs the vast bulk is accounted for by purchases from British Coal; and in turn the electricity industry is by far the biggest user of British Coal. So we thus had an artificial pricing arrangement between two state-owned enterprises: British Coal and the CEGB, both of them controlled by the same government department -- the Department of Energy.

Introducing a competitive structure

Now the CEGB has been broken up into two generating companies which are to be privatized: PowerGen is the smaller of the two generators, and National Power is the larger, in very roughly the ratio of 2:1. The government's original intention was to privatize the nuclear industry as part of National Power, comprising the first generation of Magnox reactors, the second and rather unsuccessful generation of AGR reactors, and then a new family of four PWR reactors. However, after a year or so of examining the problems associated with nuclear generation, they came to the conclusion that the Magnox stations that were coming to the end of their lives should be withdrawn from the privatization, and then that the AGR and PWR stations should also be withdrawn. This required the government to set up a third generating company to be carved out of the CEGB, called Nuclear Electric, which will stay in the state sector for the foreseeable future.

The remaining element of the old CEGB was the high-voltage transmission system; that is now to be transferred to a company called the National Grid Company (or Gridco), which is to be owned jointly by the twelve area boards. Those twelve area boards are to become privatized distribution companies, or -- as they now prefer to be called -- Regional Electricity Companies.

The obligation to supply that was previously an important feature of the CEGB has been removed. The successor generating companies are to have considerable freedom to contract with whom they like for the sale of the electricity, and equally the distribution companies will have freedom to purchase their electricity from whom they so wish, although initially the only people who are in a position to supply them are PowerGen, National Power, and Nuclear Electric.

The market for larger customers is going to be open to competition: the area distribution companies are no longer going to have a monopoly of the right to supply the customers over one megawatt in their particular area. Other area boards may supply them or any of the current or future generators.

Price formulae

The government have devised a unique system for arriving at the price of electricity to be purchased; because you cannot identify where electricity comes from, they have devised an energy pool concept in which the price is set every half an hour, based on the bid from the most expensive generation source that is required to supply the power demanded by the distributors in that period.

That clearly produces a very market-orientated solution to pricing but it also gives scope for considerable instability in pricing, both during any particular day and also at various times during the year. There is also scope for manipulation of the pool price by various types of bidding strategy.

It was, therefore, realized that if the generators, and in particular the distributors, were to be successfully floated on the stockmarket, some stability would need to be introduced into this half-hour System Marginal Price system (SMP), and the government therefore devised a series of contracts and financial instruments that will enable the distributors and the generators to hedge the risks that would surround trading in the pool itself. It is a fascinating system and a very innovative solution to the problems of privatizing the industry.

However, distribution remains a monopoly business and therefore the distribution companies are to be subject to price regulation by the regulatory authority, OFFER, 'The Office of Electricity Regulation', which has been set up under Professor Stephen Littlechild to oversee the privatized electricity industry.

The generators are not in general terms subject to price regulation, although it is of course always open for the regulator to make a reference to the Monopoly and Mergers Commission if he believes that the generators are unfairly exerting what monopoly power they may have. Obviously with only three generators, one of which will remain in the state sector, there is at least a significant risk of oligopoly power being exerted; particularly when you remember that the management of all of these generators know each other extremely well from their days in the CEGB together.

The nuclear industry needs to be subsidized by the fossil-based industry. It has become apparent over the last few years (and how long it ought to have been apparent is a matter of intense debate), that nuclear power is very significantly more expensive than fossil power in the UK. However, the government wishes to protect the diversity of fuel sources that is provided by nuclear power, and therefore all fossil units of electricity will carry a surcharge in order to enable nuclear power to be sold at the pool price.

Implications of the new structure

Clearly, the competition is going to provide downward pressure on prices. There will be an acceleration in the move towards combined cycle, gas-fired, technology. And there will be considerable pressure on overheads as the two existing generators strive to achieve price competitiveness, with new generators coming into the market who have the benefits of low cost plant in the form of combined cycle gas technology plant, combined with much leaner overhead structures. There is therefore going to be a stimulus to find cheaper fuel supplies.

The government realized early on that British Coal could not come out of its protected position, and into the world market for coal, in one fell swoop. They therefore arranged a three-year transitional period whereby the new generating companies are contracted to acquire 70 million tones of coal, broadly equivalent to their current take, from British Coal, at prices that will decline towards world market prices during that period. Thereafter the generators will be free to acquire their fossil fuel from whatever source they like, and this, combined with the fact that British coal has a high sulphur content fuel and there are very considerable pressures to limit sulpher dioxide emission, means that the volume of British coal purchased is likely to decline significantly.

So there are significant implications for the British coal industry as well as the electricity industry in this change. There will be considerably more use of natural gas in firing electricity plant both on price and on environmental grounds: natural gasses are a very clean fuel to burn for the purposes of firing electric plant.

The political considerations surrounding the relationship between British Coal and the electricity industry have given the government considerable trouble. It is difficult to see how employment in the coal industry will be maintained after the end of the three-year period, because whilst there will be some pits which are capable of producing at world market prices, that does not include all the pits that are currently operating.

The service ethic that I described previously is to be replaced by a profit ethic, and managers at all levels of the enterprise are being made aware of what profit really means. And there will be organizational changes which I shall come on to in more detail.

One of the most important indications of the radical change that the government introduced is the necessity to build new systems whereby the price of electricity can be calculated each half hour on the basis of the bids received from the generators; and whereby then on the basis of the marginal price the cash flows between the generators and the distributors can be settled. This has required very complex systems to be built in a very short time.

Final decisions on the structure of the pool were not made until the turn of the year and the system had to be ready for vesting day on 30 March 1990. In the event it was ready; the system is working, inevitably it is creaking a little bit, but it is an enormous tribute to all those who worked on that part of the privatization, that they achieved it in time.

Organizational changes

Turning now to the detailed organizational changes that arise from the government's restructuring, there will be a number of functions within the private sector companies that need either to be started from scratch or significantly strengthened. Amongst those one might mention marketing, where there was no marketing expertise in the generators, and very little in the distributors either: marketing was carried out for the industry by an organization called the Electricity Council which has now been disbanded. The financial control systems must be upgraded and bought up to commercial quality. We must introduce treasury functions to handle these large flows of cash that the movements in the settlement system produce. We need to have investor relations management in order to maintain contact with our new shareholders.

Equally there will be some functions which are not required or which can be slimmed down. For instance, the generators and the distributors had a requirement to report regularly to their supervising department (the Department of Energy), which required a significant amount of resource; but that reporting requirement is now gone. There are, as with so many state enterprises, many layers of management within the CEGB, and to some extent at least that has been inherited by the successor companies to the CEGB. There will need to be a restructuring, the removal of excessive layers of management, and the ratio of employees to megawatt of output, needs to be brought down to a level where today's generators can compete with the people who will be coming into the industry: that inevitably means some down-sizing.

There will be a general need to upgrade management information systems. The commercial IT systems within the CEGB were not by any means state of the art. Splitting that one single system amongst the four successor companies to the CEGB inevitably exacerbates an already difficult situation. And all the successor companies have found the need to recruit outside IT expertise and to invest significantly in new IT systems. This need to recruit people with outside commercial experience runs over other functions as well as IT, and one might mention particularly the finance function where there has been considerable strengthening from people in the private sector, and the commercial sector where there was little commercial expertise in the generation companies.

Conclusion

That has been a very brief excursion through the principles of commercialization with particular reference to the electricity supply industry. The electricity supply privatization is one of the most ambitious and radical privatization projects ever attempted. A remarkable amount has been achieved in the period of just over two years since the publication of the White Paper, and the pace in this year has been particularly fierce. However, the real test of the success of the government's privatization strategy for the industry will be the ability of the industry to deal with the strain which comes when the existing contracts for the supply of electricity to the distribution companies expire in April 1993. And it is anybody's guess what will happen then.

QUESTIONS AND DISCUSSION

Mr G Cephas (Zimbabwe): You spoke about the profit ethic as compared to the service ethic. In developing countries we consider electricity as something essential. If we are going to think of the profit ethic it means the poor may never get any service because they are unable to pay for it. So one of the reasons why governments would not like to commercialize is because when they are elected one of the promises they make is that they will make power more available to more people.

Neil Lerner: The question is whether commercialization is appropriate in a less developed country where the supply of electricity is regarded as an essential. I would say yes, commercialization produces lower prices and lower prices must be good for the consumer, regardless of anything else. It is then up to the government to decide what profit they wish their commercialized industry to make. I do not see any problem with that.

Mr R A Halperin (World Bank): Was there a large degree of cross- subsidization in tariffs to the ultimate consumer, and if so, are there any grandfather clauses in the arrangements with the industry to keep those subsidies, or to phase them out over time; or is there relative freedom to adjust tariffs to the final consumer?

And on the quality of the service that is provided; you referred briefly to the regulatory framework. Does that framework include some arrangements to overlook the quality for service, and if so what are these arrangements?

Neil Lerner: There was some element of subsidy for large industrial consumers through the bulk supply tariff which applied prior to the privatization. It is very difficult to disentangle what subsidies there were, but there was certainly some element of subsidy to large industrial consumers. That treatment is continuing for a very limited period of time, about one year post-privatization. Thereafter, there will be complete freedom to set prices.

I was then asked about the regulatory framework and whether there were quality controls: the answer is very definitely: Yes. The GRID Supply Code provides very tight quality control procedures and there is no doubt that the quality of the electricity will be just as good as what we have had in the past.

Mike Hoyle (Ernst & Young): I wonder if Mr Lerner would like to comment on the applicability of the solution that has been found in the United Kingdom to privatize electricity, with respect to other countries? It seems to me that a very complicated and sophisticated solution has been found and I wonder on the general applicability of it to other countries who might be considering changing their structure of their industry, in Africa or Latin America.

Neil Lerner: What the government sought to do was to introduce competition into generation and to destroy the power that the CEGB had over the whole system. If you privatize an industry as a complete distribution and generation entity, which is probably the alternative that you had in mind, it seems to me that what you do is to transfer a public sector monopoly to a private sector monopoly. That will succeed in raising funds for the government, it will succeed in reducing the public sector borrowing requirement; but it does not introduce is any competition. By the time the UK government had reached the later stages of the privatization programme, they were far more interested in the philosophical or political objective of introducing competition, than in the fiscal objective of raising cash.

John Mobsby (W S Atkins, UK): Mr Lerner didn't talk too much about the length of contracts for sale of electricity. This is an important area for those new generators that are going to finance the project from cash flow.

Neil Lerner: That is a very interesting subject, much debated during the period between the White Paper and the final publication of the Electricity Act. The thinking was initially towards much longer contracts for the successor generators; that was resisted by the government who wanted to make sure that the market was open to new entrants as quickly as possible, and the compromise of three-year initial contracts was what resulted. It was, however, always acknowledged that new generators would only build plant if the distributors were prepared to enter into much longer contracts than that ten or fifteen years. There is complete freedom for distributors to enter into long contracts; it is expected that they will wish to enter into such contracts initially because without such contracts there will be no new generators coming into the market: and without such new generators there will be nobody there to exert downwards pressure on PowerGen and National Power who could, too easily, become a duopoly. So, such contracts are expected: how many and to what extent the distributors will be prepared to lock themselves into those lengths of contracts is not clear. It may be that they are only prepared to enter into a limited number of such contracts.

COMMERCIALIZATION OF THE GHANA COCOA BOARD

Leslie Zurick

Partner, KPMG Peat Marwick McLintock

Ghana is highly dependent on the export of primary products, particularly cocoa, timber, gold and diamonds. Of these cocoa is predominant, providing about 60% of total export earnings. Although there have been attempts to diversify the range of exports, for many years to come it will be vital for Ghana to maintain its production and export of cocoa.

Cocoa's importance to Ghana extends far beyond its predominance in export earnings: the cocoa sector employs about a quarter of the country's labour force, uses about half the land under cultivation and generates 10% of the GNP. Moreover, in most years cocoa has been a major source of government revenue, since the government receives the difference between the price paid to the farmer by the monopoly buyer (the Cocoa Board) and the world price.

Problems set in

Ghana was for many years the world's largest producer with production at around 400,000 tonnes per annum from 1960 until the mid 1970s (it reached 572,000 tonnes in 1964-65 -- a freak year). From then there was a rapid decline to about 150,000 tonnes in 1983 -- though Ghana is still the world's third largest producer. Many reasons were suggested for the decline: price, unusually dry seasons, the shortage of farm labourers, deterioration of the railways and roads, and lack of insecticides. But a very large factor was the decreasing efficiency of the Board itself. As it had grown from a small regulatory and advisory body to an organization involved in all aspects of cocoa production, from the actual growing, through buying, collection, storage and selling, the payroll of the Board had grown to around 115,000 in 1981. At the same time its management had become increasingly inefficient.

One of the main sources of the Board's problems was **government interference** -- almost inevitable when cocoa has such an important role in Ghana's economy, but permeating to quite minor operational and management matters. **Corruption** -- again perhaps almost inevitable in view of the scale and range of operations, the low wages and poor financial controls, and with lucrative contracts available for roads, buildings and vehicles. But the accusations of corruption, justified or not, resulted in **the departure of many senior staff**, including several chief executives: many capable and honest staff left for better paid jobs elsewhere. This led to a disastrous shortage of experienced staff, particularly in areas such as accounting and mechanics where alternative jobs were readily available even in a depressed economy.

The failure to provide relevant training, and the promotion of staff based mainly on length of service and theoretical qualifications, heavily tempered with nepotism, exacerbated these staff problems. There was **little delegation**, almost everyone was terrified of making any decision for which they might be accountable. The purchase even of trivial items and the dismissal of very junior staff, usually had to be referred to the Chief Executive.

There was **great overstaffing**: in 1981 when we did a study of the Board we estimated that, even allowing for different work practices and a difficult environment, the Board's work could be undertaken by less than half the current staff.

For example there were many duplicated functions; inspection of cocoa beans was undertaken by several groups, and there was overlapping management for plantations and for transport. There was very poor documentation; virtually no jobs had documented procedures of any kind, and there were myriads of forms but no detailed instructions on how to complete them, reducing the value of the information they provided.

The result, particularly when coupled with the lack of insecticides, tools, fuel and vehicles to help grow, harvest and collect the crop, resulted in lower crops and much of what had been bought deteriorating in storage up country. Yet, perhaps as a result of the senior staff problems, there was **little impetus for change** -- the most competent and senior staff members were overburdened with the detail of the day-to-day operations.

The path to reform

The Ghana Government and the World Bank recognized that the rehabilitation of the cocoa sector was essential to Ghana's economic recovery and asked Peat Marwick to undertake a major study in 1981: this study proposed major institutional, infrastructure and agronomy improvements.

As a result of that report the Government of Ghana, funded by the World Bank, appointed us as consultants in mid-1984, to act as advisors to the Board and to help its management achieve the desired improvements. We provided a team of about twenty consultants covering virtually all the areas of the Board's operations.

Although to Adam Smith it would have been blindingly obvious, nevertheless it proved extremely difficult to persuade government, who had an eye on their 'tax' margin and the inflationary effects, that the main cause of the decline in cocoa production was the totally inadequate price; and that, unless the price was doubled, farmers would prefer to grow food crops or to risk smuggling their cocoa to Togo or the Ivory Coast where the price was much higher. Government's reluctance to increase the price to the farmers had resulted in its share of cocoa export proceeds rising from 18% in the early 1960s to over 50% in the late 1970s -- but on a much smaller crop. In 1984, based on the black market exchange rate, the farmers were being paid only 10% of the world price.

I should mention that I do not regard the World Bank's apparent view that the producer price should be fixed at 50% (or some similar percentage) of the world price as sensible -- although I believe it originated in some work which I managed on rubber pricing in Liberia in 1979. In fact, the price needs to be set only at a price sufficiently high to provide an incentive to continue to grow cocoa.

Restructuring steps

Although persuading government of the need for a major increase to the farmers had the most immediate effect on increasing cocoa output from 1984, I shall concentrate on our work in restructuring the Ghana Cocoa Board itself.

The first stage of this was the reorganization of the Board, integrating the almost autonomous divisions concerned with agriculture and buying under one headquarters structure. This eliminated the duplication of a number of central functions and facilitated planning and financial management for the whole cocoa sector. The overall management of the Board was provided by a Chief Executive and three deputies in charge of collection and storage, finance, and agricultural and related services. Where there was duplication of activities, the departments were combined or eliminated.

We then undertook a careful assessment of each department, determining what it needed to do, what was currently being done and the current staffing. Any activities which were not essential, or which could be combined with work elsewhere, were eliminated. We also took the opportunity of these studies to improve procedures wherever possible. As a result of these detailed investigations we were able to achieve the appropriate staffing numbers and required abilities.

It had been obvious since our work in 1981, that the Board was grossly overstaffed in most of its departments. By the end of 1985 the 115,000 staff we had estimated on the payrolls in 1981 had decreased to about 80,000 -- through wastage and the elimination of thousands of 'phantoms' as a consequence of better payroll controls. But further reductions were needed.

The selection of staff for redundancy was undertaken by a number of committees, under IMCO, the Interim Management committee which was supervising the implementation of all the changes, until the board of directors was formed. A member of our team worked with each of the committees, developing procedures and training and helping the members in selecting staff for jobs or to be made redundant. The committees, each of which included staff representatives, went about this sensitive work with great care, studying each person's file in great detail, and listening to committee members' views on the more senior personnel, before coming to a decision.

We set up the Cocoa Board Retrenchment Unit (CBRU) to administer the details of the redundancy programme. They trained staff in the selection work needed, prepared the selection procedures and made the necessary payroll and redundancy payment arrangements.

After nearly eighteen months of work, far longer than we or the World Bank had originally estimated, some 17,000 staff had been made redundant, reducing the Board's staff to some 63,000. Subsequent retrenchment further reduced the staff to less than 40,000, and the Board operated more effectively, as well as more efficiently.

The whole process was undertaken with relatively little disruption. The generous redundancy (of three years salary in three discounted annual instalments) was obviously an important factor. But equally the staff knew that enormous effort had been made to ensure the process was fair and, where possible, they had been provided with training to make them more valuable in other jobs. Perhaps most important of all however, was the firm commitment to the process at the highest levels within the government.

QUESTIONS AND DISCUSSION

Charles Mensah (IEA Ghana Ltd): Why didn't you ask for competition in the cocoa industry, instead of continuing with the state monopoly? Before the formation of the Cocoa Marketing Board we had about fifteen companies buying cocoa. One of the fundamental reasons for establishing the Cocoa Marketing Board was that the government was going to stabilize prices for the farmers and also provide amenities and other benefits for the farmers -- but then, as you mentioned, in reality the farmers got only 10% of the world price.

O A Kuye (Nigeria): Perhaps it would have improved things for both government and everybody else just to have disbanded the Cocoa board right away and let everybody trade in cocoa as they do in Nigeria. There, the Board was abolished in only one night, there was no question of retraining, no question of setting up another department. I think it was very cost- effective.

Leslie Zurick: In fact we had looked into that but politically it would have been impossible. The situation in Ghana as regards cocoa is very different from that in Nigeria in many respects. First, cocoa is absolutely vital to Ghana's economy, about 60% of its export earnings. Second, the functions of the Board in Ghana are (rightly or wrongly) much wider than those in Nigeria. It is responsible for providing essential services to the farmers, for distribution and collection, and buying as well.

As regards multiple buyers, there had been a multiple buyer arrangement re-introduced in Ghana in the mid-1970s which had been for various reasons (associated with corruption and misuse of funds) an absolute disaster. There was also, firstly on behalf of the Ghana government, great unwillingness at that time to allow in the foreign buyers who had been doing much of the buying in the most successful days of cocoa in Ghana in the early 1970s (Cadbury, Nestle, and so on). Part of what we did was to ask such buyers whether they would be interested in getting involved and there was very little interest. And there were very few organizations at that time within Ghana that the government was prepared to trust in the buying of cocoa.

I do not think it was a politically possible situation although it was one that the World Bank was advocating at the time.

Mr A Herzog (USAID, Zaire): I would like to know the order of magnitude of the consultancy effort either in terms of total billings, of man-months or man-years of consulting activity.

Leslie Zurick: There were about twenty people involved in the advising job, two of which were from Ghana. They were all paid in foreign currency under a World Bank loan. The cost of that was the order of #2 million in total. I think the ultimate savings to the Ghana Cocoa Board and the Ghana economy was much greater. It is most unlikely that Ghana would have increased the price to farmers, which was the main driving force, without our long term involvement in support of the World Bank's policies; and it is most unlikely that they would have managed to be able to reduce the staff of the Cocoa Board both fairly and relatively quickly had we not been involved in that.

PART 3 - PRIVATIZATION IN DEVELOPING COUNTRIES

Chapter 6

THE INTERNATIONAL PRIVATIZATION STORY

Dr Paul Elicker

President, Center for Privatization

The lessons of privatization

Privatization is a continuous process. Successful privatization is not a random number of isolated events but must be **a system that builds up** a regular pace and processing momentum.

Privatization is not necessarily high cost, especially in its early stages, but it **usually takes much longer** than anticipated.

Thirdly, privatization **is a political process**. The key decisions in privatization have political motivation. Privatization is a political process that operates in the field of economics, not the reverse. It should be motivated by pragmatism rather than ideology, but the most important determinant is political will. Only if a country's leaders are determined to make things happen will meaningful privatization occur. Determining the strength of political will is difficult, but there are some indicators, such as written governmental policy statements, the existence of champions of privatization highly placed in the government, and at least rudimentary legislation on the subject.

Fourth, **precision of objectives** is important: this sounds like a truism but it is a very profound statement. When people think of the various reasons they might privatize, they might list the economic pressure of the budget, popular capitalism, the ability to compete in global markets and so on. Those are all very good goals but they are generalities rather than exact targets.

We do not want generalizations, we want specifics. Our precise objectives are interlocked with our programme and strategy. The best example of this is emerging today in Eastern Europe. In Hungary there is a goal stated now that within a certain period of time, a 50% of the state-owned enterprise assets will be privatized. If that goal is to be achieved it means a very fast pace has to be adopted and a whole programme of reform must be implemented. So the objective sets the structure of the programme.

My fifth lesson is that **public understanding and support** are essential. No politician in any country, democratic, socialist, statist, or whatever, will persistently to fight the public will.

There are always groups opposed to privatization, I cannot think of a case where there haven't been. But the basic objective is to convert, or at least to neutralize, these groups. And that is certainly possible. About four years ago an interesting poll was taken in Costa Rica where 5% of the people were for privatization, 30% of them were against it, and 65% either did not know or did not care what the questioner was talking about. The poll was repeated more recently after that country's privatization programme had largely completed itself and by this time the poll said 30% of the people were in favour of privatization, 5% were opposed, and 65% either did not know or did not care what the questioner was talking about. so the 30% and the 5% changed places, which illustrates the point: in Costa Rica, as in and a number of other countries, they accomplished the conversion or neutralization of opposed groups.

There are several ways in which that can be accomplished and one that is very effective is conferences. The country that is the prime example of the multiple use of conferences is Tunisia. Before Tunisia embarked on its privatization programme there were two conferences held; by the end of the first one the Minister of Agriculture was able to announce the government's policy of privatization: at least people were used to the idea by that point.

My next lessons concern two important factors that we have learned must be among the first things you look at. The first step is **legislation**. There is almost always some legislation to deal with: it may be legislation that is rudimentary and needs improving upon; or it may be legislation that needs to be torn down and dismantled -- for example, there are 52,000 decrees and laws in Hungary, many of which have to be changed or dismantled.

One of the first things about legislation is that what we call 'omnibus' legislation is almost always preferable. By omnibus legislation I mean that you do not have to go back to an uncertain body, parliament, to do each privatization.

The second of these preliminary steps is **government organization**: again, there is almost always some government organization already, and you have to decide what to do with it. There are two basic ways to organize a privatization programme: one is to centralize the power and create a privatization commissioner (or what is unfortunately sometimes called a privatization czar), the other is to do it ad hoc -- the different ministries doing it their own pace as candidates become ready. Both are employed, both have been successful, but unquestionably trend toward a commissioner or a czar with the centralized power to privatize things is increasingly more popular.

It is interesting to note that every one of the Eastern European countries (except Albania) has, as one of its early acts, created a commissioner of privatization. There is a paradox here -- that in centrally planned economies trying to convert to a market system, decentralization is the order of the day: but perhaps some initial centralizing of the privatization process is indeed the best way to start things off.

That brings me to the touchy subject of **government holding companies**. There are pluses and minuses to these. In summary, the plus is that if the organizations to be privatized are grouped in a holding company you can at least get at them and see what they are. The minus of course is that big groups of state-owned enterprises, with their unlimited appetite for credit, has almost always has spelled disaster. Honduras is an example of both of these; 62 of their 82 state-owned enterprises were grouped in a holding company; all of them are in the process of being dealt with, but the bad news is that this all started off with a bad scandal about the holding company in earlier years.

Macroeconomic studies are needed. There are really two kinds needed: the first one is in advance for planning. Obviously you want a privatization programme, but the key question really is: is the programme we are talking about consequential to the economy? If it not, then why not? There can be good reasons for that but you ought to know how much of a bite you are taking. The second study would be an audit after the event: did we accomplish what we said we are going to do? Did we do anything that added up to anything economically? I have to say with regard to these macroeconomic studies, that they are not done as often as they should be, and for a variety of reasons I think there are going to be more of them in the future.

My ninth lesson: which comes first, **policy reform or privatization**? There are two approaches to the answer to this question: one says you have to have a level playing field before you begin or you just won't be getting anywhere. The other says privatization can be the catalyst that produces policy reform; that not only should they be simultaneous but in real life they probably will be. In Tunisia it is a very orderly and speedy process and it is interesting to note that the privatization priorities were set before any policy reform occurred: the two things were realized simultaneously and I think probably real life is like that. In reforming policy with regard to privatization you are trying to do two things: to remove impediments so that there is a level playing field; and to create an investment climate for flight capital, for local capital or foreign capital. If that climate is not created there is not going to be enough momentum for continued investment.

My tenth lesson is **restructuring** -- I will define this as an attempt to take the existing organization and to adjust it so that it can become free-standing and has the ability to run its own affairs. The question is: does the restructuring bring a higher price? Restructuring pretends that a company is independent when it is not, and the track record of restructuring is not very good -- usually it does not work. Usually the new buyer is in a much better position to make the sweeping changes that are often needed.

Speed and transparency tend to be somewhat in opposition and both have to be accommodated. The meaning of the term 'speed' is obvious -- the pace at which you go; the word 'transparency' means putting everything on the record and advising politicians that if they set up the right counterweights, committees and balances, it is likely that people will regard the process as fair and open and you will keep out of political trouble. Usually, as Eastern Europe shows us, the size and magnitude of the task sets the pace required and transparency adapts itself as best it can; but both are very important.

My twelfth lesson is one that is particularly applicable to Eastern Europe -- **privatization and monopoly**. Most centrally- planned economies were in the beginning set up to favour monopoly; and most buyers would prefer it to persist when a state enterprise is privatized.

I think of a company which offered, in response to a certain government's desire to sell its airline, to buy the airline provided that they be given exclusive routes and everybody else's existing routes be cancelled. Needless to say that did not go through.

Public or private monopoly is not going to be naturally brought to an end. But it is not true that a private monopoly is even worse than public monopoly -- we are debating two devils here but I think that while it is not good it is certainly not worse. At least a private monopoly can go bankrupt; but in the end all these monopolies, if we are to achieve something worthwhile, must be broken up and it must be the government that does it.

Who is the best buyer? **How** do you sell, and at **what price**? It is not always easy to know -- or even to get to the point where you can think about these subjects practically. There are 7,000 state enterprises in Poland for example, and they cannot all be inventoried: the prioritizing of them, and according to what scale; valuation, which is complicated; prospectus preparation (in Honduras preparing the first 13 prospectuses took over one year); all these are time-consuming. And when you do finally get down to the transaction stage you have to choose between negotiation, public auction and tender, or the stockmarket.

I would like to say our experience tells us that stockmarkets are very important but the big difference is not between a weak or a strong stockmarket but between a weak stockmarket and no stockmarket at all. A weak stockmarket is something to build on (Jamaica is the classic case here but there are others). The stockmarket in Hungary is rudimentary and I was told that at the time there were only two stocks trading in any kind of volume. The first stock market privatization just took place and predictably it was over-subscribed, and the stock immediately went up, which is good.

May I also say that the government can exclude any buyer it wishes as long as it recognizes that in excluding buyers it restricts the market. Of course, it may want to restrict that market, and perhaps you should in some cases. A country which I understand probably over-restricted its market, is Kenya, which has said that various ethnic groups, foreigners, and the largest tribe in the country may not participate at all, or only to certain degrees; and as a result Kenya has not done as much in privatization, relative to its economic strength, as probably ought to be the case.

Of course, you need to have a believable offering (and only experience can tell you what is believable), and to achieve that you need to have the best long-term maximization of profits and cashflow. For the country's welfare the highest price is not necessarily the best price: in fact I would submit to you that our experience tells us that the maximization of price is a relatively secondary consideration.

Those are some of our lessons from our experience in between 50 and 60 countries, the conclusions which (with caution) I offer you for application to your own particular situation.

THE PROBLEMS OF PRIVATIZATION IN DEVELOPING COUNTRIES

Dr Hamza Zayyad

Chairman, Nigerian Committee on Privatization and Commercialization

I believe a lot of the problems we have faced in the two years of our programme implementation are similar to those encountered by other developing countries.

In recent years, the idea of privatization has gained universal appeal in both developed and developing nations. Shortage of public funds and the growing contrast between public waste and private thrift together provide the domestic impetus to harness the energies of private entrepreneurs in country after country. Even countries once firmly committed to socialism have begun to realize that individual energy is a more reliable engine of economic growth than government business which lack the incentive to succeed. Over 50 countries across the world are currently involved in one form of privatization or another.

THE NIGERIAN PROGRAMME

As part of a comprehensive home-grown structural adjustment programme, the federal Military government of Nigeria promulgated Decree No 25 of 1988 to usher in a programme of privatization and commercialization. I call it home-grown because following the rejection of an IMF loan in 1986 by Nigerians after a six-month public debate on the matter, the government decided to develop its own programme of structural adjustment rather than adopt the standard IMF prescriptions. As a result, Nigeria is the only country in the world that I know of where the World Bank is supervising its adjustment programme in place of the IMF.

In all some 145 public enterprises, out of an estimated population of 600 public enterprises in Nigeria, were identified and listed in the Decree for either partial or full privatization or partial or full commercialization. The broad objectives of the programme are:

- to **improve the efficiency** of public enterprises;
- to **reduce the dependence** of public enterprises on the treasury for the funding of their operations; and
- to **increase the participation** of Nigerian citizens in economic activities through share ownership of productive investments.

Scope of Nigeria's programme of privatization and commercialization

Government investments in Nigeria cut across all sectors of the national economy. The current programme of privatization and commercialization touches practically every industry except defence.

PRIVATIZATION

SECTOR	NO OF COMPANIES	TYPE
Development banks	4	partial privatization
Oil marketing companies	3	"
Steel rolling mills	3	"
Air and sea travel	2	"
Fertilizer companies	2	"
Paper mills	3	"
Sugar companies	3	"
Cement companies	5	"
Hotels and tourism	3	full privatization
Textile companies	3	"
Transportation companies	4	"
Vehicle assembly plants	6	"
Merchant banks	4	"
Commercial banks	8	"
Food and beverages companies	6	"
Agriculture and livestock production	18	"
Salt companies	2	"
Wood and furniture companies	2	"
Insurance companies	14	"
Film production and distribution companies	2	"
Flour mills	1	"
Cattle ranchers	2	"
Construction and engineering companies	4	"
Dairy companies	2	"
Others	4	"
Total number of enterprises to be privatized	110	

COMMERCIALIZATION

River Basin Development Authorities	11	partial commercialization
Nigerian Railway Corporation	1	"
Nigerian Airport Authority	1	"
National Electric Power Authority	1	"
Nigerian Security Printing and Minting Co Ltd	1	"
National Provident Fund	1	"
Ajaokuta Steel Co Ltd	1	"
Delta Steel Co Ltd	1	"
Nigerian Machine Tools Ltd	1	"
Federal Housing Authority	1	"
Federal Radio Corp'n	1	"
Kainji Lake Nat'l Park	1	"
Nigerian Television Auth	1	"
News Agency of Nigeria	1	"
Nigerian Telecommunication Ltd (NITEL)	1	full commercialization
Nigeria National Petroleum Corp'n	1	"
Associated Ores Mining Co Ltd	1	"
Nigerian Mining Corp'n	1	"
Nigerian Coal Corp'n	1	"
National Insurance Corporation of Nigeria	1	"
Nigeria Reinsurance Corp'n	1	"
National Properties Ltd	1	"
Tafawa Balewa Square Management Committee	1	"
Nigerian Ports Authority	1	"
Total number enterprises to be commercialized	35	

Nigeria is one of the few countries in the world that has made conscious distinction between commercialization and privatization based on the social service content of the goods or services produced or rendered by the affected enterprises. Commercialization, partial or full, does not involve any change in ownership, except to the extent necessary to redress structural malformations likely to affect the efficient functioning of any one organization.

A fully commercialized enterprise would be expected to be selfsufficient in both its recurrent as well as capital expenditure needs. Those to be partially commercialized would be expected to operate like the fully commercialized ones in terms of better management and profit orientation, but because of the public nature of the goods or services provided by such enterprises, and in order to keep the prices of their products or services within the reach of the general public, government would still provide financial grants for their capital projects. These enterprises would however be expected to earn enough revenue to cover their operating costs. Where recurrent subventures are allowed, there will be a time-bound programme of withdrawal. In both full and partial commercialization, affected enterprises will enjoy considerable operational autonomy and in accordance with the Decree will have the power to operate on strict commercial basis and, subject to the regulatory power of the government, be able to:

- **set rates, prices and charges** for the goods and services provided;
- **capitalize assets;**
- **borrow money** from the capital market without government guarantees;
- **sue and be sued** in their corporate names.

This programme of public sector reform is not driven by financial considerations alone. Increasing productivity in the sector and enhancing quality of service of public enterprises, through commercialization are also worthy objectives. Nigerian public enterprises particularly public utilities, occupy a pivotal position in the nation's search for rapid economic development. Nigeria's inability to achieve its development goals have been blamed on the failure of these public utilities to provide reliable and efficient support services.

Privatization can be viewed as a way of stimulating the broad-based participation of Nigerian individuals directly in productive activities through shareholding. It is also a way of developing the local capital market. The process of privatization can furthermore decentralize decision-making to a larger number of economic agents thereby gaining the advantages of risk spreading and risk diversification, inherent in a large number of discrete investment decisions. This shift in focus by government further recognizes the growing sophistication of Nigerians who have accumulated wealth and entrepren eurial skills since independence. These individuals are now better prepared and equipped to take the risks of productive investments.

Shifting greater responsibility to individuals for investment and to the enterprises to self-finance, their operations will relieve government of the necessity to be the all-encompassing agent of development, therefore allowing it to focus on those areas where its intervention is critical, and the channelling of scarce public resources to areas of higher priority such as infrastructure where the general public's interest cannot adequately be met by the private sector. In the social sectors, public resources will be more readily available to enhance the quality of life, provide education and health services and constitute the safety net necessary for weaker groups.

Implementation

Decree No 25 of 1988 established the Technical Committee on Privatization and Commercialization (TCPC) and vested it with wide powers to supervise and monitor the implementation of the programme. Membership of the TCPC was drawn from both the public and private sectors with the latter in the majority.

As a measure of the commitment of the political authority to the programme, TCPC was allowed to establish a secretariat independent of the civil service and manned by professionally qualified personnel especially recruited directly by the TCPC, or borrowed on secondment from the banking system.

Another manifestation of commitment of the administration is that the chairman of the TCPC reports directly to the President.

In order to accelerate the process of implementation of the privatization and commercialization programme, the technical committee decided to adopt a multiple approach as follows:

- the use of **sub-committees** comprising of knowledgeable individuals in society selected on their personal merits to undertake diagnostic work at enterprise level;
- appointment of **Technical Advisory Groups** (TAGs) consisting of reputable financial institutions to lead teams of experts to undertake detailed technical, financial, organizational and management appraisal of affected enterprises;
- appointment of **Financial Advisers** (FAs) usually merchant banks or accounting firms with demonstrated experience and reputation to prepare detailed briefs on capital restructuring or affected enterprises; and
- appointment of **other professionals** such as issuing houses, estate valuers and legal practitioners to deal with different aspects of the programme implementation.

The sub-committees approach was used for most cases of commercialization and in a few cases of privatization, especially where the enterprise is of the type which is of strategic importance, multifaceted or not slimly organized. A total of 63 sub-committees were appointed to undertake diagnostic works on affected enterprises and three special tasks. Over 500 persons drawn from both the public and private sectors were appointed to serve on such sub-committees. The approach enabled the TCPC to achieve the twin objectives of tapping the best human resources that Nigeria could offer and facilitating the widest participation in the implementation of the programme. What is more gratifying is that the programme is being implemented entirely with local indigenous personnel without recourse to external assistance.

In all cases the TCPC developed guidelines to ensure uniformity and comprehensiveness in the work of the sub-committees, the TAGs and the FAs. Once the work of the sub-committees, the TAGs and FAs was completed the stage was set for implementation of their various recommendations.

Privatization methods

In the area of privatization the TCPC has adopted three methods of privatization.

i) **Public offer for sale** of shares of affected enterprises through the Nigerian stock exchange. It is expected that 60 out of the 110 affected enterprises will be privatized through this method;

ii) **Private placement of shares** of affected enterprises which cannot meet the listing requirements of the Nigerian stock exchange or where the shareholding is negligible. Typically under the scheme a core group will be identified as the leaders amongst the investors. Such core groups may be formed with demonstrated capabilities in similar industries or workers of an enterprise forming themselves into cooperatives. Alternatively, public sector investment agencies can get used to warehouse shares of affected enterprises pending the time they are ready to be sold through public offer of shares on the Nigerian stock exchange. About 35 enterprises are expected to be privatized in this way. Special guidelines were developed for private placement.

iii) The third method is **mergers or the sale of assets** where the affected enterprises cannot be sold either by public offer of shares of by private placement. These are likely to arise in cases of enterprises whose future outlook is hopeless. In all cases the assets will be sold by public tender advertised nationally, and it is expected that 17 enterprises will be so treated.

Our choice of **public offer for sale of shares** as the predominant method of privatization was formed by the need for wider shares ownership and the desire to extend the frontiers and depth of the Nigerian capital market.

We recognize that there are advantages of using the stock exchange as a medium of disposal of the shares, particularly in a developing economy like Nigeria's. The major **disadvantages** are:

- in a society with a high level of illiteracy, the **cumbersome formalities** of prospectuses, a multiplicity of professionals and complicated application forms that have to be returned through few and sometimes unapproachable banks and stockbrokers could prove quite daunting, incomprehensible and therefore unattractive, not only to the illiterate but also to a large section of the semi-illiterate population;

- there could also be **geopolitical imbalances** arising from unequal regional distribution of income, education, banking and stockbroking facilities. For example, out of over 2,000 branches of banks and stockbroking companies in the country, as at 31 December 1989, nearly 300 branches are based in Lagos alone;and

- where the price of the shares in an issue **collapses** soon after resumption of trading in such shares, or there are inordinate **delays** in returning excess subscription, the confidence of the investing public in the programme may suffer.

But the stock exchange medium also has numerous **advantages**, among which are the following:

- it enables us to reach a much **larger audience**, and provides a more objective allocative mechanism devoid of rancorous suspicion of favouritism in sale of the shares under private placement;

- if properly publicized it could **create a large new shareholder class** who have a vested interest in seeing that the enterprises are profitably run, and consequently higher accountability and a check on the management;

- it will deepen the Nigerian stock exchange and **facilitate the development of unit trusts** as a medium of investment for small holders, thereby creating popular capitalism; and

- the stock exchange approach, unlike asset stripping or private placement, is so **much more creative**, with the focus of all parties to the exercise being to ensure that the enterprise is sold as a going concern.

The journey so far

To date, TCPC has made nineteen public offers of sale of ordinary shares involving some 132 million shares with a market capitalization of about N$184 million. In the process a total of 373,790 new shareholders have been created across the country geographically and amongst all income groups. The result of these public issues have brought out some interesting revelations.

Contrary to fears about the absorptive capacity of the Nigerian capital market, all the 19 public offers were heavily over-subscribed, the least of which was 1.5 times over-subscribed, and the heaviest 7 times over-subscribed.

Again, contrary to fears that the programme will be cornered by the rich few in our society, it has turned out to be an exercise of popular participation. In all cases applications in the range of 100-1000 shares predominated and the total number of shares applied for by this range was several times more than shares available for sale. Consequently this group received between 75-86% of the total shares sold so far.

As a result of the awareness created by the TCPC, the number of applicants were the highest ever recorded in the history of Nigeria's capital market. Admittedly, considerably more application forms were distributed through unconventional media such as local government councils, post offices etc., so that proportionately more people will apply. African Petroleum Ltd, a privatized oil marketing company, has the largest number of shareholders in black Africa thanks to privatization. Clearly what we are witnessing is a silent revolution in the corporate ownership structure of productive investments in the national economy. To those who saw privatization as a transfer of public property to a few rich people, the message is loud and clear that it is not. It is, in fact, a programme of mass participation or popular capitalism. In place of the hitherto dominant voice of the Federal Government, there are several hundred thousand new shareholders. This is bound to increase accountability of management and consequently higher productivity. We are also in the process of deepening the Nigerian capital market and challenging it to innovate in the service of the nation.

I consider this background information on the Nigerian programme of privatization important because I believe very little is known of the great strides taken by Nigeria in this area. I will now quickly move into the main theme of this address -- problems of privatization.

PROBLEMS ENCOUNTERED

The relative success achieved in the implementation so far is not without problems.

Political decision-making

Perhaps the biggest problem is to decide on the programme itself. Given the pervasive culture of patronage in most developing countries, the very idea of privatization is an anathema to many people. In Nigeria, with a military administration, the subject was debated for two years before a decree was promulgated. In a civilian democratic setting it will take much longer time and the final is decision much less likely to be as comprehensive. Once the decision is taken the next major problem is the focal point for implementing the decision.

Focal point

The choice of institutional framework for the implementation of the programme will differ from country to country. In the Nigerian situation the decree established the TCPC as the sole implementation authority and vested it with powers to appoint professionals such as issuing houses, stockbrokers, solicitors, reporting accountants etc., and to coordinate the entire implementation machinery. Although outside the civil service, the secretary of the TCPC who is a director general in the Presidency, serves as the link between it and the bureaucracy, and ensures quick passage of TCPC matters. The direct access which the chairman TCPC enjoys with the President ensures that TCPC is heard unedited. We have found our arrangements most effective. Simple as it may seem, the decision is not easy because of entrenched interests in supervising ministries, the treasury and, of course, the politicians, who in a democratic setting will pass the necessary legislation.

Inadequacies of the capital market

Nigeria's capital market is relatively young, although the Nigerian stock exchange is perhaps the most developed in black Africa, capital market operations such as issuing houses, stockbrokers and registrars may not have hands-on experience in processing new public issues. What we did was to begin with the more experienced firms, who helped to set standards for subsequent issues.

Bottlenecks in the delivery system in the capital market

Considerable delays have been experienced in the processing of share application forms, resulting in frustration for some applicants who expect to utilize return monies from one issue to finance purchases in subsequent issues. We realized to our dismay that the registrar's offices were ill-equipped to process the unexpectedly large volume of applications received. Steps have been taken to remedy this shortcoming by using receiving agents to pay return monies to applicants.

Publicity and public enlightenment

The need and necessity for creating public awareness about the privatization programme was recognized very early in the day. Such awareness is necessary not only to dispel certain misconceptions and fears about the programme but also to explain in as simple a way as possible the technicalities of investment via the stock exchange to a populace the large majority of whom are unfamiliar with such technicalities. Also we saw the need to explain the programme to everybody in every nook and corner of the country, given the immense public interest generated by the exercise, as it is essentially not only an economic programme but an intensely political one as well.

In the Nigerian situation, the radio has been identified as the most effective medium of reaching the masses, although use is being made of newspapers, television, seminars, conferences, workshops and so on. Poor publicity and public enlightenment leads to apathy and failure of the programme.

The socio-political problems

There are some people who are opposed to privatization on ideological grounds. To them privatization and structural adjustment programmes are impositions from the World Bank and IMF, the twin champions of international capitalism. They often dismiss the explanation that Nigeria had been looking for solutions to the problem of public sector investment long before the IMF and World Bank came on the scene. They also generally do not see much merit in the argument that the Nigerian SAP is a homegrown solution, and not an imposition of the IMF and the World Bank. Those who take this position generally believe that nothing good will come out of the programme. Since such pessimism is more often than not deeply rooted in ideological opposition, it is not easy to dissuade those who express it, particularly since they are vocal and elitist. The primary argument for privatization and commercialization is of course that the efficiency and profitability of the investments will improve after the exercise. At the end of the day, it is perhaps only a clear demonstration of such improvement that will convince people who hold such views.

Antagonism by labour

A subset of the group who oppose privatization on ideological grounds are those who believe that privatization is anti-labour, as it will inevitably lead to massive retrenchment. The answer here is that this is not necessarily so. To the extent that the efficiency of the enterprises improves, the lot of labour will in fact improve. Moreover, the Nigerian TCPC decree specifically provides that at least 10% of the shares being sold in each enterprise be reserved for the employees of the enterprise.

The bureaucracy

Another group which is opposed to privatization is the bureaucracy from the Hon. Minister to the Senior Assistant Secretary who exercise authority over the public enterprises without responsibility for results at the enterprise level. They must be handled with care.

Inadequate record keeping

The Ministry of Finance Incorporated (MOFI), the primary institution that is in charge of government investments, has serious problems of incomplete record keeping. This partly arose because other ministries and departments of government often went ahead and undertook investments, the details of which they did not make available to MOFI as they were statutorily required to do. Thus one of the first tasks of the TCPC was to try to assemble complete and accurate information about federal government investments by way of equity, loans and grants in all the enterprises affected by the decree.

Geopolitical spread

Regional imbalance in shareholder distribution, particularly between the north and south of the country, is another major problem. Efforts are being made to increase publicity and public enlightenment in the north so as to ensure that the level of participation is increased considerably. TCPC is concerned with the distributional equity, geopolitically and within income groups, and will do all within its powers to achieve the objective.

Access to credit

Access to credit for a large body of interested persons has proved an intractable problem. Although licensed banks were advised by the Central Bank of Nigeria to extend credit to all interested persons the banking system has not responded favourable for operational reasons. This problem has tended to dampen enthusiasm particularly amongst the working class whose earnings are hardly sufficient to meet their normal needs let alone have surplus to invest. One reason for the banks attitude is that the system has gone through rather traumatic changes in recent months, and perhaps once the banks overcome the problems posed by the changes the situation may improve. Employers of labour have been advised to assist the employees with share purchase loans and the response has been most encouraging.

Institutional investors

A considerable part of the over-subscription experienced in the offers for sale of shares arose from the intervention of large institutional investors who saw in the privatization an opportunity to broaden their investment portfolios. With emphasis being given to the small individual investors, such institutional investors are being frustrated and there is the risk of losing their patronage. Special effort is being made to persuade such investors to have faith in the programme until such time the really large offers are made, when everyone can get a share.

CONCLUSION

There are problems and there are going to be a lot more, but part of the challenge of the job is the extent to which we can rise to meet and solve such problems creatively. To us in the TCPC, the programme is a major opportunity for the reform of our ailing public sector and our hope and prayer is that at the end of the day the Nigerian public sector will be transformed, and the culture of political patronage removed in favour of merit. It will be made more efficient, more accountable and more responsive to the needs of the clientele it is supposed to be serving -- the Nigerian public. The Nigerian private sector will also benefit tremendously in the creation of new investment opportunities and a better investment climate. A lot more new shareholders will be created and have a say in the management of the organized private sector. The performance of the Nigerian capital market will be enhanced greatly, and overall the growth potentials of the Nigerian economy will be greatly enhanced.

There may be some political and social fall-out but at the end of the day the gains are going to outweigh the losses by far, and the Nigerian economy and nation will be so much the better for it.

OVERCOMING THE PROBLEMS: CONTRACT MANAGEMENT

Richard Lloyd

Morgan Grenfell International

Let me begin by asking what is so different about privatization in developing countries. Why can you not just sell the assets as, say, Britain has done, pay off your advisers, and celebrate?

There are many difficulties. Two, in particular, are almost universal:

- there is often no readily acceptable basis for **valuing** a loss-making business in a developing country -- and the difficult cases are loss-makers; and

- there are frequently no **buyers** -- except would-be asset strippers or unacceptable groups such as foreign companies or the local rich.

Frequently, therefore, a sale in the short term is not possible or at least highly undesirable. As a result, if your definition of privatization is a sale of assets -- an immediate change of ownership -- you must probably give up at this point. That is where many governments in developing countries have got to, despite wasted years of rhetoric by politicians and advisers alike.

We have worked on a number of privatizations in Asia. In the last three cases on which I worked, we actually advised our client not to sell; there is a better way if you want to privatize quickly without political rumpus. If you are prepared to accept a more flexible definition, you can introduce creative solutions and begin to reap many of the benefits of privatization quite quickly. That way is immediately to privatize management. This can take a variety of forms: for example, through leases, management contracts, and concessions. The method chosen for a particular enterprise will depend on local circumstances and the nature and extent of interest on the part of competent managers.

Some examples

One example I particularly like was the case of the Kenya Tea Development Authority (KTDA). It was, at least for its first two decades, a stunning success. It started from nowhere in the early 1960s and, during the 1970s, became the world's largest single exporter of tea, providing a livelihood for between 100,000 and 200,000 families. It depended in its initial phase on contracted management to run the tea factories -- highly efficient factories, getting some of the highest international auction prices. This was a new project with private management from the outset, but for political reasons private *ownership* was then impossible. KTDA's subsequent history has included a number of problems. But they do not alter the conclusion that private management was a vital ingredient in the successful early phase.

The examples we mentioned in *Privatization Now!* continue to be equally interesting. The first was a loss-making, apparently doomed, state-owned bicycle factory in Zambia. The government introduced an outside management company and saved the business. These managers brought in working capital, were paid by results, and turned the business round. In the last year, profits have risen to 3 million kwacha (formerly it made losses of one-and-a- half million kwacha); the workforce has grown; wages have risen; exports have begun. Before the new management arrived a valuation would probably not have exceeded the scrap value of the assets. Now there is a relatively efficient business, worth a healthy multiple of its profits, and the enterprise is saleable.

The other case we mentioned was a steel mill in Togo. That too has been saved. In the latest year for which figures are available, exports rose, staffing rose, and profits were 14% on capital invested. It has started up three new subsidiaries -- in fact it pays increasing amounts to the Treasury. And we understand it has competed successfully against international firms for major contracts. Before 'privatization by lease' it would have realized only its scrap value, or it would have been dismantled and put up in some other country.

However, as in most developing countries the government wanted to keep it going, and now it is worth something. The government could sell it and in fact has decided to do so at the end of the lease period. Some 20% of the concession company has already been sold to Togolese and Ivorian investors. In this case too, deferring the sale, but introducing efficient managers, has enabled the country to enjoy some of the benefits of privatization quickly and still keep open its options for privatizing ownership.

Determinants of success

Apart from the need for private managers to be competent, we have encountered two important determinants of success in privatizing management. First, the managers must be made to take some risks; in the cases I have mentioned the managers put in money, as well as a great deal of effort. Second, you should pay them by results. That has proved to be a highly effective incentive.

Chapter 9

THE FUND CONCEPT AS A STEP TOWARDS PRIVATIZATION

Peter Muth

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Richard Lloyd's examples -- and there are many more around the globe -- are not simply businesses that governments did not want to sell. Those companies could not be sold at all, or not at a price that would have reflected the fair value of potentially sound companies.

At privatization conferences you will often hear the opinions that the relevant governments were wrong not to sell those enterprises. The argument will be that more effort or a different approach would have sold the bicycle factory and the steel mill.

But we itinerant privatization midwives must deal not with the saleable flagship companies, but with the large numbers of unspectacular headaches among state enterprises. These unspectacular state enterprises are typically loss-making, overmanned, obsolete, and a drain on the budget; and no-one is interested in buying them.

The concept of 'appropriate technology' -- ie technology suitable for the environment in which it is applied -- has been a useful guide to development engineers. We believe it is time to recognize the need for an equivalent approach in the privatization field. The UK privatization record is impressive and so was the privatization of the National Bank of Jamaica. But neither example is relevant to the bicycle factory in Zambia or the steel mill in Togo.

One element of 'appropriate technology' in privatization is the distinction between the privatization of management and the privatization of ownership. The Zambian and the Togolese companies were unsaleable -- at the time -- but the privatization of their managements was appropriate and beneficial. Today both are saleable. The same could apply to thousands of state enterprises in dozens of countries.

A privatization fund

I have recently been working with one of the major bilateral donor agencies to develop the concept of a privatization fund for developing countries. The core of this fund concept is that management and ownership of each enterprise would be privatized at their own appropriate speed. In practice that will usually mean immediate privatization of management, and sale at a later time.

We believe that the fund concept will make privatization much easier by cutting through a great deal of the political indecision. Typically in developing countries, each state enterprise reports to, and depends on, a variety of ministries or authorities. This applies not only to operations but also when it comes to 'letting go' at privatization time. The result is often indecision, conflict and, usually, a delayed or bungled privatization. In countries with hundreds of privatization candidates, a programme along these lines will stretch over generations.

The fund is a radical solution to this difficult problem. Establishment of the fund and the transfer to enterprises to it is the seal on an irrevocable decision to privatize, and gets the process going right now; but it entails no specific commitment as to how to privatize.

When the government transfers enterprises to the fund, it receives in return redeemable receipts. The receipts have no fixed value. They earn income as soon as the enterprise becomes profitable. When the fund eventually sells a batch of shares in an enterprise, a part of the proceeds goes towards the redemption of the receipts.

The concept foresees the swap of the receipts for debt instruments held by the country's creditors. Indeed, it encourages such swaps, because the creditors may prefer receipts backed by privately managed assets to debts payable by a beleaguered treasury.

Powers of the fund managers

The fund is run by managers. Let us call them *trustees* to distinguish them from the managers of the enterprises in the fund. The trustees hold all the powers relevant to privatization that were previously held by all those ministries and authorities. The trustees' main task is to find private sector managers *now* for each of the enterprises in the fund.

The fund's trustees are the buffers between the government and the privatized enterprise managements. They derive their powers from a law enacted to establish the fund. Their independence and the non-intervention of the government are guaranteed by the participation and financial support of one or more donor agencies.

The trustees decide how to privatize management now, and when, how, on what terms and to whom to sell shares of fund enterprises. They are monitored by a joint government/donor committee of fund overseers. The trustees, in turn, monitor the enterprise managers.

Enterprise managers come in many forms: some are lessees or concessionaires; there may be joint-venture partners or contract managers. But they all have two things in common:

- there will be little or no reward unless they perform;

- they will bear a degree of financial risk. But their resources will not be wasted on buying obsolete assets: they will provide working capital or pay for urgent investments.

Donor support is needed for funding the initial operating budget of the fund and urgent initial restructuring tasks. The fund will be self-sufficient in the longer term, and future needs will be met out of retained proceeds from the sale of fund enterprise shares to private investors.

Conclusion

The fund concept is a logical step forward, and away from the orthodox approach to privatization which has been found wanting in many developing countries.

It *is* possible to privatize management even if there is no private ownership. With the political will to do it, it is possible now. On the other hand, it is often neither possible, desirable nor necessary to *sell* now. But why postpone all change and improvement just because you cannot sell?