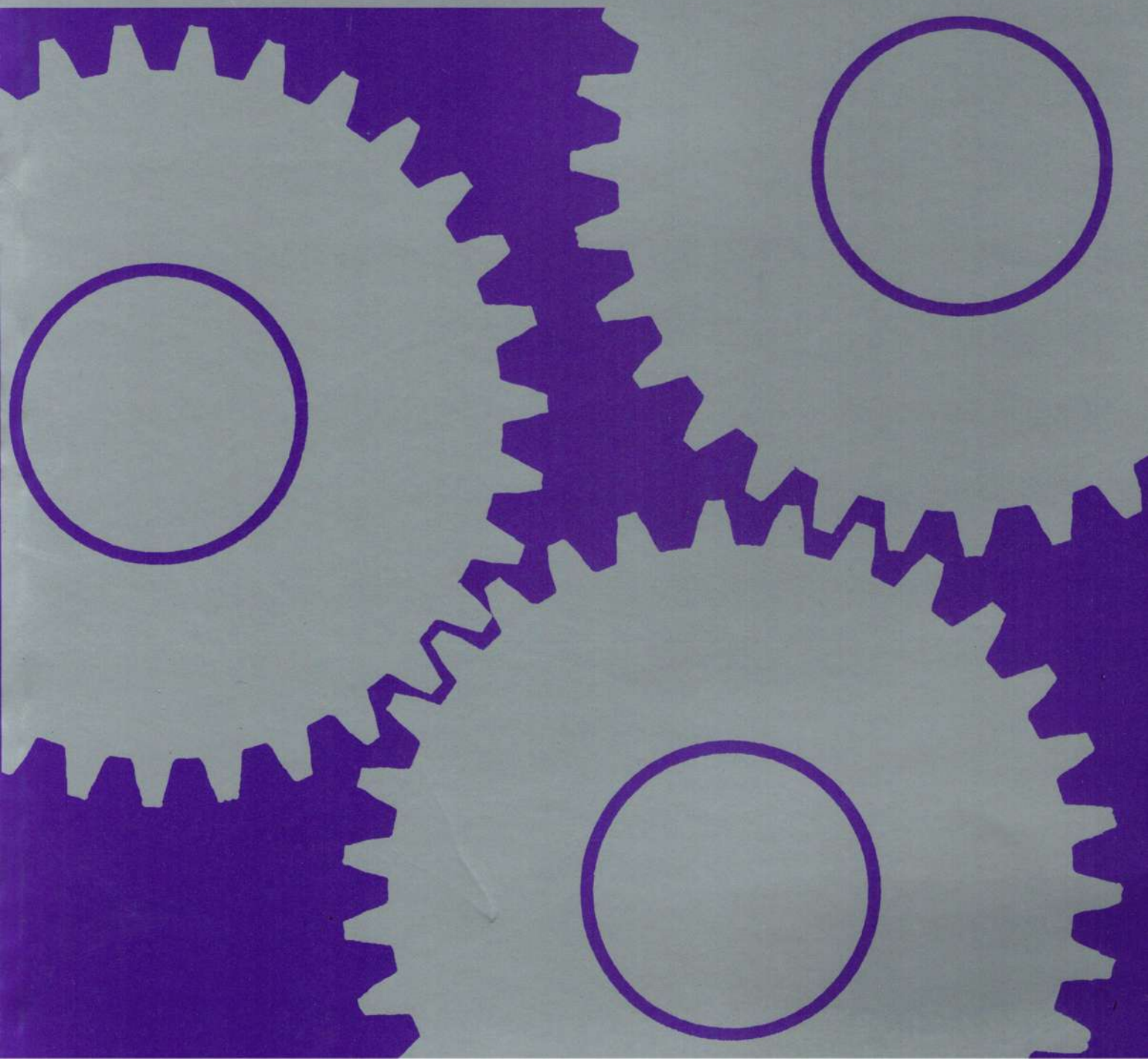


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# PRIVATIZATION NOW!

Edited by Eamonn Butler



**PRIVATIZATION NOW!**

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**The Potential and Practice of Privatization  
in Developing Economies**

Edited by

Dr Eamonn Butler

From a conference sponsored by  
**The Adam Smith Institute**

London

## Contents

Introduction	(iv)
Dr Samir Soler	

## I THE PROMISE OF PRIVATE SECTOR

1. Expanding private investment	1
John B. Good	

First published in the UK in 1990  
by ASI (Research) Ltd

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## II PRIVATIZATION IN THE 1990S

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3. Case study: private sector external works	27
Richard Lloyd	

ISBN 1-870109-75-9

7. Case study: solving an infrastructure problem	29
Peter Miah	

9. Case study: privatization in Costa Rica	35
Jack Robinson	

11. Case study: private finance of infrastructure	39
John Burnham	

13. Case study: the movement to privatization in the East	45
Alan Wright	

## III PRIVATIZATION AND THE DEVELOPMENT AGENCIES

15. International aid and the private sector	57
Christopher Patten MP	

17. The role of the Commonwealth Development Corporation	63
John Eccles	

Printed in Great Britain by Imediacopy Limited, London SW1.

Page Limit



## Contents

---

	<b>Introduction</b>	(vi)
	Dr Eamonn Butler	81
I	<b>THE PROMISE OF PRIVATIZATION</b>	87
1	<b>Spreading popular capitalism</b>	1
	John Redwood MP	91
2	<b>The principles and practice of privatization</b>	8
	Peter Stredder	
II	<b>PRIVATIZATION IN THE DEVELOPING WORLD</b>	97
3	<b>Starting out on a privatization programme</b>	17
	Peter Young	102
4	<b>Why to privatize and what to privatize</b>	19
	Alfred Latham-Koenig	107
5	<b>The special features of privatization in the developing world</b>	22
	Dimitri Plionis	
6	<b>Case study: privatization without stockmarkets</b>	27
	Richard Lloyd	
7	<b>Case study: reviving an industrial lossmaker</b>	30
	Peter Muth	
8	<b>Case study: privatization in Costa Rica</b>	34
	Jack Robinson	
9	<b>Case study: private finance of infrastructure</b>	39
	John Burnham	
10	<b>Case study: the movement to privatization in the East</b>	46
	Philip Wright	
III	<b>PRIVATIZATION AND THE DEVELOPMENT AGENCIES</b>	
11	<b>Economic aid and the private sector</b>	57
	Christopher Patten MP	
12	<b>The role of the Commonwealth Development Corporation</b>	70
	John Eccles	
13	<b>New capital for economic development</b>	72
	Roger Leeds	

#### IV PRIVATIZING UTILITIES

<b>14 Why privatize utilities?</b>	<b>75</b>
Lynda Rouse	
<b>15 Public and private approaches in the electricity industry</b>	<b>81</b>
Oliver Letwin	
<b>16 Privatizing a telecommunications sector</b>	<b>87</b>
John Collings	
<b>17 Case study: the privatization of British Telecom</b>	<b>91</b>
Peter Benson	

#### V OTHER PRIVATIZATION TECHNIQUES

<b>18 The mechanics of the buy-out</b>	<b>97</b>
Laurie Brennan	
<b>19 Contracting out local services</b>	<b>102</b>
Robert Poole	
<b>20 Case study: Wandsworth's experience of contracting</b>	<b>107</b>
Sir Paul Beresford	

<b>APPENDIX</b>	<b>113</b>
Recent Publications on Privatization	

## Introduction

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**Dr Eamonn Butler**

Director, Adam Smith Institute

This report contains the edited transcripts of the remarks given at the **Third London Conference on Privatization**.

The London Conference has now become a principal event in the international privatization calendar; and at the Third Conference we welcomed over 170 top-ranking delegates from 42 different countries and dependent territories.

London is a natural home for such an important event. Nowhere does there exist a greater concentration of expertise on 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.

Indeed, 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.

Professional advice is essential for any country embarking on a privatization programme. It is very easy to make mistakes and to jeopardize 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 authors' worldwide experience prompted us to concentrate the focus of the Third London Conference onto the special features of privatization in developing countries. This resulting report provides policymakers in the developing world with a manual of great insight, which should help them press ahead towards the important political and economic benefits of privatization.

## ENHANCING HUMAN CAPITALISM

John Edwards MP

Parliamentary Under-Secretary of State at the Department of Trade and Industry

### PART I -- THE PROMISE OF PRIVATIZATION

The major reason why the Government is so keen to move forward with the sale of state-owned enterprises is that it has been proven that the private sector is more efficient than the public sector. In the United Kingdom, the private sector has created a record of productivity and innovation that the public sector has been unable to match. This is why the Government is committed to the sale of state-owned enterprises and to the creation of a new public sector.

Let me begin by asking the question: what is the purpose of privatization? The answer is simple: to create a new public sector that is more efficient and more innovative than the old public sector. This is why the Government is committed to the sale of state-owned enterprises and to the creation of a new public sector.

The new public sector is more efficient than the old public sector because it is more competitive. In the private sector, companies are forced to compete for customers and to provide the best service possible. In the public sector, companies are not forced to compete and they do not provide the best service possible. This is why the Government is committed to the sale of state-owned enterprises and to the creation of a new public sector.

### THE BENEFITS OF PRIVATIZATION

One of the main benefits of privatization is that it creates new jobs. In the private sector, companies are forced to create new jobs in order to compete for customers. In the public sector, companies are not forced to create new jobs and they do not create new jobs.

Another benefit of privatization is that it creates new products and services. In the private sector, companies are forced to create new products and services in order to compete for customers. In the public sector, companies are not forced to create new products and services and they do not create new products and services.

One of the main reasons why the Government is so keen to move forward with the sale of state-owned enterprises is that it has been proven that the private sector is more efficient than the public sector. In the United Kingdom, the private sector has created a record of productivity and innovation that the public sector has been unable to match. This is why the Government is committed to the sale of state-owned enterprises and to the creation of a new public sector.



### SPREADING POPULAR CAPITALISM

**John Redwood MP**

Parliamentary Under-Secretary of State at the Department of Trade and Industry

The Adam Smith Institute have done a great job in putting forward the arguments for privatization and in explaining many of the techniques that have now been pioneered and developed in so many countries: in Europe, in Asia, in the Americas, and in Africa. The movement is widespread, and is making a constant progress. It is discovering that there is no political boundary it cannot cross, no ideology that it cannot live with, no group of politicians (or almost no group of politicians) that it cannot sway with some of its charms.

Let me begin by asking the question: why should it be that privatization is now so popular? Why is it sweeping the world and appearing in so many different countries, climates, shapes and forms?

The main reason is because there has been a catastrophic failure of state capitalism in so many countries. A large number of public enterprises set up in the last forty-five years have been disappointing in their performance; they have let their customers down; they have let their employees down, and have not been good places to work in; they have lost a great deal of money for the governments that have sponsored them, invested in them, and backed them; in many cases they have become great state liabilities which obstruct those trying to balance the budget or roll back the large amounts of debt that so many countries have incurred.

### THE BENEFITS OF POPULAR CAPITALISM

On the other hand, popular capitalism has many attractions that can be sold to the electorate, to the wider public, to the employees and to the managers.

#### **Customer benefits**

If we take first of all the customers, in how many countries have they experienced the same problems with state services -- no choice, rising real prices, and a quality of service that leaves a lot to be desired? In other countries abroad where there has not been the same state monopoly or state dominance, they have seen a much better range of service delivered at a more attractive price. They have often found that when relying on state enterprises they experienced difficulty in getting the goods or service at all;



delay is a characteristic of much monopoly business, and government monopoly business has been particularly bad in this respect.

So for the customer, privatization can offer a better deal. If privatization takes the form of introducing competition then it can offer the customer choice. If the good or service is bad or not supplied on time he can go to another supplier. He may well find that the privatization process itself is an opportunity to raise the quality of goods and services: by laying down standards if a monopoly remains, by stimulating greater quality through choice and customer power if competition is developed. That can be the deal for the customer: a much better deal on price, on service, on delivery, on the whole operation.

### **Employee benefits**

But what about the employees? Sometimes trade union leaders will say what the customer gains the employee must lose; it must mean lower wages or less increase in wages, that it must mean fewer strikes, that it must mean less employee power.

Not necessarily. In many cases there can be more employee involvement, there can be better wages, there can be a better deal for the employee at the same time. If you manage for quality and you manage for the customer, it does not mean that you have to pay starvation wages or that employee rights have to be removed from the system. It means that the whole business is run so much better, the inefficiencies are squeezed out and those who do work in the business can take a pride in it, can achieve so much more, and can be properly rewarded for the work that they deliver.

More importantly, in many privatization strategies the employees can be directly empowered in the life and work of their business because they themselves can become shareholders in that enterprise, often for the first time. They become shareholders in a business, they become directly involved in the ownership of an organization which seemed so remote when it was in the hands of the state.

### **An example**

The remarkable transformation in morale and attitudes which employee shareholding can generate has been illustrated in many examples. My favourite is still the UK National Freight Corporation, partly because it was one of the first and so there is now a good history to investigate to make sure that the success lasted, partly because it was a very well structured privatization which did deliver so many of the classic benefits of giving employees a large stake in their business.

The lorry drivers and the managers of the National Freight Corporation, primarily a road-haulage business, bought their company from the Government for £53 million in 1981, and their shareholding then multiplied in value remarkably a more than seventy-fold increase in value before the decade was finished.

That increase in the value of their shares took place because of the actions they wanted to undertake as the new owner-managers of the business. It was not a syndicalist tea party, although it could have become so: instead the workforce decided that they wanted to have professional managers running their business and they liked the leadership that the management team



offered them in undertaking the employee buyout. Their new independence gave them a new sense of pride in their business, a new enthusiasm for it which made profit and investment important to them, as part- owners of the business, so much so that a long decline profits, investments and jobs was reversed by their efforts and by the change in their attitudes.

At an annual general meeting of the employee shareholders they were asked two important questions. Would they like employee representatives on the Board? They answered no, because they wanted serious managers on the Board, people who really knew what they were doing. And would they like to invest overseas? This question came against a background of years of trade-union opposition to overseas investment on the grounds that it would sell Britain short. The employees answered positively: the firm should invest overseas by all means, if it would make a profit.

And that was the new spirit of the National Freight Corporation which took it to much greater heights in terms of profitability, new investment, marketing, and customer service. It has been one of the models of privatization success.

### **Management benefits**

So if you wish to involve the employees in a big way you can do so and you might be delighted by the results. But then, what about the managers? Won't you find that the managers fight it tooth and nail? Perhaps they do not want to pass out of the comfortable state sector where your losses can be covered up or can be paid for by the government? Maybe they do not like the idea of the challenge of the marketplace, of facing the customer eyeball to eyeball and having to produce a better service at lower cost?

Well, that has not been our experience here in recent years, nor elsewhere in the world where I have been involved in privatization. Managers see immediately that privatization can offer them new opportunities and new freedoms. Through privatization, the manager can cut loose from all that difficult negotiation with government; instead of having to ask the government over his investment programme he can decide what investment programme is best for his business, subject only to the limits of the financial marketplace. Whereas he might have to consult the government over a whole range of issues concerning the detail of his business, once moved out of the political sector he can get on with running it in the interests of his customers and with the views of his employees in mind.

Most of the chairmen and senior managers of companies privatized in the United Kingdom would tell you just this: that it has been a great success for them, though many of them came to it skeptical at the beginning; and that their success has rested on the freedom they have gained as managers, to be able to take on the customer and not have to cater to the changing whims of those awful civil servants and politicians that constrain the economy of every country.

### **Public benefits**

Last but not least, there is something in a popular capitalist programme for the citizens at large.

The UK pioneered the very large privatization issues which required mass shareholding. There was no way to sell the very large companies to a few financial institutions: they would have driven a very hard bargain, the price



would have been unsatisfactory and not a great deal would have changed. But enfranchising the millions to become shareholders means a better price for the privatization and more importantly, a new set of attitudes: a diversified share-owning base can be a source of strength, but it can be a source of criticism should the company fail to live up to the standards expected.

That mass shareholding idea has now spread to other countries. Every country which has tried it, from France to Jamaica, has discovered the same thing: that however big or small your stockmarket, however unused people may be to owning shares in your country, if the government says that it is going to make opportunities available for mass shareholding, the circumstances will develop where it can take place. You might need to be sensible over pricing for the first issue or two to make sure that people do not suffer a loss immediately afterwards. You will certainly need to look in detail at how the stocks and shares can be bought and sold subsequently, and there may need to be some changes in the delivery mechanism for share certificates and for the sale of shares in subsequent transactions. But these are technical matters that can be solved once you have captured the imagination of the public as to the advantages of wider ownership and the joys of becoming direct participants in the industrial and commercial life of the country.

#### MEETING THE OBJECTIONS

If these advantages are so obvious, and if they are now proven by experience in many countries, you might ask why it has taken so long for some people to understand these benefits. And why are there still some countries around the world that are only thinking about it and not actually doing it?

Like all improvements in life there is always resistance to change and there are always obstacles, and a large number of obstacles have been trotted out to impede the progress of privatization in many different countries. They are worth looking at, one by one.

#### **Ideology or pragmatism?**

The first argument runs that privatization it is all very ideological: it really started with the British Conservatives and others may not want that kind of thing.

I find it very difficult to understand how anything can be branded as ideological when it has been taken up by the Labour Party in New Zealand, by the Socialists in Spain, by the Government of Costa Rica, and by both parties now in Jamaica, in addition to many Conservative administrations. That does not sound to me like something that is so narrowly ideological that it cannot spread beyond the confines of a few select countries.

Nor do I find it easy to define whether the type of employee buyout I have described in the case of the National Freight Corporation, is a triumph of right-wing free enterprise capitalism on the one hand, or perhaps a triumph of the old socialist workers' co-operative tradition on the other.

So I do not mind how you characterize it, what I know is that it works. It is very good politics and it is very good economics, because by giving people



the right to acquire shares, a business is transformed, prosperity is created out of dereliction and decline, and a major contribution is made to the economy and the politics of the country undertaking it. Do not worry too much about labels, just look at the immense practical benefits that can flow, the great advantages that can come from giving free enterprise its head and from allowing people to own things that before only the state did own.

### **Political and stockmarket limitations**

The second series objections come when people say: it is alright for you, here you are in Britain, a relatively rich country, with very strong leadership, a well-established parliamentary tradition, and a strong stockmarket; but so many countries do not have a large capital market nor such a helpful constitution, and it cannot work there.

You are quite right that only one country has Mrs Thatcher, but I have not seen many other countries around the world with totally different kinds of leadership that had nonetheless piloted through successful privatization programmes. It can happen if your politicians wish it to happen, or if a debate is conducted in your country so that enough people see its positive advantages. I have already described how four very big groups of people can be persuaded that privatization has something in it for them.

As to the issue of how big is the stockmarket, the essential message to remember about privatization is that it is the best known means of making your stockmarket bigger, however big or small it might be to begin with. It has proved possible to sell stocks and shares in almost any conditions providing you are sensible about price and providing you do your homework on how the shares can be bought and sold. If you have decided to do it, then it can be done; and there is plenty of evidence that shares can be sold in all sorts of conditions, even where no large or reputable stock market currently exists.

### **Selling the assets**

Some people remember the only serious criticism that has ever stuck against privatization, which was the criticism levelled by a former Conservative Prime Minister from Britain, Harold MacMillan. He suggested that privatization was like "selling the family silver" and he thought that this was an undesirable thing.

Yet privatization is actually about *returning* the family silver, the family assets, back to the family so that they can enjoy it. It is about giving ownership back to the people -- ownership of assets that were highjacked by the politicians, the bureaucrats, and the producer interests, and then turned from silver into base metal by the state's remarkable ability to make a mess of practically everything it tries to run.

### **Importance of state control**

Then there are people, particularly in government, who say that they accept that with the spur of private management, private capital and competition, the industry will make more profit and will invest more; but that in their own country there are some very important political issues, which mean that these industries have to remain in the ownership of the state.



That is the biggest lie of the lot, because the very industries that governments never succeed in controlling properly are those industries which government itself owns.

A marvellous example is the privatization of the water industry in the United Kingdom. When we examined closely the belief that we should keep water management in public hands in order to maintain the quality and purity of the supply, we discovered how hollow that assumption really was. We discovered that after forty-odd years of nationalized ownership, one-fifth of all the sewage works in this country failed to meet the quality standards set for them by the government; and that there is a massive backlog of investment which now needs to be made good because the public-sector management failed to win sufficient resources from governments which always faced more politically urgent competing claims.

That illustrates a very basic problem: that if a government both owns an industry and is trying to regulate it, it will do one or both of those things badly because they are in conflict. How can you be responsible for the profits, the cash, the employees on the one hand, and be responsible on the other for making sure that quality is high, investment is high and standards are adequate? There will always be conflicts, and governments around the world, however good they might like to think they are, will compromise regulatory standards and quality -- because they are always short of money and are more easily pressurized by the managers and workers than by the general public. And that is a fact of life whether it be the water industry in this country or a whole range of public utilities in a lot of other countries around the world that I have worked on.

The way out of this problem is in the separation of ownership from regulation. Government certainly has an important role to perform as regulator. Yes, government should be the one that says we want clean water. Yes, government should say that electrical power must be generated in a safe way. Yes, government should say that mining companies should have high standards to protect the employees' lives from danger -- there should be safety standards. But government should not at the same time be compromising itself by owning the assets and trying to make a profit. That should be done by private companies operating under licence and working under regulation.

So if you are worried about the state wishing to preserve its role in particular industries, privatize them and you will discover that the state has more control and can demand higher standards. Even in the defence field (as the United States has proven over many years and as the United Kingdom is now proving again), it is quite possible for supply to come from a series of competing private companies, with the government buying the goods, regulating, controlling the secrets and the technology, but not itself directly involved in the business of production.

## CONCLUSION

My conclusion is quite simple: popular capitalism is a powerful group of policies.

It is a way in which countries can reduce their debt burden, can raise money, and can involve their employees, their managers and the wider citizens of that country in the business of ownership of industry and commerce. It is





## THE PRINCIPLES OF PRIVATIZATION

### Peter Stredder

The recent World Bank Report, *Developing the Private Sector*, stressed that encouraging the growth of an efficient private sector is an important means of stimulating economic development in developing countries. The report identified five key means of encouraging such growth:

- \* reducing market distortions
- \* deregulation
- \* facilitating the growth of the private sector by such means as making credit and advisory services available
- \* infrastructure and human resource development; and
- \* privatization.

Privatization is now contemplated, underway, or implemented in over thirty developing countries. There are many other countries in the developing world that are liberalizing their economies as a first step in privatization. So why is the trend to privatization so widespread in the developing world? Why should such countries want to privatize?

### Personal experience

This is a question which has occupied me, and my company, for many years. I started my career as a civil servant in the Department of Trade and Industry where I worked in nationalized industry policy; I then had a spell in the Treasury before moving to the Prime Minister's Policy Unit. There my work included diversifying the ownership of council housing, Water privatization and some of the early stages of Electricity sale.

The public sector unit at BZW is responsible for project-managing privatization advisory assignments and undertaking the earlier stages of such assignments. The later more technical aspect, such as writing prospectuses and flotation are dealt with by our mainstream corporate finance specialists. Currently I am a member of the teams advising Northern Ireland Electricity, Anglian Water, and the Turkish Government.

Barclays de Zoete Wedd, the investment banking arm of the Barclays Group, have undertaken a significant number of privatization advisory mandates. We advised the successful management and employee buyout of National Freight, we advised British Steel on privatization, we advised Anglian Water on privatization. We advise the Government on Electricity privatization in Scotland, we advise Manweb (a distribution company in England), and we advise Northern Ireland Electricity (an integrated electricity utility). And



finally, we are advising the Turkish Government on the privatization of Suma Bank, which is a textile and retail conglomerate.

### **Topics to consider**

I would like to: define more clearly "privatization" as I propose to discuss it; to explain what it entails; to describe the main methods of privatization; to look at some of the disadvantages faced by public sector enterprise; to give the main arguments in favour of privatization; to suggest how one can resolve some of the difficult issues that arise; and to look at the evidence for the success of privatization through an example.

I shall cover a considerable number of factors, not all of these will be relevant to each country's circumstances, but I suspect that some at least will be relevant in every case.

### **THE MEANING AND SCOPE OF PRIVATIZATION**

I shall talk about privatization as the transfer of ownership of all or part of a public sector business to the private sector. I shall be concerned with businesses as such: that is to say, parts of the public sector providing goods or services, rather than the regulatory or policy formation arms of government.

A good example of the sort of enterprise I am talking about is British Steel, which was privatized earlier this year. The essential feature is that this kind of privatization involves the transfer of an entire business, both physical assets and the employees, to the private sector.

### **Different approaches**

The word "privatization" is also used to describe a number of other means of replacing public sector activity by private sector activity.

One example is the sale of public sector assets such as land or housing to the private sector, including the sale of council houses to their tenants. In this case assets transfer from the public sector but not the management and employees. Another type of privatization is the use of private sector contractors to provide services hitherto provided in the public sector, this is often known as "contracting out". An example is refuse collection; here different assets and generally different employees are involved in providing the service. A third possibility is the use of private sector managers and workforce to operate assets that remain in the public sector, for example the UK naval dockyards where the management and employees transferred but the assets remained.

### **THE PRIVATIZATION PROCESS**

We start with a public-sector enterprise and we want to see whether it can be privatized.

What kind of enterprise might this be? It could take a number of forms: it could be an integral part of government, for example a ministry; it could be a separate corporate entity with a status peculiar to the public sector, for example a public corporation; it could be a company with the same status as



private-sector companies but all of whose share capital is owned by the government; or it could be a part of any of the above.

Let us consider then what needs to be done in order to privatize such an enterprise. This will involve fundamental changes in the way the enterprise is managed and operates. Understanding these changes should help answer the question: Why privatize? I would like to describe the process of privatization in three steps: the first one I will call "evaluation"; the second "design", and the third "implementation".

### **The evaluation stage**

The aim of the evaluation stage is essentially to determine whether, and if so how, the business concerned can be privatized.

Key questions that need to be answered in making the judgement are whether, and if so how much of, the enterprise concerned is capable of becoming a commercially viable and competitive business. One needs to determine the desired structure for the enterprise: for example whether it should be divided into a number of parts (perhaps in order to enhance competition,) or should remain a single entity. One needs to decide the preferred method of privatization and to give a preliminary idea of the proceeds.

In essence, what determines whether a business can be privatized is whether it is capable of providing its new owners with adequate returns. This means that the business must ensure that it is competitive: it needs to focus on providing goods and services required by customers, it must seek the best balance between capital and labour, and it must use those resources as efficiently as possible. The business may either be made viable whilst in the public sector or sold to an existing business at a price that takes into account the costs and risks of making it profitable.

### **The design stage**

The second step is the design step. This step involves detailed preparation for privatization by the business and the government.

**Aims for the business:** The key aim is for the business to operate as commercially as possible for a period, to give it a track record for potential investors. For the business, this involves developing a strategy that will enable it to become and remain commercially viable; this may involve what is sometimes known as "corporatization", the transformation of a government agency into a commercially oriented corporate entity. It may involve reorganizing the business internally to enable it to focus more clearly on the markets it serves. It may involve capital investment to ensure that the business is competitive and commercially viable; it may also involve eliminating over-manning. And finally, it may involve re-training, to give the workforce new skills and help management develop a commercial edge.

These steps can sometimes take several years and may well precede a firm decision on privatization. Perhaps an extreme example of this is the British Post Office which was corporatized in the late 1960s. In the early 1980s Telecommunications were separated from Posts and a measure of competition was introduced into the telecommunications market. And finally the Telecommunications business was privatized in the mid-1980s.



**The government's aims:** For the government, the design step involves setting targets for the business which focus on the need to become commercially viable, and in doing so the government must be prepared to move away from the non-commercial objectives that are so often set for such businesses and focus on commercial criteria, such as rates of return. If necessary, it will have to appoint new senior management, it may need to inject new funds into the enterprise to help with restructuring costs, and it will of course have to secure the necessary legislation.

In some cases the government may not wish to carry out all these stages before privatization, but there may be advantage in allowing private sector disciplines to operate. Provided government is prepared to accept the consequences of this in a lower sale price, possibly including the need to provide a dowry, then in certain circumstances it can privatize without going through all these stages.

### **Implementation stage**

The third step is implementation. Implementation may involve establishing a regulatory authority where the business is essentially a monopoly and needs a firm regulation by government. It may involve the transfer of the business or business to be privatized, where necessary to a company framework. It will involve giving that company an appropriate capital structure -- that is to say, a mixture of debt and equity reflecting that of similar private-sector companies, and the relative risks and rewards of the business. It will involve technical steps such as the preparation of a sale memorandum or prospectus. And finally, it means the sale of shares in the business or the transfer of all or part of the equity in some other way, to private ownership.

**Types of transfer:** There are three principal methods in which that transfer of ownership can take place.

The first is flotation, which is a general offer of shares to private investors. Typically in the UK, privatization has been used to encourage individual share ownership, and this has been reinforced with particular incentives for employees and for the customers of utilities. This method is appropriate to a company that will be viable from day one.

The second possible approach is a trade sale, which involves the sale of the business to another company at a price that will be determined by negotiation. This method is appropriate where speed is of the essence, where the company is too small to justify the costs of flotation, or where the company is financially weak; because it allows the management of the purchasing company to undertake the necessary restructuring.

The third possibility is a management/employee buyout; this involves selling the enterprise to its managers and/or its employees. Typically they might need to borrow to finance the purchase; it may be necessary to establish special arrangements to enable shares to be held collectively for the employees. This method is only appropriate where the capital employed per employee is relatively low, but it can be undertaken in conjunction with a trade sale.



## **What you leave behind**

Looking through the reasons given by various governments for privatization, the most often quoted is the inefficiency of public sector enterprises; this is inevitable perhaps because of the lack of real incentives to efficiency.

The next problem for public sector enterprises is that they are often set a confusing and conflicting set of objectives by government. These can include encouraging employment, regional development, subsidizing consumers, regulating certain types of economic activity, meeting essential needs, safeguarding national security, and implementing pay restraint. But very rarely is there a clear focus on meeting the needs of customers. Because of the government's accountability to its electorate, the focus of such business is often upwards on government and not downwards on meeting the needs of consumers, they are producer oriented. Because public-sector enterprises in practice cannot go bankrupt, the interests of those who work in them tend to dominate those of their customers.

Management freedom of action tends to be circumscribed both by the government and by the workforce, commercially necessary decisions are frustrated or overruled, enterprises can be starved of capital where the government have more pressing priorities for public expenditure. Such enterprises can be forced to undertake uneconomic investment for political reasons.

And finally, there is often a conflict of interest between the government's role as shareholder and the needs of consumers.

## **WHY PRIVATIZE?**

Why privatize? There are several powerful arguments in favour or privatization. Listed here are the main ones, and against these each reason some of the countries whose governments have given that as a reason for privatization.

The key reason is to improve the performance of the business concerned, thereby improving the performance of the economy as a whole. The governments of Argentina, Senegal, Ghana, Sierra Leone, Guinea, Kenya, Niger and Turkey all give this as a reason for privatization. The need to satisfy shareholders is a most powerful stimulus to improving performance and to maximise efficiency. Provided there is effective competition this means that there is a powerful incentive to meet the needs of consumers as effectively as possible, because otherwise competitors will take market share, and shareholders' returns will be diminished.

Privatization also provides a capital receipt to the government. This receipt is available for one of a number of purposes. It can be used to reduce taxation, thereby providing a further economic stimulus. It can be used to reduce public-sector indebtedness. Or it can be used to increase public expenditure, for example on badly needed infrastructure: this is a reason given for privatization by the governments of Argentina, Brazil, Uruguay, Peru, Turkey and a number in South East Asia.

Privatization is a means of widening share ownership, so as to spread wealth. It increases the number of people with a stake in society. In particular, privatization gives the government an opportunity to give



incentives to certain groups, for example employees or customers of utilities, to acquire shares. The Turkish government put this vividly by saying that its privatization programme involved making the Turkish people the real masters of the Turkish economy.

A further reason for privatization is that it can give managers and employees a stake in a business, which can be a powerful means of promoting an understanding of the economic realities and giving them an identification with the interest of their customers. Privatization frees up management to focus the business on meeting the needs of shareholders and thereby of customers: Turkey cites this as a reason.

It can be a means of developing capital markets by widening and deepening the market for shares. Turkey and Taiwan give this as a reason for privatization. Privatization also gives businesses direct access to private sector capital for investment where this is commercially justified, rather than subject to the conflicting demands of other public sector activities. Indonesia, Kenya, South America, Malaysia, Singapore, Philippines, Sri Lanka and Thailand, have all given that as a reason for privatization.

And finally, privatization can assist in the deregulation of industry and commerce and increase competition. Except in cases of natural monopoly, the government can structure the privatization so that there is more competition, which enhances consumer choice. In those cases where there is effectively a natural monopoly, privatization facilitates effective regulation because it removes the conflict of interest between the government as shareholder, and the government as regulator.

## OVERCOMING THE DOUBTS

If it is all so easy then why haven't more governments gone ahead with privatization programmes? The fact is that there are also a number of difficult issues that have to be faced in some privatizations, sometimes these are seen as objections by those opposed to privatization. Let me suggest some answers.

### **Rising prices**

One complaint is that prices will increase because of the need to pay dividends to private shareholders.

The first point to make here is that public sector inefficiency may outweigh the additional returns required by shareholders. But assuming that the enterprise is as efficient as possible, it is important economically that all businesses, both public and private, secure proper returns; this ensures there is proper allocation of resources. Competition or regulation can ensure that prices do not produce excessive returns, but if the government wants prices to be lower it can provide an explicit subsidy, which is a more efficient route economically than accepting inadequate returns from public sector businesses.

### **Monopoly and responsibility**

The second objection is that we cannot privatize such and such a business because there is inadequate competition or because it is a monopoly. The first thing to do is to endeavour to maximize competition, restructuring the



industry whenever possible to achieve this; this is an approach used in the Electricity Industry in the UK where the government has sought to inject competition into the Electricity market in two different ways. But where this is not possible, regulation can be used as an admittedly imperfect substitute for competition.

A third objection is that there will be inadequate protection for consumers if certain services or goods are provided in the private sector. What this ignores is that public-sector businesses often do not serve their customers well; they have no overriding incentive to do so, and whether or not they do so is largely a matter of chance, depending on the priorities of the government of the day and the inclinations and skills of the management concerned. Consumer representation has sometimes been tried as a means of protecting the interests of consumers, but it is generally an ineffective substitute for market forces. I believe that market forces, coupled where necessary with effective regulation, is the best approach.

A further criticism is that private industries will neglect their other responsibilities, the responsibilities that are looked after so well by public sector industries, such as concern for the environment, for health, and for safety standards. The fact of the matter is that in the public sector the government faces a conflict of interest between its role as shareholder and its role as regulator; privatization with effective regulation can allow these to be separated.

#### **Assets and employment**

A further criticism is the old jibe that it is "selling the family silver" -- selling valuable assets. The point to make here is that there is no loss of assets. They remain in productive use and indeed almost certainly they will be put to *better* use.

Another potential barrier to privatization is that it may involve a loss of employment because the businesses concerned are inefficient and cannot be made commercially viable without reducing the numbers of people they employ. This is a very real concern, particularly if activities are concentrated in areas of economic disadvantage, but in such circumstances the government can use various means to stimulate new employment; and it can use part of the privatization proceeds to do this. A reduction in the workforce of British Steel by some two-thirds was made less uncomfortable by the establishment of a new company, called British Steel Enterprises, whose role was to stimulate the formation of new business in steel closure areas, and to stimulate other businesses to move into those areas. That initiative alone made up for half the number of jobs that were lost as a result of the restructuring that took place before British Steel was privatized.

#### **Foreign ownership**

Finally, there may be concerns about the privatized company being taken over by foreign interests or by local monopoly interests. In this case it is possible to protect the position by devices such as the golden share, which can be used to limit the ownership of any shareholder or specific type of shareholder. This approach has been used in a number of privatizations in the UK where typically shareholdings have been limited to 15% for a period after privatization.

## CONCLUSION

The World Bank, in a recent report which I referred to earlier, noted that privatization was now a buzz word in development conversations, but that the evidence suggested that there was more talk than action. It considered that the lack of progress stemmed from entrenched opposition from bureaucracies and trade unions, unrealistic hopes for enterprises that should be liquidated, indecision on whether to sell an enterprise as it exists or to restructure, political concern about the concentration of control in foreign or local monopoly hands, and serious gaps between the government's valuation and the valuation of potential purchasers.

In trying to answer the question "Why privatize?", governments in developing countries should seek to overcome these difficulties and answer: "Why not?"

PART II - PRIVATIZATION IN THE DEVELOPING WORLD





### STARTING OUT ON A PRIVATIZATION PROGRAMME

**Peter Young**

Director, Moncrieff Strategy

#### The idea of privatization

Let us imagine that the persuasive people contributing to this symposium do convince you that privatization is an excellent thing. You realize, of course, that your public sector is a dreadful mess and you need to privatize it.

So you choose ten or fifteen companies that you think should be privatized. You make some hints about selling off (for example) the telephone system. And you are met by a wave of hostility and abuse from all quarters, including all the employees in the public sector, users of the service, and people who are concerned about the economy being handed over to foreigners. You are told that you are all lackeys of the IMF who want to put everyone out of work. Your political colleagues complain about you being full of ideas that are going to lose them the next election.

Your problem is that you have not tried to sell the idea of privatization. And unless you do try to sell the idea of privatization itself you will fail miserably.

#### Building up the idea

In 1979, Mrs Thatcher did not suddenly see the light and announce a massive privatization programme. That was not how it happened in Britain at all. Over many years there was a massive educational programme carried out by think-tanks, by pressure groups, and by campaigners. It involved academics, journalists, and analysts; numerous reports, articles, papers, books, and adverts in the papers. Several forests have probably been cut down to supply the paper to print all these things. There have been enough conferences and seminars to keep any sizeable conference centre going for a hundred years. There have been probably two hundred seminars on the subject of contracting out alone, some twenty of which were run by the Adam Smith Institute.

So, by this process, privatization has been explained to a far wider number of people than those involved directly in privatization. It has slowly become accepted by people.

#### Selecting the candidates

We did not start out by saying that we were going to privatize all the things that, a decade later, have in fact been privatized. If you had said in 1979 that



the management of prisons should be privatized, you would have locked up in one for making such a lunatic suggestion. Yet the government has recently said that they are going to do just that. We have proceeded step by step, from the easiest privatizations to the hardest, building on our success and learning from our mistakes as we have gone along.

Most privatization candidates in this country have been rejected by the government several times. The government has said it has no intention of privatizing an enterprise or service, but two years later, after the idea has been floated, discussed, and debated, the government has come round to that very idea.

### **Learning the lessons**

So in taking up the idea of privatization in your own country, you have to sit down and ask yourself: Why are we doing this privatization? What are our aims? What are the benefits for our country? Then you can construct a persuasive rationale for your country, based on your own objectives, and seek help from outside agencies.

Right at the start, you must work out who in each case is likely to oppose privatization. Devise policies to take account of that opposition and reduce it. And then devise a large educational strategy to appeal to those groups, to target the employees and the public at large. You are not, perhaps, going to need quite as many conferences and seminars as we needed in the UK, but you will need detailed reports and publications.

Unless you achieve some consensus that supports privatization in your country then it is not going to go anywhere and your privatization programme will fail.

## WHY TO PRIVATIZE, AND WHAT TO PRIVATIZE

**Alfred Latham-Koenig**

Special Advisor to Ernst & Young

I would like to share with you some of the lessons Ernst & Young have learned from advising on privatization in developing countries: in fact we have carried out forty-eight projects in twenty-seven developing countries.

The worldwide process of privatization is much more than the mere selling-off of state-owned enterprises. The process is really a continuum: divestiture itself is just the culmination of a series of necessary stages which include the reorganization of the public enterprise so that it can operate more as a private enterprise, its financial restructuring to improve its performance and efficiency, changing the environment in which it operates by abolishing regulations, allowing private operators to compete with the state enterprise, improving the quality of management, and so on. But the key issue underlying these various stages is the degree to which they improve competition within the government sector.

### Reasons for privatization

The reasons for privatization which have been put to us have of course varied from one government to the next. No two developing countries have the same sociopolitical environment, business climate, kind of public enterprise, or availability of local managerial and technical skills.

One of the most important reasons I have encountered, and a very pragmatic one, is the desire of a government to divest itself of unprofitable businesses which are a drain on valuable resources and often an embarrassment to it.

The reduction in the burden of debt is another common reason for privatization, especially in Latin America. Many developing countries have accumulated enormous debt burdens. Privatization, through the mechanism of debt equity swaps, provides the means by which that burden can be reduced. (But we must not exaggerate: in Chile for instance, debt-equity swaps have reduced the burden of debt from \$20 billion to \$17 billion.)

For most developing countries, expanding the industrial base is of course a priority, and as there is typically a shortage of funds for this the need to attract new investment is a powerful reason for introducing a privatization programme. This investment can come either from foreign organizations taking an equity stake in the industry, or from nationals of the country



concerned being persuaded to bring back funds that have been deposited overseas.

Another reason for privatizing is the achievement of more effective management. The review of management inherent in the privatization process usually leads to recruitment of missing skills and the introduction of improved management techniques. Even if the business is never actually sold into the private sector, the very process of carrying out such a review and motivating management and staff is a permanent gain for the enterprise.

I have referred to the investor, the management and the staff, but the customer should not of course be forgotten. A further reason for privatizing is the achievement of a better customer service: the private sector business environment, and the need to remain competitive through providing a quality service or product, will lead to a better customer service.

Also, privatization provides a route for removing ineffective services; the selling-off of businesses which entrepreneurs are better equipped to own and manage.

And a last important reason is of course to provide the government with the necessary cash to reduce taxation for instance, or carry out essential investment.

#### **Choice of candidates**

We now come to the question of what businesses are being selected as privatization candidates. The answer again differs from one country to another.

Ernst & Young has been involved in the privatization of some of the largest airlines in the world: British Airways, Air Canada and Singapore Airlines. We are receiving many enquiries from governments in both developed and less developed countries, for advice on their national airlines. But why are countries so interested? I believe it is because their airlines need to be competitive to stay in business.

Our experience has predominantly been in full flotation of airlines, but privatization can occur by inviting foreign airlines to take a partial stake. Private capital can be injected by a privately operated airline and benefits can be gained from the training programmes and other back-up facilities of the investing airline. The very successful Cathay-Pacific for instance, started with a large equity stake owned by British Airways.

The banking industry is another business sector which operates in an international environment. Credibility and independence from government control are important factors if local commercial banks are to prosper.

Several countries throughout the world are considering privatization of state-owned financial institutions; some (like Jamaica and Turkey) have already done so, others (like Kenya and Korea) are about to do so.

Highways might seem at first unlikely candidates, but in Malaysia we have advised on projects where private capital has been used to build by-passes and where toll collections have been introduced as a source of finance.



Hotels and tourism are other important candidates for privatization. Many governments own tourist hotels and operate significant parts of the local tourist industry. It is not a sector where much privatization activity has occurred yet, but it is an area which is being increasingly considered.

Manufacturing is, in our experience, perhaps one of the most active areas of privatization. A good example is Sri Lanka, despite recent civil unrest. Ernst & Young have been involved in giving advice on the privatization of state-owned distilleries, textile mills, producers of industrial gasses, and even a local agency for the sale of Japanese motor vehicles. These businesses are usually badly managed by the state and they are ideal candidates for starting a privatization programme because they give credibility. The sale of British Steel in the UK has prompted other governments to consider selling their steel works. Taiwan has made a partial sale, and Brazil and Mexico are contemplating sales.

Ports and shipyards can also be good candidates for privatization. If a country wishes to have a successful industrial base it obviously needs efficient ports. We have been involved in the corporatization of harbour boards into port-operating companies in New Zealand, and I know that Malaysia is going further and intending to sell two ports.

Finally, utilities, such as the remarkable flotation of British Gas and the Water industry in the UK, and the forthcoming flotation of Electricity. Enormous interest has been generated worldwide in the possibilities of privatizing utilities. Without established stockmarkets such flotations are impossible, but where there is a stock exchange the potential for exploding share ownership is substantial. We have been advising in Malaysia on the valuation of the National Electricity Board to be used as a basis for privatization. I know that Chile is gradually privatizing its telecommunications industry, and Jamaica, Korea, Malaysia, Mexico and Singapore are all at different stages of privatizing telecoms. Local private-sector investment is being sought, usually through joint ventures to develop, for example, hydro-electric projects. The World Bank has established an energy development fund in Pakistan to help private-sector developments of this sort. In Jamaica the government are considering the full flotation of the electricity industry. In Korea 21% of the electric power industry has been sold. And in Malaysia and Singapore they are considering the potential of electricity privatization.

## **Conclusion**

In summary, there are many valid reasons for privatization and each nation's reasons will be different.

The greatest progress is of course being made in countries with developing capital markets. But for those developing countries which do not have a developed capital market, the message I would like to leave with you is: start on those businesses that are small and easily transferable to private ownership. Try to attract private capital for specific projects. Begin the process with corporatization, reorganization, and restructuring of parastatals, thereby improving their efficiency and making them worthwhile investment opportunities for your people.



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## THE SPECIAL FEATURES OF PRIVATIZATION IN THE DEVELOPING WORLD

Dimitri Plionis

Ernst & Young

### STOCKMARKET CONSIDERATIONS

The first topic I would like to discuss is the unavailability of capital on stock markets.

#### No customers, or poor product?

On the basis of our experience, shortage of capital does not appear to inhibit privatization. In fact I am not aware of even a single state enterprise which was potentially viable as a private enterprise, which could not be sold because of lack of funds.

This is not to say that all companies put up for sale have been sold. When that happens, however, one should look for other intrinsic reasons to explain the fact.

For example, the Philippine government has tried to sell the Philippine Cotton Corporation. We were actually involved in preparing that company for sale; it has not been sold yet, though one more attempt is going to be made in the near future. The principal reason seems to be the over-sized cotton gins that are part of the assets of the corporation. And that excessive size makes production uneconomical, so potential buyers are worried that they will not be able to make the business competitive and are therefore reluctant to bid.

In most cases where you find that an enterprise cannot be sold, the real reason is not that there are no funds, but that there is something else intrinsically wrong with the assets. If a company has the potential to operate economically, the money will be found and it will be sold at a price roughly commensurate with its potential profitability. Funds often come from flight capital that has been repatriated. That certainly has been the case in several Latin American countries that we have worked in: Chile, Mexico, and Honduras. Debt-equity swaps have been effective. Other sources of funds have been the government itself which may (for example) provide loan funds or guarantees for ESOPs or outright grants. The funds may come from foreign donors, as in the case of USAID in Costa Rica or the IFC (International Finance Corporation) fund to acquire assets in privatized companies in the Philippines.

## **Alternatives to stockmarkets**

There is one more alternative that can be tried in a country that does not have a stockmarket; and that is the instrument of a unit trust. The concept of a unit trust is that a pool of funds is put together, primarily by collecting funds from small investors, and that fund is used to acquire assets in privatized companies. There are certain guarantees that have to be made about the saleability of funds within the trust and between the owners; it is a little like the case of an ESOP in a country that does not have a stockmarket. But it is one more extra vehicle that is available, and in fact is being tried in Indonesia and we are experimenting with it in Western Somalia.

Another way to get around the problem of inadequate stockmarkets is that the sale of shares can be made through other vehicles like the banks; and a market can be created in that way. Turkey has tried this strategy.

Finally, ESOPs themselves do work in a situation where there is no capital market. One USAID-funded project is underway right now: Egypt with the Alexandria Tyre Company; and another one by the same organization is being planned in Costa Rica. So it is possible to achieve privatization and broad share ownership, even in a case where a stock-market is not well developed.

## **EMPLOYMENT WORRIES**

I would like to address another substantial difference between a developed country and a developing country, and that is the impact of employment losses.

Let me emphasize that I consider this to be a short-term problem, but one that developing countries cannot afford to ignore because of its political forecast and social implications. There were gains of employment forecast in Honduras from the privatization process, and sure enough this is happening. In the long run one would naturally expect that the rationalization of the economy, resulting from privatization, would deliver this boost.

However, in the short term you will undoubtedly have employees who will lose their jobs and even though there may be some employment gains somewhere, it is not the same people losing their jobs from one place who are getting the new jobs in another. In some enterprises, you have to accept that over-manning is in fact one of the major reasons why state enterprises are not efficient and therefore you can not improve their efficiency unless you are actually prepared to let some employees go.

## **Approaches to the problem**

What can one do? I will describe a few of the various approaches that have been tried by a number of countries, though none of them is a perfect solution; they are all ways of reducing the pain rather than eliminating the pain.

Some governments, such as in Malaysia, require retention of most employees with reductions through attrition or by transfers to other government departments. This of course solves the problem merely by transferring it to the buyer, with the attendant impact on the price -- the price will have to be lower in order to compensate the buyer for this burden.



However, Malaysia at least thinks this is a fair trade-off: the objectives of the government are to achieve privatization while maintaining certain social objectives, and this is how they express it.

Some governments and donors are encouraging creative ways to re-employ the dismissed workers -- for example as preferred suppliers of certain services or products that the enterprise buys. Often, there are some funds spent on developing small businesses for dismissed workers. The problem in the case where the workers are turned into suppliers is that somebody else gets displaced so that is really just robbing Peter to pay Paul. And in the case of trying to set up new enterprises, the problem is that not every worker can be turned into an entrepreneur overnight. So there are some drawbacks to these solutions. However, I should say that they have both been tried: Costa Rica and Sri Lanka are working with these types of options.

Some donors are setting up labour capitalization funds. Where workers are entitled to severance payments, sometimes generous (the norm is that a discharged worker gets one month's pay for every year of service), it can be relatively expensive. This is where the various donors come in with funding for such costs.

Finally, some sort of re-training programme can be set up by the government, or by donors, to re-train workers to do something else which may be required in the economy. However, in my experience there are problems with that option as well because even in the United States I do not believe that re-training programmes have been very effective. Some people will benefit from them but a lot just cannot be re-trained. So the problem still remains, and I would say that this is an area of privatization where innovative solutions are still being sought.

## THE IMPORTANCE OF GOOD VALUATIONS

Let me turn now to another issue, which is the importance of valuation. In developed countries valuation is a relatively technical issue, the standards are fairly well developed and the major concern is to hire a competent valuer to produce a range of possible prices for an offer, or for purposes of negotiation. In developing countries, valuation takes on much greater importance.

### **Book value and sale value**

The difference arises in part because the governments of developing countries tend to have unrealistic expectations regarding the value of their assets, based on book value. This can cool the enthusiasm of a government and present it with a nasty political problem. How can a company that cost \$10 millions to build be worth only \$2 millions when you try to sell it?

We are discovering just that situation in a Latin American country now; there is a large plant in a relatively small country with a plant capacity far beyond what the local market can absorb. Neighbouring countries banned the importation of the product because they have their own industries to protect; and the commodity is too heavy to be transported long distances.

Any reasonable valuer would have to assign a fairly low value to this (otherwise very good) plant. And other countries have to bite the same bullet



and admit that their cherished industries are not always worth what they paid for them.

### **The value of different packages**

However, it can work both ways, because a properly conducted valuation may identify some new possibilities that actually add value to the existing asset structure.

A good valuation exercise will identify the highest and best use of the existing facility. But then it will go on to look not only at the facility as it exists but how it could be of higher aggregate value by either breaking it up into pieces or combining it with another facility.

An example of the latter is a soya bean unloading facility in the Philippines. The facility as it exists has a very low value because of market and other factors: however, with slight modifications it could be combined into a package with a neighbouring chemical facility to enhance the value of both; then they can be sold as a package at a higher price.

So much for integration. Examples of an increase in value generated by breaking up an enterprise are far more numerous. This is because many state-enterprises were saddled with all kinds of related but incompatible (or sometimes too large) facilities, or even unrelated facilities.

For example, in Western Somalia we have a situation where an equipment repairing facility was part of a large estate but far too large for the estate's needs. A buyer of the estate would probably not value the repair facility as much as somebody who would be interested in buying it for the repairing business. Therefore, selling them separately would result in a higher price to the government than if one tried to sell it as a package.

If the Soviet Union ever goes for privatization in a big way there is going to be plenty of scope for this sort of thing because most state enterprises are into all kinds of businesses; we have found some state enterprises running farms, hospitals, schools, roads and much else.

### **SETTING THE PRIORITIES**

I would like to talk briefly about establishing priorities in privatization.

LDC governments have a tendency to place high priority on the privatization of either glamorous or non-performing assets. The first one is for reasons of trying to encourage the process by putting the best (the flagship), assets for sale; and the second to get rid of the budgetary drain.

However, I believe that a more appropriate rule for selecting candidates is the relative ease of privatization and its anticipated economic impact of the process.

By the ease of privatization I am talking about factors such as investor interest, commercial viability, minimum legal impediments and minimum political impediments. In terms of potential impacts I am talking about factors like total asset value, budgetary impact including the impact of taxes, and employment impact. The knack is to pick relatively safe winners first to build constituency and support for privatization.



## OTHER ISSUES

### Public awareness and education

The importance of public awareness and educational programmes in privatization was not recognized by many at first, and some of the first privatizations ran into considerable difficulty because of lack of preparedness and understanding within the population at large, as well as the predictable prejudices of the vested interests.

We made some mistakes ourselves in not recognizing this early on, but since then most people have learnt the lesson and there have been a number of very good public awareness campaigns. One of my favourite slogans is from Sri Lanka: "Going private -- for the good of the people".

### Availability of buyers and competition

The big problem in small countries like Honduras is that the number of potential buyers of any enterprise is small, a stockmarket does not exist and (for a variety of reasons) it is difficult to work an alternative.

This means that too often, the potential buyers are the very people who are responsible for the circumstances in which those companies were taken over by the government in the first place. There is, for example, a wealthy individual in one country I know, who ran a particular company into the ground not once but several times, whereupon the government felt that it had no choice but to bale the company out each time, to save the workers' jobs.

We think that selling state enterprises to such individuals must be resisted by all available means, or privatization will be associated with privilege.

Therefore, many alternative buyers must be sought, as many as possible, to provide for a reasonable choice. This makes good business sense as it is more likely to extract the best market price for the enterprise.

### Availability of skilled human resources

This is an endemic problem in developing countries but one which is not further aggravated by privatization. Management is in fact required by state enterprises as well as private enterprises, and often the current managers can function quite well in the private sector, given the proper incentives.

In addition, we have noted in several countries where we have worked that privatization and the attendant liberalization of the economy are perceived as opportunities by many of the country's expatriots who have been trained in their adopted countries. Their skills are valuable: and privatization can go some way towards getting those people back on side.

## **CASE STUDY: PRIVATIZATION WITHOUT STOCKMARKETS**

**Richard Lloyd**

Director, Morgan Grenfell

One of the most promising approaches to speeding up the process of privatization in developing countries is through transferring the business without necessarily transferring the assets. We are talking essentially about privatizing management.

Privatization is defined far too narrowly. It is not just a matter of shovelling the assets out of the door and letting someone else run them; and frequently in developing countries that is far too politically controversial to do anyway. The essence is to introduce efficient private sector management, get the right management in, reacting to market forces, and maybe later on do the rest if you want to.

So the term "privatizing management" can be used to include all sorts of different technical solutions -- leases, contracts and concessions -- right up to the size of Eurotunnel which we advised on last year, down to some tiny little deal. We think that this general area is very much neglected in less developed countries.

It is in countries without stockmarkets where the unrealized potential for privatization is now the greatest. In many cases a sale is not possible, or it is not desirable. So you have the choice: do nothing or privatize without selling those assets.

### **A CASE IN POINT**

In 1983, a state-run bicycle factory was set up in Zambia. It soon started making losses, it operated at less than 20% of capacity, it was unsaleable, its equity was eroded, it was a total mess -- but it was not actually closeable. Politically and socially it had become too important, and it was a major employer in its area.

The question was: How can you privatize it? The answer was to privatize the management, and worry about the rest later.

### **The new strategy**

With this in mind, the government brought in a management company, (from India, although they had a lot of local experience,) which was offered 100% of the losses but they were also offered 20% of the profits. That does not



sound a bad deal for the government but luckily the new managers also thought it was a good deal for them. It was enough incentive for them to turn the business round, which they did.

The management company had to bring in all the working capital, which they did. They were at risk for all of that. They did not need to bring in fixed capital because the machinery was pretty new and in good order, but they did have to use all the depreciation funds to keep it in that condition -- again, not a bad deal for anybody.

The management company also had the right to select the staff they wanted. They did not have to take on everybody, but once they got going they actually increased employment levels and the staff had their first pay rise for three years.

### **The rewards of imagination**

In the Zambian context (where I was for three years recently an adviser to the government) there are one or two problems associated with debt, and it is not an easy environment in which to do this sort of thing. In fact, many other African countries are in a better position but have not yet done anything as good or imaginative as this.

The result of this imaginative exercise was that in a couple of years we ended up with a profitable business, something that could be sold, an asset that was worth something.

That is just one example, but the basic point is clear: the assets were not being used as well as they should have been, while a private operator could see more value in those assets than the current owner could extract from them. It is the essence of every good takeover bid, probably the essence of every sale that ever takes place, that someone sees more value in a thing than you do so he is quite prepared to buy it off you.

### **A GENERAL STRATEGY**

I think the example I gave could be replicated not only across Africa but in all sorts of other places. People in many places are already trying similar imaginative approaches.

### **Reducing the risks**

What the strategy offers is a way round key blockages which are stopping very many privatizations from happening. For instance, lack of good local management may be a problem and if you introduce foreign ownership as well as foreign management you are doubling your political difficulty. So your compromise could be outside management for a while but without outside ownership. And this gets round your problem of closing things which you must not close for social reasons or political reasons.

Another key point is you can actually rescind the whole deal if it fails. If you had actually transferred all the assets and it fails, you have got to re-nationalize, which is not always very politically appetizing.

Also, it does not depend on having a stock market, you do not have to reform your capital market before you can privatize, and in fact you may well do

things the other way round. Later on you may very well take the business to the stock market.

## Conclusion

So what it comes to is: if you cannot meet your privatization objectives by selling, why not find a manager? Share the profits in some way, and you may all then benefit.



## CASE STUDY: REVIVING AN INDUSTRIAL LOSSMAKER

**Peter Muth**

Advisor to Morgan Grenfell International

My case study happens to be in Africa as well. Some of you may recognize the profile:

Built on the basis of an equipment seller's feasibility study. Over-capacity of about 400%, given realistic local demand estimates. Over-priced by a substantial percentage, leaving the government with a total debt of \$42 million, and at the end of the first four years of operations, notching up losses totaling some \$50 million.

When (at the urging of the World Bank) the country closed down the enterprise in 1983, the market value of the assets which had been bought for over \$50 million was estimated at \$3 million, which is 3% of the original investment plus the accumulated losses.

Sounds familiar? I suppose in a number of your countries, with a number of industries, the same thing has happened. This particular case I have in mind is the National Steel Works of Togo.

### **What solution?**

What was the government to do in a situation like this?

First of all, the non-existence of a stock market in Togo is totally irrelevant to the situation because there would not be a buyer. Would you buy shares in a company that has a track record of losing \$10 million per year?

If you want to sell in a trade sale the likely buyer you attract is the asset stripper. He makes a low bid, takes the assets, exports them and sells them somewhere else, and you, the country, the government are left with an unuseable building, with a bad reputation, with losses, with debt service, with unemployment, and of course with a political backlash.

In this case there was no ideal solution and the fact that this case has become controversial reflects that some people expect the world from privatization. They think privatization is a cure for everything, that a loss-making company is easily turned into a money spinner and brings big money to the government.

Unfortunately, UK privatization experience has raised peoples' expectations too high: this was not the raw material for an ideal privatization case. The

ideal solution was not to have built the plant in the first place, but anything after that was less than ideal.

## FINDING THE SOLUTION

The solution that was found has been criticized as a rip-off, and it has been praised as an imaginative stroke of genius -- when I describe it, you will be able to take your pick.

The government signed a ten-year lease contract with a newly established local company, which in turn signed a management contract with a company owned by an American entrepreneur who had made his money by developing and rehabilitating steel enterprises in developing countries.

The government guaranteed the new lessee company that there would be no interference in the business. It also assured the company of an unchanged protection level (this disappointed some economists, but at least the protection was no greater than the level at which the government made annual losses of \$10 million with the enterprise). And it conceded that the company would have the right to review the price of the product it was selling, in line with inflation, every six months.

## The results

What happened since then? Production has doubled. Annual losses of \$10 million have stopped and have been replaced by a total of \$5.5 million in payments to the government in various forms (relief payment, taxes, social security contributions and customs duties). Forty per cent of the company's production is now exported to neighbouring countries. And prices have remained unchanged.

In addition, the company now employs 230 people, many of whom are being retrained for management positions under new training initiatives. The company has developed four new businesses. In Togo it has started the manufacture of galvanized pylons and steel structures, and it has started a steel fabrication business which has real potential. In Benin and in the Ivory Coast the company has bought two other derelict steel companies which it is now restructuring.

By these measures the introduction of private management must be judged a success.

## The future

Of course, private ownership has not come yet; the government still owns the assets. But now the earnings capacity of these assets has been demonstrated, and a loss-maker has been turned into a revenue generator.

In five years the government will be free to deal with these assets as it wants. It can package them, for example, in a unit trust and sell shares in that unit trust and continue the management arrangement that exists. It can sell the plant to the present managers if they want to buy it. It can hold on to the plant and just continue with the present arrangement. All the options are open today, compared to no option except the asset stripper at the time when the plant was closed.



## **A new era**

The management company has done a first in Black Africa. It has gone private -- outside any stock market, because Togo has never had a stock market and does not have capital market institutions. And it has gone private with a prospectus that would stand up to prospectuses in many developed countries in terms of disclosure, of interests, in terms of emphasizing the risks to the private shareholder, and in terms of the comprehensiveness and quality of the information.

Today 7% of the company's capital is owned by Togolees, though this number would be much higher if in opening up it had not made very serious mistakes: the initial subscription amount of \$4,000 was far too high for the small Togolees investor, well over one year's salary; the initial subscription period was too short (only one month); there was not enough marketing; and the people that marketed the prospectus were not in a position to explain what it meant. So the management is convinced today that had it not made these mistakes in marketing the issue locally, all of the 30% of the capital that was on offer at the time would have been placed locally. But those who bought at the time, at a premium of 25%, have since received their third annual dividend of 10%, so these mistakes are no disaster.

## **LEARNING THE LESSONS**

### **Lessons for the government**

For arrangements of this kind to work the government must think realistically.

It must forget about cost and think value. The cost of the enterprise I cited was \$50 million, but its value was \$3 million when it was closed.

Then the government must recognize the advantages of privatizing management instead of attempting to transfer the ownership of a very unpromising asset.

It must get its priorities right. In this case the priorities at the time were the need for some cash contribution to help with debt-service obligations, the need to maintain employment, to re-launch production, and to establish the true earnings capacity of these assets before they would be sold. Selling at scrap value because you do not know the earnings capacity of your assets is not an acceptable answer.

### **The entrepreneur's obligations**

The entrepreneur must also live up to certain expectations if such an approach is to work.

Even from a position of strength, which in this particular case he had, he must negotiate a fair agreement. Ideally, he must promise less than he can deliver, which in this case has happened; he must exceed expectations.

He must at the earliest possible time invite local participation in the management company (or in this case the lessee), but not before the risk is known and can be described. This will generate goodwill, it will avoid or stave off the danger of future rationalization which will be particularly

unpopular if local people are not involved in the ownership, and it will lay the groundwork for a future extension of the lease.

The private entrepreneur should also take great care to train the local labour force to ensure the demonstrative effect of a successful privatization -- that a worker in a successful private company invariably does better than the worker in an unsuccessful public company.

Jack Robinson

J. Robinson and J. Robinson

Privatization has an explicit purpose: to transfer ownership of state-owned enterprises to private hands. It is a process that involves the sale of state-owned enterprises to private companies. The process is often criticized for being too slow and for not involving enough local people.

While the main purpose of privatization is to transfer ownership, it also has other goals. It is intended to improve the efficiency of state-owned enterprises and to create a more competitive environment. The process is often criticized for being too slow and for not involving enough local people.

#### Structural changes

In virtually every case, other than in the case of the privatization of state-owned enterprises, the process involves structural changes. These changes are often criticized for being too slow and for not involving enough local people.

Privatization has a long history. It has been used in many different countries and for many different purposes. The process is often criticized for being too slow and for not involving enough local people.

There are many different ways to privatize state-owned enterprises. The most common way is to sell them to private companies. Other ways include leasing them to private companies or allowing them to be run as private companies.

#### PRIVATIZATION IN - J. Robinson

To illustrate the process, let us consider the privatization of state-owned enterprises in China. The process was initiated in 1978 and has been ongoing ever since.



### CASE STUDY: PRIVATIZATION IN COSTA RICA

**Jack Robinson**

J Robinson and Associates

Privatization has an appeal to governments across a wide political spectrum. In some instances privatization may have political overtones, but it probably achieves its most beneficial and lasting results if it is not ideologically-oriented and if decisions to privatize are characterized by pragmatism.

Also, while the initial impetus may be the result of "negative" factors (e.g. when state-owned enterprises, or some of them, constitute financial and economic disasters), the greatest national benefit and best results are probably obtained when the impetus is "positive", i.e. when privatization becomes an integral part of government policy to achieve national economic and social goals. There is some evidence to suggest that when positive factors replace negative ones as the primary determinants, the pace of progress is accelerated.

#### **Structural changes**

In virtually every case, other than for peripheral actions, privatization tends to alter power structures. Experience shows that broad and significant political support is essential in overcoming entrenched opposition.

Privatization also has potential for changing the concentration of wealth, or the concentration of power, or both. And, as a government commits itself to a process of privatization, it has choices and should explicitly decide whether to reinforce or diminish such concentrations, and how.

These are national responsibilities, involving national decisions, and are not reasonably subject to prescription from abroad. Nevertheless, privatization requires the institution of complex processes. These quite frequently differ in important respects from corporation to corporation even in the same country, but governments can usually benefit from a measure of external managerial, technical and financial advice and assistance in carrying out privatization programmes.

#### **PRIVATIZATION IN COSTA RICA**

To illustrate these conclusions, I would like to draw, particularly but not exclusively, on my experience as the Privatization Adviser to the Government of Costa Rica from November 1986 to April 1988.

President Oscar Arias will be remembered internationally for his contribution toward Central American peace and for his Nobel Peace Prize in 1987, but I think he may more likely be remembered in his own country for his "economic democratization" programme. President Arias combines those all-too-rare qualities of vision, sense of mission, perceptiveness and great personal and political courage. He is a pragmatist, but with a keen sense of social obligation and purpose. He chooses his associates well and delegates operational responsibility confidently. I cite these qualities because each came significantly into play as he undertook to rationalize governmental functions and privatize some of the large state-owned enterprises.

### **Earlier mistakes**

In 1972 the Government had created a development institution, called CODESA, which was intended to be a development bank/venture capital partner with the objective of turning over its interest and holdings to the private sector as enterprises became viable.

The opposite occurred. CODESA's stewardship was characterized by poor investment decisions, inefficient management and financially unviable enterprises.

CODESA had ready access to Capital Bank credit to cover deficits and operational losses. A 1983 study revealed that CODESA subsidiaries provided only 2,122 direct jobs (0.3% of the labour force) and accounted for 1.1% of the GDP, but it was absorbing one-third of all public sector credit. There was no possibility of these corporations servicing their ever increasing debt to the Central Bank: in fact they had significant negative impact on the economy.

There were many anomalies. To cite one, the cost of inputs, primarily because of economies of scale, for one manufacturing process was more than the landed cost of the finished product imported into Costa Rica.

### **The privatization answer**

The decision to divest and privatize was taken by President Arias's predecessor in 1984 and 1985 and this courageous decision meant disassembling an institution and structure which had mainly been put in place by his own political party.

The decision was confirmed in enabling legislation. The implementing plan contained two especially unique and innovative features. A private sector trust was created to handle the selling of corporations to be privatized. And counterpart funds, generated by the US economic aid program and intended to be demonetized in any event, would be attributed (i.e. used) to cover the difference between so-called "valuations" and the real market price required to sell the corporations.

However, a cumbersome and convoluted administrative structure was established on the assumption that progress could be made despite the lack of a national, or even governmental, consensus. The system which was set up did not work well and only one large corporation was moved toward genuine privatization.

When Oscar Arias assumed the Presidency, CODESA's holdings consisted, wholly or substantially, of 54 corporations. Thirteen corporations which had



been transferred from the private sector to CODESA in trust were promptly returned to its private sector owner. Of the 41 remaining, two were to be retained, leaving 39 to privatized, liquidated, dissolved or transferred. Within two years, most of the fundamental decisions had been taken on target corporations and action had virtually been completed on three-quarters of them -- a very considerable achievement in a short period of time.

### **The virtue of momentum**

Some advocate moving slowly and deliberately to privatize over a period of years. Certainly, privatizations should be undertaken carefully and consistent with policy, and, inevitably they will take considerable time. However a sense of urgency and the factor of momentum can be positive influences in helping to ensure success of privatization programs with reasonable promptness.

These benefits should not be overlooked. Others advocate half measures and "partial" privatization, ostensibly with the objective of improving the efficiency of state-owned enterprises. Improvement in the more efficient use of scarce resources is indeed to be welcomed, but I think that experience demonstrates that where state-owned enterprises are notably deficient, full privatization holds the most promise for rapid improvement in efficiency and effectiveness.

### **Rationalization**

A principal element of President Arias's domestic policy has been the rationalization of governmental functions and strengthening even further the democratic structure of Costa Rica. "Economic democratization", as it has been called, provided shape and form to the privatization efforts which he saw as supporting importantly his domestic policy.

Transferring ownership of the largest agro-industrial enterprise to an estimated 7% of the population is significant in and of itself. However, how this has been done is even more important. Some advocated that the enterprise be run as a cooperative by the leadership of a cooperative federation. Others suggested that the corporate form be retained, but that the controlling share interest be vested with the large cane growers. Still others advocated that shares be sold directly to individual cooperatives and to cooperative members -- more consistent with the President's "economic democratization" policy. The third alternative was chosen.

Costa Rica has an extensive system of cooperatives which are imbued with historical characteristics. Weaknesses included benefit-orientation rather than profit-orientation, under-capitalization and (all too frequently) weak management. If the enterprise were to be run as a cooperative, it was likely that it would remain dominated by such historical weaknesses. If the enterprise were not to be profitable, further privatization would be jeopardized. But the persuasive argument was, that by introducing cooperatives into a corporate environment, this would help bring about reform and improvement in the cooperative movement, whereby it could become a more effective and responsible participant in the economy of the country and help the movement overcome historical weaknesses.

Thus, once privatization became a means to an end rather than an end in itself, and a positive means to achieve national economic and social goals, (rather than merely "stopping the rot" important though that was), a wider



consensus in support of privatization was obtained, providing additional impetus for more rapid progress.

The policy base was secure, but would, of course, be subject to continued attacks. Those who lost power, or the circumstances favourable to personal gain, remained in opposition, but their ability to frustrate the process was diminished.

### Getting it right

President Arias appointed an outstanding private sector manager as President of CODESA.

The cumbersome administrative mechanisms, established by the previous Administration, were first modified and in parts later scrapped. Shares of corporations to be privatized were transferred, rather than sold, to the private sector trust. Onward sale could be made pursuant to private corporate law rather than public corporate law. The private sector trust was given full and complete authority to undertake financial, technical and managerial restructuring -- without any political interference whatsoever.

The government retained decision authority in two areas: (1) overall price and (2) who, (general public or highest bidders), or what organizations co-operatives or Solidarity Movement, should have opportunities to acquire shares. These were mostly political judgements, not normally to be delegated, and intended to ensure the carrying out of the "economic democratization" policy.

The basic principle with respect to price was that the share price should not exceed the opportunity cost of money. Technical and financial studies by experts, both external and national, assessed the potential and value of an enterprise both as a going concern and for liquidation. These were generally close -- with liquidation value frequently higher than going-concern value. Consequently, real market price reflected, as it should, the Costa Rican market situation. Sale at 10% to 20% of replacement costs was not unusual. But it was found that an enterprise need not be brought to profitability before sale, if prospects for profitability could be reasonably assured.

And, contrary to predictions of some, entrepreneurs in developing countries -- like entrepreneurs everywhere -- protect their investment, contract for managerial and technical assistance, secure additional equity participation, establish market agreements, and all the rest, without always having to rely on national sources for political reasons. The common argument that the essential skills do not exist in the private sector of a particular country may well prove quite mistaken when such managerial freedom is actually given to people. And what may in the past have been thought of as "flight capital" may have been in part a reflection of the scarcity of sound investment opportunities. In such instances, so-called "flight capital" can be converted to "equity investment" with obvious benefits accruing to the country concerned.

### CONCLUSION

What can be learned from such experiences? Many things! There is a degree of transferability of privatization techniques and mechanisms, but the circumstances of privatization between a developed and a developing country differ in very significant ways. Developing countries are well on the



road to privatizing state-owned enterprises, but the stages of preparation, execution and completion differ markedly. Consequently, developing countries have much to tell each other.

Governments can exercise their legitimate public responsibilities and obligations without having to own 51% of corporate shares through the judicious use of regulatory mechanisms and licensing provisions such as the Golden Share.

We frequently hear the question as to whether a particular country has the political "will" to privatize. I would suggest that the question might usefully be reformulated: "Will privatization in that country serve national political, economic and social goals?" If the answer is "yes", then privatization -- and other beneficial actions -- should be the consequence of national policy. The choice is the responsibility of the government concerned, but experiences to date suggests strongly that those governments which choose this alternative can make much more effective use of scarce resources. They can provide opportunity for enhancing the well-being of their peoples and fostering "economic democratization" with extensive economic and social benefits far beyond the immediate privatization. Those governments deserve the encouragement and support of those governments, organizations and institutions committed to extending economic advice and assistance.

Privatization is proving to be the most promising development choice of the last two decades. It is the new development growth area. But the political dimension is the critical key to understanding the probability of success of this complex development alternative in any particular country.

## CASE STUDY: PRIVATE FINANCE OF INFRASTRUCTURE

**John Burnham**

Director, J Henry Schroder Wagg

For some years has been continual discussion among banks, among contractors, and among governments about BOT (build, operate and transfer) infrastructure projects.

There have been some successful ones in developed countries -- most of them not yet complete, but successfully financed and under construction; things like the Channel Tunnel and the Dartford Bridge, the Eastern Harbour crossing in HongKong, and Sydney Harbour Tunnel in Australia. But despite all the talk, and all the time and the money spent, there have been very few BOT projects successfully implemented in developing countries.

There are two potential reactions to that, and the tendency of a lot of people is towards disillusionment. However, Schroders believe that such projects can succeed in developing countries if they are very carefully managed. We also think that it is a more constructive guide to the future to look at a country where they have succeeded, and try and learn lessons from that, rather than to complain about the countries where it has not succeeded.

### THE MALAYSIAN EXPERIENCE

It is my intention to concentrate on one country which has a successful BOT programme, namely Malaysia. Starting in 1984 they have completed construction of three such projects, numbers four and five are currently under construction with the financing complete; number six has started construction and the financing is just about to be completed; and there are others in the pipeline.

#### Early examples

The early projects were two toll roads. The first was a bypass which was a twenty-five year tolling concession, and cost only about 20 million Malaysian dollars. The second is a flyover where there was a difficult traffic junction in Kuala Lumpur, where a nine-year concession was let and the works cost about 86 million Malaysian dollars. Those were early experiences which were both financed off the balance sheet of the companies which now toll them, and although they both worked, that is not normal concession-financing model.



But a lot was learnt from that early to a water supply project which 56km pipeline, at a cost of about 100 million dollars. The construction of that is a concession was let by the government, founded for the purpose of distributing water to the grid, a capacity charge of 60:40 which, gives 90% of the equity to the government, debt in the form of an interest-free loan with recourse to the shareholders.

### Increasing complexity

The next project, which is still under construction, is a transmission line. That cost about 100 million Malaysian dollars. The concession was let to a contractor, and in that case the concession

Again, it involved setting up a new company at which the concession was let, which then raised debt and equity. The high-voltage transmission lines for fifteen years belong to the government free of charge. Again, it works in exactly the same way, but in this case with the government Electricity Board operating the thing, because obviously if you have one transmission line which is part of a huge system, the grid controller has to be centralised. It was funded on the rather more aggressive debt:equity ratio 75:25, and 90% of the equity from institutions, the 10% was the contractor, and special dividend shares with a ten-year Malaysian dollar loan which was part fixed and part floating rate -- again, without recourse to the shareholders.

So you can see a trend developing which is that financing is getting progressively more complicated as familiarity grows.

### The third phase

The next example is a whole series of seven urban interchanges in Kuala Lumpur which the company has to build and then build toll plazas on an open tolling system. Construction of that is underway by Mitsui but the concession was let by Kuala Lumpur to a private company which took a twelve-year concession.

What is interesting here is that the government specified the toll rates and the design of the works. The competition was all about the period of the concession, with the shortest practicable offer the winner. Since it was quite a viable project the private sector was to take the traffic risk on the number of cars that would drive down the road. The debt:equity ratio was 73:27. It had a mix of equity investors, some individuals coming in, and three tranches of debt, some fixed throughout, some part-fixed, some part-floating, and some floating throughout.

The next example is the North-South Highway project which is very widely known. It is a major highway right from Thailand to Singapore where the concession company has to fill gaps: some part of the thoroughfare exist already but others need to be upgraded or built from scratch. I believe there is a seven-year construction period and the concession company is letting



But a lot was learnt from that early experience, and Malaysia then moved on to a water supply project which consisted of building a treatment works and a 56km pipeline, at a cost of about 118 million Malaysian dollars. The construction of that is complete and it was built by a local contractor. The concession was let by the Ministry of Works of Malaysia to a new company founded for the purpose. It has a concession to supply bulk water to be distributed to the government for thirteen years, and it does it in exchange for a capacity charge. That project was funded using a debt:equity ratio of about 60:40 which, given that it was fairly secure, was pretty conservative. And 90% of the equity came from institutions, largely local institutions, and the debt in the form of an eight-year floating rate Malaysian dollar loan with no recourse to the shareholders.

### **Increasing complexity**

The next project, which is still under construction, is a power transmission line. That cost about 100 million Malaysian dollars and was built by the same contractor, and in that case the concessionaire was the Ministry of Energy.

Again, it involved setting up a new company at the start to which the concession was let, which then raised debt and equity to fund it. It operates the high-voltage transmission lines for fifteen years before giving them back to the government free of charge. Again, it works in exchange for a capacity charge, but in this case with the government Electricity Board actually operating the thing, because obviously if you have one transmission line which is part of a huge system, the grid controller has to be central. That was funded on the rather more aggressive debt:equity ratio 75:25, again, 90% of the equity from institutions, the 10% was the contractor, and split into ordinary and redeemable shares with a ten-year Malaysian dollar loan which was part fixed and part floating rate -- again, without recourse to the shareholders.

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out construction contracts to a number of different contractors. Phase I has started and the concession was let by the Ministry of Works to a subsidiary of an existing company, but a much smaller company than could possibly undertake this without massively increasing its capital, on thirty-year concession.

But because parts of the road do not pay too well, while other parts do, the net effect is that the project is not really financially viable. There is provision for subordinated government loans and also further loans in the event that traffic risks, exchange risks, or interest rate risks go beyond a certain point -- quite a lot of government support. And the funding of that is a massive exercise of \$2.5 billion Malaysian dollars worth of commercial loans, all to be raised in the local market with fifteen-year loans, some fixed and some floating, plus \$1.7 billion in government loans and \$1 billion from the cash-flow of the early phases of the project. An equity of \$800 million means that the debt:equity ratio is really whatever you choose to calculate it depending on whether you include the cash derived from operations, and how you count the subordinated loans.

Through that project the Malaysian government showed its flexibility to adjust where the project was not inherently viable in its own right, and bring some public-sector approaches to a largely private-sector project.

## **LEARNING THE LESSONS**

If we go on, the future suggests a bold programme of new projects underway in roads, in water supply, in telecommunications, in sewage and waste disposal, and perhaps in power stations.

But the programme has not been without its difficulties. It would be unfair to paint too rosy a picture; the problems come in three categories.

### **The problem areas**

The first is that much of the programme ran contrary to the interests of the civil service in Malaysia and the statutory boards which were involved in some of the cases. And that was characterized through direct opposition, or if that would not work because of political pressure, then through bureaucratic delay and difficulty in negotiations.

The second category were legal, procedural and administrative system difficulties, because such systems were not set up with privatization in mind; and for instance the land laws, the tax regulations, and the stock exchange regulations, had never contemplated privatization and ways round them had to be found pending change to the law.

The last problem is that although there have been successes, there have also been some failures. The reasons for those differ, but I think the most common one has been poor selection of the concessionaires -- failing to examine whether they really had the credibility and the credit standing to implement the concessions that they had won.

### **Reasons for success**

Despite those difficulties, the system is now underway. Malaysia has had successful BOT projects and has developed a momentum of its own. Since



that success is rare, I want to conclude by going through the reasons why I think it happened.

The first was need on the part of the Malaysian government. They started the programme at a time when they were in acute economic recession by their normally strong standards, and they did not have the public spending capacity to maintain their infrastructural development programme; so there was a strong need to push it towards the private sector to fund it.

Secondly, there was a feeling at some of the top political levels, and within the civil service, that perhaps the public record for implementing these projects had not been too good, and that maybe the projects might be better implemented in the private sector. There had been cost over-runs, foreign exchange losses and so on: it appeared that perhaps the government was not too good at managing the risks.

The next category of reasons is that the Malaysian government was quite realistic about the concession terms they granted. It takes a very flexible and positive attitude on the part of a government to put itself in a position where it tries to assess what the mix is between risks that can be given to the private sector, and those that should be retained by the government: and to design that mix for every separate project in such a way that it has a realistic chance of success. I see many countries around the world, where the government seems determined to shift all the risks to the private sector despite the fact that it really does not have a hope of doing so.

The Malaysian government was realistic in another way too because it recognized the need of the private sector for shorter-term returns than the public-sector normally aims for. It would often have feasibility studies done by well-reputed consultants, which looked at the project from a public-sector perspective, with returns over thirty or forty years. The Malaysian government recognized that the private sector wasn't interested in returns over that period but that it could average them out, accepting that it was going to pay the private sector rather more in the shorter-term, while it would capture the longer-run income once the concession expired.

The fourth reason for Malaysia's success has been great determination, the common theme in successful privatization programmes around the world. It had political drive from the very top, not least from the Prime Minister, and that overcame the bureaucratic obstructions -- though not easily, and not necessarily all the time. That was complemented by the fact that on the administrative front the administration was put in a central coordinating unit. That meant that the unit could take a wider perspective outside of a particular ministry, and also make the most of the precedents without having to educate many different parts of the Malaysian civil service.

The next thing, which has been the subject of much debate here in Britain, is how to give a reward for initiative to the private sector. If a particular, imaginative contractor proposes to the government that it should do a certain project, but then the first thing the government does is go out to international competition for the job, you will not get many people bothering to think up viable projects for you.

The Malaysian government went to the other extreme at the outset, and deliberately so. It gave exclusive negotiating rights to people who put up conceptual proposals which the government felt were reasonable. There



was then a period of about six months during which that company could try to negotiate a deal to implement its idea.

That policy is now being changed, though because of its success rather than its failure. It had its effect, and played a major part in getting the programme off to a quick start. The programme is now underway, there is plenty of investor interest, and plenty of contractor interest; so there is no longer the need to give the exclusive negotiating rights which of course have a cost. With the ball now rolling, they can come back towards more competitive deals -- except for cases where contractors come forward with genuinely innovative proposals that nobody had previously thought of, and there Malaysia is intending to maintain the negotiating rights on an exclusive basis.

The next reason for success is that they offered generous initial terms. The terms were not outrageous, but there was a lack of familiarity with this type of thing in Malaysia. They wanted to encourage local investors who had not seen it before, and so there were slightly higher returns for the first few projects and now they are more modest. In the projects I described the returns were coming down progressively and the financings were getting more complex.

The next reason that we can identify is that Malaysia has a very high standing as a developing country in terms of sovereign risk; there is therefore room for project risk to be taken. If the sovereign risk in a country is high then there is an absolute limit to the risk that a bank will take, whatever the margin you pay them. And so if you have a good sovereign credit rating you have much more room for passing on some of the project risks to the private sector. If you are operating in an environment where the sovereign credit-rating is poor then you have to accept that the government is going to have to bear many more of the project risks.

The next reason for their success is that they have an exceptional local capital market by developing-country standards. This, quite significant amounts of local capital has been raised. That means that you have the potential to avoid the exchange risks which otherwise burden any funding in foreign currency. Since most of these projects are infrastructural projects with local currency income, you need to avoid foreign exchange risks.

Then we have low interest rates in Malaysia which make it easier to raise equity capital and improve the project economics.

And the last thing which I think is much under-rated is that the projects, with the one exception of the North-South Highway, were of modest size. Despite all the advantages I have catalogued, they did not attempt to go for huge prestigious projects, massive power stations and so on, straight away. If you look at the projects I have described they tend to be in the order of 30-50 million US dollars. That makes it very much easier to get them off the ground; I think that is the right attitude, having got some off the ground, people understand the risks and rewards better and it becomes very much easier to move on to larger projects.

## **Conclusion**

So Malaysia's programme is succeeding because in the critical early phase there was a strong need, and that need was translated through the Prime Minister and senior politicians' personal drive to push the projects through. And that attitude on the government's side was met by enthusiasm from the



private sector which was generated by giving this reward for initiative in the form of a negotiating rights and because the initial terms offered were generous. All this was facilitated by a very good general economic environment with a high sovereign credit-rating, well developed capital markets, and low interest rates. But all of it was made much easier by choosing small projects.

## APPLYING THE EXPERIENCE

Of course there is a flaw in transferring that experience to other places, and you may well say that it sounds as though Malaysia had everything on its side. If one conducts a world survey it is difficult to identify another developing country which shares every one of the conditions to which I have attributed Malaysia's success. Perhaps the reason for that is that Malaysia is no longer a developing country.

But that does not mean that BOT projects cannot succeed in other developing countries. Where one or two of the ingredients I have described are missing it will not necessarily be impossible to finance the project; it will be more difficult, and finding ways to fill in for the missing ingredients will probably be the prime focus of the exercise.

### Role of overseas aid agencies

For the aid agencies and the multilateral institutions, I suppose that the consequence of this experience is to say that the effort they put in should be inversely related to the number of ingredients for success that are present. If all the ingredients for success are present then really the aid agencies have to do very little. The private sector will take most of the initiative. If, on the other hand, very few of them are present, then that is where governments and some aid agencies have to come in and help.

There are many different ways in which that could be done. For instance, if the local capital market is very limited then perhaps an international institution can counter-guarantee loans by local banks, to increase capacity. Perhaps it can help set up or sponsor an investment fund to develop the market for that purpose.

Alternatively, if those measures are not sufficient and the project will have to be funded partly overseas, there will be an exchange risk. The government then has two options: either it offers a higher return on the project, therefore allowing it to bear the exchange risk; or alternatively it takes the exchange risk off the company by providing some sort of protection.

If the sovereign credit standing of the country is doubtful then the government will have to take more of the project risk so that the total risk offered to the private sector is still within bounds.

As a last example, if local interest rates are high, perhaps the government could borrow concessional credits, soft loans and so on, and on-lend them to the private company. The World Bank have taken a very good initiative with the Pakistani government in that sphere, with their private-sector energy development fund, which I gather is intended to have a wider application than just Pakistan. I am sure there are more initiatives that could be taken of that sort.



## Conclusion

I am convinced that BOT projects could make a major contribution to infrastructure development in developing countries, but will only do so in a very few fortunate countries where conditions are exceptional, unless special measures are taken. It needs care and good advice to get it right. In fortunate circumstances such as those of Malaysia, we can transfer most of the risk to the private sector. In less fortunate circumstances the government will have to bear a much larger load and it will end up in some sort of risk-sharing partnership with the private sector.

Lastly, these BOT projects ask difficult questions; questions which public administrations were not designed to answer. Political determination is therefore a vital ingredient for success. The more difficult the circumstances, the fewer conditions for success that actually exists, then the greater the political determination required. If the governments of most developing countries want private infrastructural projects they can have them, but only provided they are prepared to do their part in the process.

## CASE STUDY: THE MOVEMENT TO PRIVATIZATION IN THE EAST

Philip Wright

Privatization Unit, Price Waterhouse

The potential for privatization in countries that have long been Communist-run, and in particular the Eastern block, is perhaps greater than any other area. Quite simply, the Eastern block has had the greatest concentration of state control and central planning, and therefore has more to privatize than anywhere else.

This potential can be realized only if the political will exists. The decay of the socialist economic system in Eastern Europe, combined with the accelerating pace of economic change in the markets of Western Europe, is providing the necessary stimulus for the change in political attitude.

However, what is different about privatization opportunities in the Eastern block is the quality and modernity of their industry. In the West, critics of privatization complain about the sale of the family silver; but in the East it is seen by some cynics as a sale of rusty cutlery!

I intend to paint a brief historical backcloth to the present loss of confidence in socialist ideology and then to describe the different responses to the crises of communism in the Eastern bloc, which range from the old guard unsuccessfully clinging to the status quo in East Germany and Czechoslovakia, through the Heathlike attempts to make the system work better in the Russia, to the radical Thatcherite experiments in the market economy in Poland and Hungary. I will dwell on this last country in rather more detail since it is there that I was personally involved in the first significant privatization by an Eastern Block country.

### THE SOVIET EXPERIENCE

#### Privatization -- the first round

When the Communists first came to power in Russia towards the end of the First World War, all firms were nationalized, grain was requisitioned from the peasants, private trade was banned and labour was directed by the state. According to Lenin this policy was dictated not just by economic but by the military needs.

Economically it was a disaster. By 1921, soviet industry produced only 15% of its 1913 total. Food became even more scarce as the peasants objected to the forced requisitioning of their produce so much that they only produced



enough to feed themselves. The shortages inevitably caused inflation and in the three years after November 1917, prices rose one hundred-fold.

Although not widely recognized for it, Lenin was probably the first state leader to embark on a programme of privatization with his New Economic Policy. All firms with less than twenty employees were returned to their former owners and the administration of the remaining state-owned firms was decentralized. By 1923 nearly 90% of firms were controlled by private individuals and gradually the economic position improved and by 1926 industry was back to its pre-war level. Privatization was a success.

### **Socialism -- round two**

However, if Russia was to become stronger economically, new plants and the modernization of industry and agriculture was necessary. Stalin aimed for very rapid industrialization in order to catch up with the advance countries of Western Europe. New machinery was required, would have to be imported and paid for by agricultural exports.

To achieve this end, 25 million independent peasant householders were formed into very large collective farms. Economies of scale were to be achieved, mechanization was to aid grain collection, labour was to be freed to move to the towns. Land was once again taken from private ownership and, by 1937, 99% of farmland was collective. Once again the policy was a disaster and the new collective farms proved less productive than the small ones they had replaced. Meanwhile, industrialization proceeded apace with technical assistance from abroad, paid for by the exported grain, whilst at home up to 10 million people died of starvation. However, the State Commission which was responsible for plans had a very useful method of incentivization: meet the target or -- imprisonment!

Even after the War, the lessons had not been learned. In 1950 Khrushchev decided to amalgamate the 250,000 collective farms further into 95,000 larger ones so they could be better controlled. It was not until the late 1950s that he complained that "private cows multiplied while socialist cows did not", and so divided Russia into about 100 regions each having the power to plan and organize their own industries.

Monopoly power and economies of scale were not a policy specific to the Soviet Union. Countries all over Europe (including Britain) were keen to have large government enterprises running utilities, business and social services. In many countries the state stepped in as the only source of capital sufficient to develop industry. Even in the USA the "progressive" movement felt that the area of economic life capable of improvement through expert, professional government administration would inevitably expand.

However, the economy in Russia (and, after the War, in the Eastern Bloc as a whole) remained the extreme example of a production-led rather than a demand led economy; this being the key difference between East and West. It is the State, that is the bureaucracy, and not the customer who is king. Russia "had worked up from nothing to a state of extreme poverty".

Until late October 1988 official Soviet Government statistics had shown that a budget surplus had been achieved every year since 1944 -- revealing the wisdom of central planning as against the vagaries of the market. Therefore it was a startling disclosure in October 1988 that the 1989 Soviet budget would show a 36 million rouble deficit, that is, about \$53 billion, over 7% of



the total State budget. More recently government estimates stated that the deficit was three times higher than this.

The problem for the Soviets is how to improve productivity. To improve labour productivity people need to be given incentives to work longer or harder. However, because of the inflationary consequences of financing an internal deficit, Soviet workers already had too much money which was worthless. It is a different form of inflation to the West. In the West, inflation means the same bunch of grapes cost more. In communist countries the price remains the same but the bunch is smaller. It is often referred to as disguised inflation. So the rewards of extra money for additional work have become weak in incentives and carry little appeal. What the consumers of the East want is videos and washing machines.

The other way to increase productivity is to improve capital by applying new technology to existing methods. Whilst research and development has in the past been led by the military, now that would be too slow and costly a method of improvement. The West has already devoted research time and money to developing state-of-the-art equipment and technology. Why waste time repeating the exercise? Why not import it from the West?

## REFORM IN OTHER EASTERN BLOC COUNTRIES

The other Communist countries in the Eastern Bloc are to a greater or lesser extent in the same boat, though it is quite interesting to compare the differences between them. To put these countries into a league table we would find Hungary at the top of the league followed by Poland and the USSR, and at the lower end of the league would probably be Bulgaria. The future for Czechoslovakia, Romania and East Germany remains doubtful. Yugoslavia would certainly be a league of its own, and Albania probably would not pass the qualifying round!

### Hungary

Although I intend to look at Hungary in more detail later, as this is the country where most of my personal work experience lie in the Eastern bloc, a quick look at this country's economy and politics can explain why they are at the top of the league. Politically the will exists towards liberalization. Exports have been the key to success especially in aiding the debt problem which most Eastern bloc countries suffer. The GDP estimates per head which you can see on the hand-outs show Hungary leading the Eastern bloc even though far behind the USA, UK, or West Germany.

Even so, its economy is in a parlous state with foreign debt of \$18 billion, average earnings of \$150 per month and inflation over 20% and rising.

### Poland

Moving down the table we have Poland and the USSR. Poland suddenly has the will to reform but this again is not matched by their economic awareness or efficiency. Inflation reached about 75% in the first quarter of this year. While earnings increased by over 90%. But even though real earnings appear to be growing this is not matched by a greater availability of goods and services.



Poland has by far the highest net debt figure of all the Eastern bloc countries and, although it is one of the few who export more than it imports in hard currency, the debt repayments remain a massive problem and indeed a problem for the Western Banks. About 50% of the interest is being rolled up each year and until Poland can sort out its economy this problem will not simply disappear.

The Poles have also suffered from Western sanctions, so the Bush administration offered a package of aid when certain conditions, such as the withdrawal of martial law, were met. Some of the package offers include investment (or at least recommendations of investment) by Westerners in Poland: for example, support for a joint governmental agreement designed to assist collaboration between private firms in both countries or encouraging US firms to form joint ventures in Poland. And most importantly for the Poles, there is on offer some hope of rescheduling their debt.

Joint ventures are now relatively popular in Poland. By the end of last year over 25 Western businesses (mostly West German) were involved in Polish joint ventures. An Agency for Inward Investment has been established and is projecting that 500-600 new joint ventures will be formed this year.

What is on offer is similar to Hungary: cheap labour, often well trained; tax holidays of up to six years in certain sectors such as electronics and foodstuffs; cheap fixed assets; and access to other Eastern European markets, in particular the Soviet Union.

However, there are problems. Firstly, there are domestic economic pressures, especially inflation which as in Hungary deters potential investors. Secondly, profits in zlotys are not easily converted to hard currency. Thirdly, the infrastructure is poor compared with what Westerners are used to, and it shows few signs of improvement. Put bluntly, Western capital labels Poland as high risk and joint ventures are most likely to come from firms who for one reason or another are familiar with or are committed to the Polish market.

Another form of private enterprise associated with Poland has been the establishment of medium and large private firms called "Polonia" firms. Although the number of these firms grew rapidly in the early 1980s, it has since declined sharply as the authorities concluded that, at least temporarily, these firms needed to be checked. Labour productivity in Polonia firms is on average 4 to 5 times higher than the socialized sector and they have also contributed to hard currency trade through the production of import substitutes. The authorities' desire to fragment the private sector has meant that the Polonia firms have not been able to participate yet in joint ventures with Western partners.

The economic crisis in Poland has meant that the state has not been able to provide in areas such as housing, and has turned to selling off these assets to individuals in order to improve its budgetary position. As Jacek Kuran, one of Solidarity's leading candidates commented on the state's method of restructuring, it is "the way of Mrs Thatcher, whom they love."

There is no doubt that Poland's leaders take the view that Polish industry is ageing, uncompetitive, badly managed in many respects and generally unproductive. Their solution now is the market and a list of state enterprises to be privatized is being drawn up. New laws are being put in place to help the market along. For example, a law on shares clears the way for a new



Stock Exchange to be established; new tax laws will shift responsibility of payment to the individual rather than companies.

Privatization, as we know it, has so far been limited to Poland. Many companies and banks are joint stock in form but the shareholders are generally other state enterprises or regional authorities. Shares will be offered to private individuals but capitalization will inevitably be limited.

### **Romania**

Recently quite isolated from both the West and the East is Romania. Any type of reform here was unthinkable under the Ceausescu regime, which took the economy in the opposite direction to other Eastern bloc economies. He managed virtually to clear Romanian debt, and hard currency exports have played a large part in achieving this. On April 30th the *Observer* newspaper carried a half-page advertisement on behalf of the Romanian Government stating that "at the end of March this year the country has reached a point where -- for the first time in its history -- it owed nothing." Because of this, the government of Romania felt itself to be immune to external pressures. Legislation outlawing foreign borrowing meant that any potential privatization activity in Romania, sponsored by international equity, would be difficult to contemplate.

### **Czechoslovakia**

Czechoslovakia has in the past been one of the more successful Eastern bloc countries economically with 5% growth and a trade surplus in the early 1980s. However, the recent position has declined somewhat to approximately 3% growth with increasing indebtedness.

A well-known Czechoslovakian author, Karel Dyvan was an early advocate of "market oriented reform". The research that led him to this proposition was based on a study of individual enterprises. It showed that 29% of Czech and 12% of Slovak exporters are excellent earners of foreign currency, with the rest disastrously bad. But, there is no relationship between export performance and profitability; therefore he recommended that state supports only the successful enterprises rather than whole industry sectors. The question is whether the government would be able to suffer the associated unemployment.

Joint ventures with Westerners have also been allowed with foreign majority shareholdings. However, it is early days.

### **Bulgaria**

The Bulgarian state plan for economic development refers to continuing co-operation and ties with non-socialist countries. The leadership also wants to increase its debt so as not to cut back on imports of capital equipment from the west. Bulgarian planners appear to hope that by importing this equipment and implementing their reform measures this will eventually lead to a surge in exports by tapping previously hidden reserves.

The Bulgarian trade position with the West is the next worst to the USSR and so this policy remains highly risky. One would have expected that the Bulgarian economy would have responded well to the large injections of Western technology; however, economic indicators suggest otherwise and



our GDP per head estimates show Bulgaria to be at the lowest end of the scale.

Once again, joint ventures with Western corporations are evident and the will to reform does exist in the Bulgarian leadership. New reforms include weakening the role of the state; increasing the autonomy of enterprises; and a reorganization of the banking system. These measures have been designed to make the Bulgarian economy work on the principles of self-management and self-financing.

The Bulgarian authorities are increasingly aware that the public needs better services such as bakeries, laundries, taxis and so on, and it realizes that it cannot provide these services efficiently and quickly, so it has had to open up the economy.

Young enterprising Bulgarians are hoping that this enterprise culture will expand further. But their parents point out that a similar experiment was tried in the late 1970s. The state then allowed privately run restaurants along the Black Sea. They were an immediate success; service was better and so was the food, and the entertainment was more varied. But the state-run restaurants could not rise to the challenges. Many lost customers and others complained to the local powers. The time-honoured traditions of the egalitarianism -- if not jealousy -- put an end to the brief honeymoon of private enterprise.

Price Waterhouse have recently performed a management training exercise in Bulgaria. There is a huge potential demand for such training throughout Eastern Europe and we are also working on an economic model for comparing planned and open-market variables of the national economy.

### **Yugoslavia**

Yugoslavia appears to have the will to reform but has not yet done much to put this into action. One of my colleagues recently made a trip there to find out whether there would be any scope for us to provide consultancy services.

His message was that no private sector exists, no contracting out of services exists, and privatization looks very doubtful at this stage. He says inflation has reached such ridiculous proportions that, to give you an example, his outward journey through a road toll cost 10,000 dinar and when he returned the following day it was 15,000 dinar!

The Yugoslavian Prime Minister, Mr Markovic, recognizes that Yugoslavia can only recover itself economically through deregulation of the economy with genuinely free markets in goods, capital and labour. "We need a new morale to be espoused by all the forces of society, the morale of winners", he said. "It is necessary already now to embark on the process of transforming the State. Rights and competences should be transferred from the State institutions to the market, from the commune up to the federation," he said.

These policies, which rely on a mixture of price liberalization, and controlled domestic demand represent the most serious attempt so far to reform the economy. However, this has been frustrated by the inability of the economy to adjust to a competitive regime quickly enough. Yugoslavia is faced with a vicious circle of ever-increasing inflation which could only be brought down by a sharp reduction in real wages, bankruptcy and closure of many enterprises.



Because Yugoslavia has in the past been more liberal than many other Eastern-bloc countries, the explosion of Glasnost and Perestroika from the USSR has not had the same impact that it has had in neighbouring Hungary or the USSR itself.

The new programme of reforms asserts that "the free market is the ultimate achievement of mankind for which no alternative has yet been found". Not even everyone in the West could completely agree with this bold assertion. However, Yugoslavia has been well documented for worker participation, and the reforms now mean that not only the workers within those enterprises, but independent shareholders will be able to invest in them.

## AN EXAMPLE OF ACHIEVEMENT

Returning to Hungary, Price Waterhouse were appointed by Tungsram, the international lighting company, in September 1988 to advise them on the steps necessary to transform the company into a state to raise money on international capital markets. This study was funded by a World Bank loan. There were two ways of approaching this. Firstly, could Tungsram raise Western equity funding now? And if the answer was no, then would it ever be able to? We believed that it could, but only if fundamental changes are made.

### Problems

One of Tungsram's major problems is that the business is not profit-oriented. This is seen in a variety of ways. For example, management incentives are based on quota achievements, on factors unrelated to profit such as volume sales and hard currency earnings. This can actually work as an incentive not to make profits. Also, there is no system for calculating the production costs of a product and comparing this with the sale price in order to ensure the profitability. There is a tendency in Tungsram to make the products, almost regardless of cost, and then see if they can be sold.

From our discussions with their management, it became clear that many of them do not understand the Western concept of using profit as a measure of the health and performance of a company. Therefore there is a conceptual problem to overcome which requires a fairly radical change in the way management thinks about their business. Because of this lack of understanding, business controls in a Western sense are very poor.

To give a few examples of the problems we encountered, there was a high proportion of overhead cost to direct cost, inconsistent management information, outmoded technology and communications, lack of financial and accounting sophistication, lack of understanding of company valuation principles, management inertia, lack of any professional managers, poor cash flow management, non-productive assets, high stock levels, severe debt collection problems, quality control problems, poor research and development, and no dividend history. Labour costs were indeed much lower than its competitors, but so is productivity with the result that profit per employee is several times lower than in comparable Western companies.

### The potential

However, what makes Tungsram potentially attractive to investors is its international profile. Tungsram has a turnover of US \$250 million and 13



subsidiaries throughout the world. It also has two joint ventures in the West and a 6% world market share in the light bulbs. However, without further capitalization, Tungsram would not be able to undertake the much needed and long overdue investments.

This contrasts with its position before the Second World War when it was bigger than Siemens or Philips. Its lack of development is now seen as a direct result of the lack of accountability and motivation for managers and workers.

In our report we recommended a course of action which over a period of four to five years would put Tungsram in a state where an investor in the Western capital market would be interested in it. This involved tackling the problems identified by reducing overheads, business planning and management reporting routines, concentrating on profitability, management development and training in areas such as financial and management accounts, the introduction of professional management expertise, the restructuring of the balance sheet and a whole host of other recommendations.

Following, and as a result, of our report the Hungarian Minister of Finance approved of the re-structuring of the balance sheet, including the conversion by the Hungarian Credit Bank with a 92% shareholding in Tungsram with the other 8% being owned by other banks. In a recent speech, the President of the Hungarian Credit Bank said: "I recognize that today's modern capitalism is the greatest thing that mankind has yet achieved."

### **Restructuring programme**

Our report was used as the basis to open discussions with a group of investing banks headed by Girozentrale, a leading Austrian bank. In the spring of this year the sale of 49% of the Hungarian Credit Banking shares in Tungsram to the consortium for a price of US \$110 million was concluded. This was an historic sale -- the first of an important Eastern European company to Western shareholders.

However, the deal goes far beyond just a share transaction. The banking consortium headed by Girozentrale will be heavily involved in re-structuring the company. There are already plans to bring in around half a dozen Western managers, mainly Austrian. This is seen by Hungarians as of more importance to them than the injection of capital. As Mr Foltin, a senior banker at Girozentrale said: "The end result will be the transformation of Tungsram into a truly Western-style enterprise". He continues: "Our transaction creates the possibility of direct investments in a company in the Eastern bloc".

The intention of the Consortium is to list Tungsram's on an international exchange as early as 1992 if possible. This is a punishing timetable and requires amongst many other things the first international audit of an Eastern European Company.

Girozentrale has negotiated a safety net -- if certain performance targets are not met, then there are buy-back arrangements with the Hungarian Credit Bank.



## Hopeful signs

Skeptics in the West point out that since the Forint is not convertible, foreigners will be suspicious of investing in this enterprise. However, the Hungarian authorities know that these concerns exist in the West and through recent reforms have tried to allay Western businessmen's fears. Under the terms of the new Hungarian Companies Act and Foreign Investment Act, foreigners will be allowed to buy registered shares for hard currency. Indeed, companies with more than 20% foreign ownership obtain significant tax benefits.

In addition, companies with foreign shareholders will be allowed to pay dividends in hard currency, whereas Hungarians, who can buy registered shares, will be paid in the local currency.

Finally, a Transformation Act has been passed regulating the conversion of state enterprises into shareholding companies as a first step to re-privatization -- an interesting word consistent with renaming the counter-revolution of 1956 a popular uprising.

Tungsram is a test case, and all parties are keen to make it work. It is hoped that Tungsram, a flagship of the Hungarian economy, will lead a convoy into the private sector. Although the way in which Tungsram will be re-structured and floated is not necessarily a blueprint for other leading Hungarian companies, it has certainly provoked a lot of thought and discussion in Hungary, and has started the re-privatization ball rolling.

## Changing attitudes

By the end of last year about 250 joint ventures have been formed with Western partners, although the amount of foreign capital brought in the country remained modest at approximately \$300 million. Interest in joint ventures shows no sign of slackening. Recently Tamas Beck, Hungary's Foreign Trade Minister, went to Germany with a list of 50 Hungarian companies he would like to sell off either wholly or in part to the West.

We in Price Waterhouse see this as an opportunity and opened an office in Budapest, which now has about 20 staff, and are advising several of the 50 companies on how to restructure and present themselves to the West -- companies in the banking, chemical, engineering, vegetable oils and meat industry -- even a tank manufacturer which has recently lost its market in Russia and wishes to switch to making heavy lorries. In addition we are advising numerous Western clients who are investigating opportunities both in Hungary and Eastern Europe more generally.

As I have said, Hungary leads the way in the Eastern bloc towards Western-style capitalism. This is the country where the potential for privatization is likely first to be realized. The risks involved are large, both at a political level, and in terms of the size of the restructuring costs. It is for this reason that it will be particularly important to avoid outright sale to foreign capitalist shareholders and the redundancies consequent on restructuring without incentives to management and employees.

The Hungarians are developing a Stock Exchange, the first in Eastern Europe, and are most interested in the application of management and employee buy-outs in the Hungarian context. It will not be easy. However, the potential benefits for both East and West are immense.



## CONCLUSION

Opportunities exist for both sides -- the East to raise capital and pull their countries swiftly into modern industrial competitive nations, and the West to break into new markets and to invest in corporations which will be major trading partners of the future for Europe.

PART III - INTERNATIONALIZATION AND THE DEVELOPMENT AGENTS