PRIVATIZATION IMPLEMENTATION: ISSUES AND CONCEPT

Deepashree*

Countries with different economic and political systems are increasingly privatizing their State-Owned Enterprises (SOE) so as to improve the efficiency of the enterprises and to lenen the financial burden of those enterprises on the national budget. This paper examines the issues and concept in implementing privatization programme the study reveals that the main issues in implementing privatization programme are planning and management, preparation of SOEs for sale, valuation and pricing, determining future ownership, employment issues and cost of privatization. The issues need to be deeply analysed and evaluated for privatization to succeed to have the desired effect.

What makes a privatization successful is not easy to define. Several studies have shown that privatization tends to gets bogged down at the implementation stage. According to Steve H. Hanke,[1] the issues related to privatization are many. Besides broad issues of economics, privatization raises issues of finance (what financial strategy should be adopted to accomplish a particular privatization objectives?) property rights and law (is the legal structure, especially as it related to property rights, adequate to support successful privatization?), tax structure (does the tax system encourage private equity ownership?), and especially politics. In some ways, of course, the last of these issues is the most important, since political factors will ultimately determine whether a venture in privatization can be tried. Therefore, a critical part of any privatization strategy requires thinking through a plan that will mobilize coalitions in favour of privatization to overcome expected opposition from interest groups.

The main issues in implementing privatization are:

1. Planning and Management.
2. Preparation of SOEs for sale.
3. Valuation and pricing.
4. Determining future ownership.

* Reader in Economics, Department of Commerce, Shri Ram College of Commerce, University of Delhi, Delhi-110007

5. Employment Issues and Employee participation.
6. Cost of Privatization.
7. Resource Mobilization and Financing.

It is extremely important to deeply analyse these issues so as to be able to anticipate and evaluate the possible responses.

I. PLANNING AND MANAGEMENT

This deals with those planning and management arrangements which will ensure orderly, transparent and expedient privatization process. Various steps in this direction are:

1. Initiating measures.
2. Organization of departmental responsibilities.
3. Use of external professional services.
4. Mandatory guidelines.

Initiating Measures "Initiating measures" are meant to cover initial implementation measures, that is, after a government has redrawn the line of state ownership. The initial announcement of privatization by the government can be either as an element of economic policy or an ad hoc policy, without spending much time and effort in preparing it. To move rapidly, a country indeed needs to be clear in advance about the initial steps to be taken and have identified some initial viable candidates. If those conditions cannot be met, it is perhaps best to proceed case-by-case, rather than launching a general program. Even with a case-by-case approach, however, the government should announce its intentions publicly. Otherwise, critics may view the transactions as underhanded. In most countries, it is also necessary to continue publicizing the government's progress in varying degree of detail. Initial announcements should present the privatization transparently and invite constructive discussions with all parties. Otherwise, it leads to severe criticism for lack of open debate and leads to labour unrest and subsequent reversals of divestitures. Socio-political constraints and interests of various groups must be addressed at the earliest stages. Promotional campaigns with respect to the government's overall efforts at privatization can be extremely important, particularly if lack of response or even opposition is due to lack of understanding.

It is found that extensive announcements were made and initiating measures taken by several countries while not much implementation action has taken place.

Whatever be the approach to privatization, careful planning and phasing of activities is important. The timing of offerings must take into account market conditions. The program should seek to maintain investor interest though a variety of offerings, mixing types of firms, partial and full privatizations, and public

offerings and private sales, in keeping with market conditions. The pattern and pace should be reviewed continuosly.

The selection of first candidates for privatization may be determined by various socio-political factors.

Authorization of privatization in a given country may be determined by existing legal requirements, such as those in the constitution. Usually there is some room for discretion, however, France passed special legislation authorizing a privatization program for a group of sixty five SOEs (a separate law authorized the privatization of TFI, a television channel). A similar law was enacted in Senegal authorizing the total privatization of 13 **"Societies d' Economic Mixte"** and the partial privatization of another 13 such enterprises. The United Kingdom needed separate pieces of legislation for practically every privatization. This led to delays of over one year for individual entities, whereas in France the processing time per entity is about three months from the decision to proceed to the actual offering. Turkey's law gives the executive branch the power to decide on privatizations. The care with which the privatization process is prepared can greatly influence the ease with which a privatization program is launched and implemented.

Organization of Departmental Responsibilities : Implementation Units A government needs analysis and informed advice on many issues, coordinated formulation of recommendations, prompt and expedient decision-making, as well as effective implementation capability. The possibility for abuse must be minimized. The emphasis is generally placed on centralization, simplicity, flexibility, speed and transparency. No one organizational model for managing a privatization is appropriate in all circumstances.

Managing a privatization program requires a variety of skills. Some may be available within government departments, others must be hired from outside. Some of the organizational set ups are:

(a) **Specialized Government Ministry**. A number of governments have used a specialized ministry to carry out and coordinate the privatization program, such as in Canada (Office of Privatization and Regulatory Affairs as well as some provincial ministries : e.g., Quebec has an Associate Minister for Finance and privatization). France had a "Minister delegue a la privatisation" until the privatization law of August 1987–responsibility was then transferred to Ministry of Finance, Economy and Privatization.

(b) **Permanent Privatization Committee.** To ensure decision

making by consensus, it is advisable that countries have set up a permanent governmental committee or commission to oversee privatization, or some specific aspects such as the valuation. In some cases it may be assisted by a specialized task force. Typically, the committee includes representatives of the ministries and public entities most concerned with the privatization exercise, but may also comprise personalities from outside government. Brazil, Canada, the Philippines and Senegal established such committees and gave them principal authority to carry out their privatization programs.

(c) **Sectoral Ministry.** A number of countries have given the responsibility to privatize SOEs to the sectoral ministry or department most closely involved with their operations. In the United Kingdom and the United States, for example, Principal responsibility for privatization was assigned to the Ministry (or Department, in the United States' case) of Transportation in the case of airline (U.K.) or railways (U.S.), or the Department of Trade and Industry in the case of telecommunications (U.K.), etc.

(d) **Ad Hoc Privatization Units.** Where privatization is restricted to specific companies or groups of companies and is not global policy affecting all SOEs, ad hoc implementation units have been used.

(e) **Privatization by the Parent Holding Company.** In many countries, privatization is carried out by the parent or holding company, in some cases as a routine part of corporate operations.

To varying degrees, the Philippines, Brazil, Tunisia and Turkey are also following this course. Obviously, the level of commitment of the professional management of the parent company to the goals of the proposed privatization is of paramount importance to the success of this approach.

At the same time, because privatization involves by necessity several government departments, to ensure adequate coordination, one party (ministry, committee, etc.) needs to be designated as the lead unit through a formal administrative instrument. Boards of directors and management often play a key role in the process jointly with the government-owner. There are various examples of this. Of course, management thereby becomes an interested party in the outcome of the process, particularly if they are given responsibilities in the selection of the acquiring party.

The countries where the implementation of privatization has

been more speedy are seemingly those that have avoided the complexities of involving too many government departments other than through the membership of government ministries in a policy-making body (such as CORFO's Council in Chile). The privatization structures adopted in Chile and France have permitted efficient implementation of privatization decisions. Clearly, each country needs to devise its own approach based on factors such as the scope of the program, and the political and administrative characteristics of the country. If the scope of the privatization program is one of fundamental economic policy reforms in the country, then the responsibility to carry it out will need to be placed at the highest levels of government. In both developed and developing countries, a minimum degree of checks and balances, coordination and transparency is necessary to try and protect the public interest when taking up privatization.

Use of External Professional Services Generally, governments have found it necessary to hire external services in carrying through privatization. The degree of reliance on external advisers is primarily a function of the type of transaction or transactions envisaged and of the specific tasks to be carried out. Advisers may also assist in developing the overall policy approach and basic orientation of a program.

In the case of developing countries, the advisers should have experience adapting divestitute and financial techniques to local conditions. Often, some association between local and foreign advisers is the most appropriate arrangement with respect to both technical advice and development of the required network of contacts to solicit investor interest. In some instances, all a government needs is associational assistance in selected fields. Governments have also decided to use external services to formulate their overall privatization program.

Whether the advisory and implementation assistance can or should be delivered by one or more advisers depends largely on the size of the program.

Advisors can be selected through a variety of procedures. A bidding process has been followed in many instances. In some countries, priority was to be given to local firms with local establishments, or joint ventures between local and foreign firms.

Mandatory Guidelines or Procedures

The procedures for privatization (particularly private sales) should safeguard the public's interest. Individual deals should be subject to clear minimum standards that ensure orderly disposition, maximum return to the state, a fair process for the general public and assurance that the purchaser is qualified to run the enterprise productively.

A number of governments, when planning privatization, have developed mandatory procedures for their

programs. These involve mechanisms for setting floor prices, procedures for selecting purchasers (e.g., through bidding or direct negotiation, minimum qualifications, whether to limit purchases by non-nationals, etc.). They may also involve obligatory payment guarantees or various forms of security where the government provides the financing or accepts payment terms. As in many countries the initiation of any privatization requires legislative authorization, Laws on privatization have been enacted spelling out the basic conditions applying to the process. In some cases where governments did not apply minimum criteria, they suffered adverse consequences. Chile's experience in its first phase of privatizations revealed that it needed to formulate better prequalification criteria. Bangladesh, which accepted payment terms when reprivatizing a substantial number of firms, has suffered from defaults for which it did not have remedies, such as mortgages or other financial security.[2]

Some countries (in West Africa, for instance) are characterized by extremely cumbersome procedures for setting up and administering corporate structures. According to a recent study,[3] the most crucial limiting factor in Africa is not the lack of entrepreneurship, but weaknesses in the policy environment which inhibit effective investment.

Approaches taken recently by several countries, including Brazil and Morocco, place privatization in a broader context of "modernization" of the economy. The Moroccan Administration is currently expected to present to its legislature draft laws introducing various accompanying measures to privatization such as a reform of the stock exchange and relating intermediation, tax incentives to stock ownership and to the trading of shares on the stock exchange (designed also to address capital concentration concerns by encouraging widespread shareholding), certain reforms to the company laws, and antitrust provisions.

Briefly, therefore, the overall gains grom privatization can be greater in a policy environment that encourages the efficient operation of private enterprises and that avoids giving special privileges to private parties acquiring or leasing SOEs or their assets. Thus, privatization may need to be accompanied by well-planned policy reforms that promote strong interest by the private sector and permit competition and efficiency pricing.

II. PREPARATION OF SOEs FOR SALE

Some SOEs however are in a condition that permits sale or other transfers to the private sector without readying measures.

Based on a detailed preparatory analysis which will precede just about any divestiture, it will frequently be determined that the SOE is not salable on an "as is" basis, and a wide array of preparatory restructuring measures may be called for.

Procedure for preparing SOE for sale includes :

1. Diagnosis of the SOE.
2. Satisfaction of Legal Requirements.
3. Conversion of Legal Form.
4. Modification of overall Legal Framework.
5. Financial Restructuring (including measures with respect to excess liabilities).
6. Physical Rehabilitation.
7. Changes with Respect to Staffing.
8. Effectiveness of Management.

Diagnosis of SOE A first step in any privatization is normally a thorough examination of the SOE's finances and operations. Following this examination, preliminary values should be established for assets or shares and an initial determination on the relevant privatization method or methods should be made.

The enterprise diagnosis will first consist of a corporate finance analysis, covering the SOE's debt situation (and in particular the state's exposure with respect thereto), capital structure and past financial performance. Auditors may need to be retained to review the adequacy of financial statements and, in many instances, prepare financial statements in accordance with sound accounting practices. Indeed, some SOEs, especially in developing countries, are without adequate records, have over-valued assets and have lacked financial discipline.

The diagnosis will further examine the SOE's past operations and market situation, possible special privileges granted to it as an SOE and their impact on performance, and the relevance of existing plants or other assets to potential investors, as well as the physical condition of these assets.

Satisfaction of Legal Requirements The rights of existing shareholders have to be taken into account. The charters of SOEs set up as mixed joint stock companies routinely contain restrictions on the transferability of all or certain classes of shares, provide for preemptive rights of existing shareholders, and the like. These provisions have reportedly been a hindrance to some privatizations in Kenya, and in the Philippines the proposed purchase of Associated Bank from the government-owned Development Bank of the Philippines could not proceed because of such restrictions. Under the Brazilian rules governing the privatization process, the presence of a requirement of existing shareholders' consent is one instance where direct negotiation rather than bidding is an accepted procedure for selecting the purchasers.

Other commitments of the SOE may also need to be satisfied, such as contracts with management and employees (pensions, allowances, etc.) and commitments to suppliers, contractors and customers.

The identification of all these requirements is an essential

preparatory step to the sale of an enterprise. The impact of these requirements may be close involvement by all relevant parties (creditors, employees/unions and others) in the privatization process, and/or additional costs to settle them. Satisfaction of all legal requirements is essential to avoid continuing claims after a privatization.

Conversion of Legal Form A very large number of, if not most, SOEs cannot be privatized in their existing legal form which then needs to be converted.

Legal restructuring may range from simple amendments to the articles of association to the dissolution of an enterprise and transfer of its assets and liabilities to a new corporate entity. When shares are to be offered to a private purchaser or to the general public, a number of specific legal steps may be required to convert the enterprise into a joint stock corporation of a public limited company. Where the entity is a non-stock enterprise (e.g., a statutory body established by an act of parliament), the government needs to convert it into a stock corporation under ordinary company law. British Telecom (BT) was, immediately before privatization, transformed from a public coporation into a public limited company. As a public corporation, BT had a quasi-governmental power to grant licenses under the monopoly it enjoyed; these powers were removed by legislation before privatization. Dissolution of a statutory body and the transfer of its assets usually require special legislation.

The reorganization of an SOE into component parts may be a preliminary step to privatization. In Chile, the state-owned generating and distribution electricity utility was broken up, starting in 1985, into several smaller corporations. It was recently decided to privatize one of the corporations, PULLINQUE S.A. (and the process took no more than six months, the preparatory conversion work having been complete previously). The British National Oil Corporation was split into two components and the operational activities were privatized as Britoil.[4]

Modification of Overall Legal Framework In many situations, conversion of the legal structure of the activity is accompanied by ancillary legal changes, such as revision of special privileges (e.g., termination of monopolies), establishment of a licensing system, introduction of a revised regulatory system for utilities, and so forth.

Financial Restructuring Balance sheet restructuring and ancillary financial measures have been necessary for many SOEs privatized as going concerns (particularly where public offerings and sales of shares are involved). Other sometimes more far-reaching measures of a financial nature have been necessary with enterprises that cannot be privatized as going concerns (particularly in the

case of dissolutions followed by the sale of assets and fragmentation into component parts). The amount of change necessary will vary from enterprise to enterprise depending largely on the manner in which it was operated. Most measures have had to do with the write-down of assets, alleviation of liabilities, recapitalization and spinning off of assets. It is very difficult to know the extent of justified restructuring, particularly for SOEs which are no longer self sufficient or profitable. Restructuring of SOE pricr to sale does not necessarily make it a going concern but may only establish the conditions under which an eventual going concern could be established, and it is particularly difficult to assess the extent to which that premium can be recouped in the sale price. In case of excessive debt liabilities, each situation has to be handled on its merits.

Debt restructuring may involved various types of arrangements such as: complete reorganization, with debt selectively assumed by new operating entities; rescheduling; repayment (possibly accompanied by a selective sale of some assets to finance it); direct buy-back of a discount; conversion into equity; and arrangements for a third (governmental) party of service the debt on behalf of the SOE, possibly as an interim arrangement. Assumptions of debt liabilities and rescheduling would require the consent of the creditors and will therefore involve negotiations with them. Whether the liabilities are settled or assumed, such actions are calculated as cost of privatization. As far as possible, internal restructuring should be explored. Governments should carefully explore the conditions under which they would be prepared to maintain liabilities on account of privatized SOEs.

Relief by the government of an enterprise's liabilities must be seen as a readying measure to permit a sale.

One way to establish an upper limit for the debt to be assumed by the government is to estimate the liquidation values of the targeted SOE, should it not be privatized.[5]

Other actions with respect to SOE debt might be taken, such as illustrated by the readying of the Caribbean Cement Company (CCC) in Jamaica. To make the company more attractive to prospective investors in this public offering, the government agreed to assume the foreign exchange risk on approximately US $ 62.3 million of CCC indebtedness owed to foreign creditors. This was coupled with a capital injection to strengthen the debt to equity ratio and a moratorium on a substantial amount of import duties.[6]

One of the relevant methods of privatization of undercapitalized SOEs could be a new (primary) share issue to raise new equity prior to or simultaneously with the sale of an enterprise. Most privatizations of industrial SOEs in Guinea involved the transformation of debilitated SOEs into

a new corporation whose equity was to consist, on the one hand, of a government contribution in kind of the assets of the former SOE and, on the other hand, of an infusion of fresh equity by private investors (often resulting in 49 per cent government and 51 per cent private ownership). The government-held shares are then divested at a later stage. Various other balance sheet modifications may be appropriate as reshaping of an SOE by removing certain assets.

Physical Rehabilitation Physical rehabilitation may increase the sales potential of the enterprise and permit the cost to be recovered, but no example is known. Physical rehabilitation and modernization through privatization occurs regularly. It is sometime financed through new private investment in SOEs.

Changes with respect to staffing The legal situation with respect to personnel of state-owned enterprises (in terms of labor law and social security) needs careful review. Liquidation means laying-off personnel; privatization sometimes means a drastic reduction in the work force as a precondition of sale (e.g., SEAT in Spain), even in the case of management contracts (industry experience indicates that employment reductions are often necessary). The cost and timing may depend in part on whether personnel are under civil service or private labor laws (e.g., with respect to severance pay, etc.). Even when no lay-offs are involved, some personnel questions may arise as part of the readying process, as in the case of a change of legal form from a public corporation to a joint stock company. In such a case, complex questions may arise with respect to the transfer of personnel from civil service or quasi-civil service to private employment. In the case of Jabatan Telecom Negara in Malaysia, when the public corporation was transformed into a joint stock company, the disposition of the existing pension system was a major hurdle. Turkish legislation on privatization provides for the maintenance of entitlements in the State Retirement Fund. Because of potential labor rigidities, a prospective purchaser may insist on staff reductions prior to the acquisition.

Effectiveness of Management Preparing a large SOE for privatization can in most cases never be done without the full commitment by the enterprise's board of directors and top management. A supervisory ministry hiring investment bankers to implement the privatization without the consent of the board and management may be a possible mode of implementation if the enterprise is relatively small. However, in very large multi-businesses, multiplant operations, it is a must that the preparation starts with assuring the full commitment of the enterprise's board of directors and top management. They would normally be given the task to prepare and implement the privatization plan or to

provide extensive assistance and support. Management may be in favour or against privatization for many different reasons.

Management related actions yield much less clear conclusions than other readying measures. They vary greatly. In few instances of direct or private sale of shares will purchasers want to acquire the SOE "as is" and the key question which arises is whether the government should take responsibility for management changes or should leave it to the purchaser. Prior changes in management are more likely when the enterprise is being substantially restructured in view of a public share offering than is the case with private sales, where the new owner will want to restructure management to fit its needs.

III. VALUATION AND PRICING

Whether for the purpose of selling shares or assets, valuation and the resulting pricing are sensitive and difficult matters even where developed equity markets exist as shown, inter alia, by the recent experience of France and the United Kingdom. Invariably, substantial oversubscription of shares in many public offerings for privatization (Cote d'Ivoire, France, Jamaica, Malaysia, U.K.) possibly raises questions about their pricing, but at the same time the pricing may have been a determinant of their success.

Only very rough guidelines can be set for SOE valuation. A value can be determined by reference to recent earnings or future earnings potential, dividend paying capacity, adjusted value of its asets, or various combinations of the above. Where liquidation of the enterprise is a possible alternative, the liquidation value may also be used. The practices of using book values, assessing net assets values, calculating the government's total investment, or discounting average maintainable (historical) profits are usually not adequate.

In general countries need to deveolop a practical approach for valuing enterprises or assets, with sufficient flexibility to permit the establishment of a price that corresponds realistically to the level of interest in the private sector. In most instances, the approach will use several criteria with proper weighting. The mandatory procedures in France and the Philippines illustrates this point.

With respect to pricing mechanisms, they depend on the type of transaction envisaged. Two methods have been used for public offerings. One is to offer the shares at a fixed price, to be set before the offering. The number of shares sold to each applying party is scaled down in proportion to total applications. The second is an offer by tender in which the striking price represents the balance between tenders made at different prices and the number of shares available, with all those who have tendered above the striking price receiving shares at the striking price.

As to private sales of shares or assets, one approach is competitive bidding or an auction, which leads to a price determination in line with the enterprise's or assets' market value. Governments may, however, wish to set a floor price in advance of calling for bids.

Several factors may affect pricing. In preparing for a particular privatization, as thorough a review as possible is necessary to identify the existence and impact of these factors. One is potential market response, a key determinant, in particular the level of investor interest and availability of financial resources. The profit record is another key determinant of the value of a company.

The general business environment will be an important price determinant. If a crude price-earnings multiply is adopted as a method, a low multiple of earnings may be the way in practice how an investor will value a business if he perceives a high level of risk and requires his money back in say two or three years.

Finally, the selection of the actual privatization technique for a given SOE will largely determine its value and price.

IV. DETERMINING FUTURE OWNERSHIP

An important question is to find the desirable level of private membership i.e. partial vs total privatization and the nature of private ownership.

Partial vs. Total Privatization

Privatization through a transfer of ownership can take place to varying degrees, generally depending on the government's objectives or market conditions. Governments usually retain partial ownership for purposes of control, for instance, over "strategic" sectors, or when the government's objectives is to increase efficiency only, or when gradual privatization is called for. The specific reason for retaining partial ownership largely dictates the best method for doing so. Partial privatization usually results in a joint state private company.

Widespread Distribution of Ownership

The promotion of wider share ownership among both employees and the general public has been a major objective of the privatization programme of several countries.

The United Kingdom trebled the number of shareholders through privatizations, while France's goal was to quintuple it. Beyond increased share ownership, several countries have also aimed to develop their capital markets through privatization.

Governments have deployed various techniques to encourage widespread share ownership. Several are relevant to countries intent on privatizing through public offerings. They include phasing (so as to crow the market), allotment techniques, incentives to purchase and ad hoc distribution mechanisms.

Phasing is equivalent to gradual privatization. Carefully weighted alloatments have been used in recent privatization to give priority to employees and small investors. The British Gas privatization is a case in hand. The planned initial allotment is for 40 per cent of the offering to go to individual investors, 40 per cent to British institutions and 20 per cent to be offered abroad. However, if applications from individual investors reach twice their 40 per cent allotment, shares from the allotments to institutions and foreign investors will be transferred to them, up to 64 per cent of the total. Restrictions on individual shareholdings, as described in the following section, are themselves a method of allotment. As far as maintaining those initial allotments is concerned, incentives have been offered, such as loyalty bonuses for investors holding on to initial shareholdings for a minimum period of time (used by France with Saint-Gobain and the United Kingdom with British Gas). In Chile, loan advantages are eliminated if the buyer sells the shares to a third investor. The sales promotion techniques applied will largely influence the attainment of allotment targets.

Restrictions on Ownership Composition, Controlling Interests or Foreign Ownership

A large number of governments have restricted individual shareholdings in privatized enterprises to limit the potential for undesirable controlling interests or private concentration of economic power, both domestic and foreign. As described earlier, a public offering with welldevised allotment procedures is a main vehicle for achieving widspread shareholdings. This section reviews the mechanisms used by some governments, which can be divided into the following groups :

- Limitations on Individual Shareholdings.
- Options with respect to Foreign Ownership.
- Other.

Limitations on Individual Shareholdings It is necessary to differentiate between the sale of shares to the public and a sale of shares assets to a single purchases or a group of purchasers. In the latter case, the government selling the SOE or its assets selects the purchasers and may decide not to proceed with the transaction if certain prequalification criteria are not met. That is, the prospective purchasers are known in advance. When inviting the offers, the government or owner will indicate any restrictions to them. Restrictions may, in theory, also be placed on the power of the new private owner or shareholder to dispose of its interest.

In the case of a public offering of shares, the purchasers are not known in advance, and the government may want to avoid certain patterns of ownership for general policy reasons or because of the characteristics of

the enterprise (e.g., to avoid monopoly control in the case of public utilities. Restrictions may be incorporated in the specific legislation authorizing the privatization of a given enterprise or in the articles of association of the company to be privatized.

The main disadvantage of limiting single shareholders or blocks of shareholders to a few per cent of the shares is that it prevents the concentration of ownership that enables shareholders to pressure management to improve its performance. To turn a company around, some core group may need to have and to use a large if not controlling stake in the enterprise. While perhaps not a serious issue with well-managed firms with a strong technical partner, it is of concern where the firms to be privatized are weak or underperforming, often the case in developing countries.

Options with Respect to Foreign Ownership A number of governments have allowed foreigners to acquire interests in their SOEs. Some have done so with limitations in general instruments such as general investment laws or privatisation laws, quite a number without limitations, and some with limitations only for specific enterprises or certain sectors. Other countries have limited foreign participation as a general policy (Brazil's mandatory privatization rules exclude foreign participation if voting control is to be transferred) or with respect to specific enterprises (Jamaica). Yet other countries, such as Senegal, have provided for general priorities to local investors but permit, within controllable limits, foreign participation. The record shows that many countries are quite successful at divesting to local investors; Cote d'Ivoire has reportedly transferred about half of its 28 privatized SOEs to Ivorian interests. In Guinea, a country without a capital market, several companies were either sold outright (SOCOMER, a fishing enterprise) to a local private company, or local investors acquired substantial interests.

Policy Restrictions on Foreign Participation[7] Some countries restrict foreign investment in certain sectors, either on grounds of the political sensitivity of certain industries for reasons of national interest, or to reserve for local enterprises those industries with relatively simple technical and financial requirements.

Policy toward foreign investment in Privatization depends to a large extent on the basic objectives of the government with respect to privatization. The problem in many economies will be that there are only a small number of corporate investors with the financial resources and management expertise required to acquire larger SOEs.

In general, the total exclusion of foreigners may be unproductive, although all the gains and costs need to be weighed. In particular, decisions of foreign participation may have a very heavy political content, and what

makes business sense may simply not be feasible politically. A strong political debate arose when the Canadian government proposed transferring de Havilland Aircraft of Canada, Ltd. to the Boeing Company of United States. In the end, Canada sold all the shares to Boeing because it felt that Boeing's technology, financial and marketing strengths gave de-Havilland the best chance of a commercial success. A balancing of foreign and local investment is the best approach to this issue.

Other Procedures Buy-back options, such as those retained by the Government of the Netherlands when privatizing KLM[8], constitute another method of restricting certain patterns of possibly undesirable ownership. Arrangements for the privatization of another airline will include power of approval by the government of any resale of stock in the airline.

Special procedures were introduced by France in connection with the maintenance of a stable group of shareholders of SOEs to whom shares were sold privately ("noyau dur") prior to the public offering of further blocks of shares.

V. EMPLOYMENT ISSUES AND EMPLOYEE PARTICIPATION

The restructuring that may accompany privatization, can result in retrenchment, and perhaps unemployment, or a new owner may reduce the work force in the short term in order to turn the company around. In certain cases, the single most important issue or obstacle to divestiture is the impact on employment. Labor commonly opposes privatization because of the potential effect on jobs. Privatization can be extremely difficult unless ways are designed to counter these situation. It should be noted generally that the employment issue often is a latent one with SOEs, which is not brought about by, but rather needs resolution under, privatization. Indeed, for many SOEs it may not be possible to attract private equity capital if excess employment issues are not resolved. The interests of union and management are too divergent, and there is no way to accommodate both.[9]

Employment related problems

Recently, the International Labor Organization (ILO), the United Nations Development Program (UNDP), and ASEAN organized a symposium[10] to look into the labor issue (ILO/UNDP/ASEAN 1987). The symposium came with a set of policy recommendations that may be a useful starting point in developing privatization proposals. The following issues in the field of labor relations and employment were identified as being critical to workers: (1) loss of jobs due to cuts motivated by reorganization, (2) preservation of benefits already won, and (3) policy on whether or not the firm will rehire workers. In addition, privatization is expected to extend to affected workers the right to organize and unionize. Public sector workers are usually not allowed to organize or unionize.

The type of privatization determines the range of employment problems likely to arise. In the sale of shares in part or in whole, employment contracts do not necessarily change, since the enterprise is transferred as a going concern. However, enterprise restructuring prior to a sale of shares may, as noted, affect employment. The sale of assets usually involves a major transformation (and possibly liquidation) of the business that may involve termination and possible reemployment by the purchaser (or transfer of the employment contract). The privatization of Japanese National Railways involves the gradual laying-off of 92,000 employees (almost one-third of the work force): the SEAT privatization in Spain likewise involved substantial employment issues.

Employment will be a much bigger problem in several developing countries than they have been under, e.g., U.K. or French privatization. Fears of unemployment are leading Sri Lanka to pace its privatization slowly. It is mostly at the readying stage that overstaffing needs to be addressed, since investors may avoid enterprises with excessive work forces because of the difficulty of addressing labor issues after privatization. However, there are instances where the excess employment issues are just left to the buyer to handle, like in the case of Compagnie Generale de Constructions Telephoniques (CGCT) a sale of assets. Various regulations required the initial absorption of all presonnel by the party acquiring the assets. Substantial layoffs of about one-fourth of the work force subsequently took place.

The employees of an SOE may still oppose the privatization as they perceive that less employment security would result under private ownership.

As many developing countries do not possess the income maintenance system of developed countries, termination from (just as recruitment to) public employment tends to become very politicised. Pension benefits are a major issue as well, as illustrated by the privatization of Jabatan Telekom Negara in Malaysia and British Airway in the United Kindom. For example, employee attitudes are strongly influenced by whether index-based pensions are to be maintained.

Experience seems to demonstrate that in many circumstances it is absolutely essential to address employee concern at the earliest time of initiating and implementing a privatization program. Several governments, including Morocco and the Province of British Columbia in Canada, have careflly presented the issues in initial announcements on privatization. The weight placed on personnel factors will logically determine the degree of employee confidence in the privatization process.[11]

Remedies to Negative Employment Effects

Seiji[12] cited several options open to governments to avoid labor problems.

Governments can : (1) encourage workers' companies or cooperatives to pool resources and buy state-run enterprises scheduled for privatization; (2) establish an ad hoc privatization arbitration board where the peculiar employer-employee difficulties of transitional companies may be brought for final decision-making; (3) provide formal transition arrangements for employees in a buy-out by private parties, including payment of benefits, rights to rehire, etc.; (4) encourage workers' associations if unions are not allowed to ensure workers' protection and bargaining leverage in the event of privatization; (5) provide government-initiated training or retaining activities to allow employees to assume new positions in the bigger labor market.

With respect to remedies to negative employment effects, there are many options, a few of which are discussed below. Again, crircumstances will dictate which approach or combination of measures is the best.

1. **Productive Dialogue**

Productive dialogue with workers' associations or unions addresses the merits and rationale of privatization. Measures to lessen the adverse consequences on employees should be widely publisized. It should also be explained that under any circumstances government ownership of enterprises is no guarantee of continued employment. In recent years, some SOEs have, in fact, reduced their employment substantially.

The long-term benefits of privatization should also be emphasised (particularly to trade unions), such as the possibilities for sustained of expanded employment as the private sector grows. Without reform, there is risk that the enterprises would have to be closed at a later date. Workers are frightened by the privatization process, as they do not understand it. Management must make all necessary efforts to speak to them and alleviate unjustified fears.

2. **Employee participation in ownership**

One measure to negate employment effect of privatizations is the reservation of shares for employee participation. This was done in Malaysia, Britain, France, Canada, Jamaica.

Public announcements and literature in respect of government restructuring and privatization in British Columbia (Canada) have stressed that affected employees will be given fair treatment, and have emphasized and described in detail special incentives for employee acquisitions (including

a 5 per cent preference in bidding, and training and advice to interested employees) and announced special retirement schemes.

U.S. is also experimenting with Employee Stock Ownership Plan (ESOPs) and making effort at determining their applicability in other countries.

3. The Management/ Employee Buy-Out

In a labour/management buy-out, a combination of labour and management gains a controlling interest in the firm being privatized, often by means of leveraging.[13]

4. Lessening the Adverse Consequences of Employees

Retrenchment may necessitate specific compensatory measures that entail considerable costs to the government and/or SOE. Such measures include severance pay and bonuses for employees who voluntarily resign.

A fund for financing retrenchment was set up in Sudan, Mali. Reduction through attrition, early retirement and other common employment reduction measures can also be used to ease the transition. Basic welfare concerns and the need to deflect possible labour unrest call for the establishment of a support system for displaced workers and public officials. In some instances, governments are considered applying proceeds of privatization to retraining. Other measures include :

—special payments to employees retiring voluntarily or laid off.

—Adjustments to pension benefits.

—Obtaining a commitment by the private purchaser to maintain employment.

Only partial solutions have been found to the very difficult problem of redeployment of redundant staff. Several privatizations have been handled without specific arrangements. Dissolved SOEs have simply laid-off all personnel, with legally required serverance pay, leaving it up to a reconstituted new enterprise (acquiring the asset of the former) to re-employ all or part of the work force. Job retaining can offset some of the dislocation of labor reductions, but the experience with these programs is inconclusive. The more effective approach appears to be direct incentives to existing and potential employers in the private sector and the provision of adequate redundancy settlements directly to employees. The employee then has a safety net while attempting to find another job of even to start a small business. An information network and access to counseling for

laid-off employees are also vital. The parallel development of business advisory services and credit facilities linked to enterprise restructuring[14] or privatization programs have potential to enhance the mobility of laid-off employees. Recent initiatives in developing countries like the Bureau d'Assistance a la Reconversion d'Agents de la Fonction Publique in Guinea, are commendable.

It is obvious that, while purchaser may be willing to try to lessen the employment effects of privatization, they generally want to reduce purchase price as the quid pro quo. However, to the extent that a purchaser's proposed handling of the employment problems helps solve certain critical issues, the foregone proceeds may be sound investment by the government. Greater reliance on the purchaser and/or privatized SOE to help solve the employment difficulties can be envisaged. Incentives (tax or otherwise) to the SOE to absorb part of the cost might be appropriate.

Changes in labour legislation or 'exist' policies and compensation to workers only of cosmetic value in bringing about industrial restructuring and labour adjustment. At the national level what the country needs are policies towards literacy, education, training and retraining of the workforce and making the workforce and managements accountable for their preformance.[15]

VI. COSTS OF PRIVATIZATION

It is advisable for governments to carefully estimate the costs of different scenarios before deciding what course of action to follow. There further ought to be an effort at reporting a posteriori the actual costs of individual transactions.

— The various costs of privatization are :

- Transaction Costs.
- Residual Costs.

Transaction Costs

It is the cost of the measures necessary to carry out a privatization transactions.

The cost of a privatization transaction involves one or more of possible expenditures,[16] such as administrative costs, financial restructuring, physical rehabilitation and settlement of employment claims. The administrative costs include essentially advisory services, but may include underwriting and brokerage commissions in public offerings and even brokerage commissions in private sales. In the Philippines, commission will be paid to brokers who bring in winning bidders (and even other bidders under certain conditions). The financial restructuring costs may include the settlement or assumption of loan and other liabilities, or the conversion of government-held loans into equity and the recapitalization of SOEs prior to sale. In some instances, SOEs have significant tax arrears that the government may forego as part of the privatization transaction. Physical rehabilitation might be a cost, but generally the government would

leave this to the purchaser. Interim physical maintenance, on the other hand, is often a cost to the government. The settlement of employment claims may involve severance pay, pension plan funding and possible retraining. The need to grant a discount in public offerings must be regarded as a transaction-cost in terms of foregone proceeds. The granting of payment terms at other than market interest rates also is a cost of concluding a transaction.

Residual Costs

Various countries experiences show that results range from enormous capital gain to the state, to enormous residual liabilities on the state budget after privatization.

Two further observations need to be made. One relates to the major difference between the sale of shares (where the purchaser acquires assets and liabilities) and a sale of assets (where the purchaser generally does not take over the liabilities). In the latter instance, the purchaser price may or may not cover the liabilities, and the state may or may not restire the liablities from the proceeds of the sale. The second relates to the residual costs of privatization (such as continuing liabilities). A large residual does not necessarily mean that a transaction is not financially beneficial because it may still be less costly to sell the SOE than to retain it. It may, however, create substantial problems in that the budgetary cost must then be recognized.

VII. RESOURCE MOBILIZATION FINANCING PRIVATIZATION

There are techniques which have the potential to increase the flow of private resources into privatization. As stated in the Philippines' Operating Guidelines for the Asset Privatization Trust :

"In developing the disposition strategy for each asset, due consideration will be given to the availment of public securities markets, employees stock ownership plans, debt/equity swap plans and other possible sources of capital."

Capacity to Mobilize Private Resources/Domestic Financial Markets[17]

The applicability of the method of privatization is determined by the level of development and of liquidity of domestic financial markets, and especially equity markets.

Development here refers to the extent to which there is access to the general investing public or other investors for privatization purposes, which in turn depends on the availability of intermediation for share distribution, other financial services, the sophistication of potential investors, and the liquidity of the investing market. A public offering is difficult in the absence of an organized capital market or when there is a lack of local financial intermediation. Nevertheless, measures have been used that compensate for the weakness of capital markets.

In an example of the NCB privatization in Jamaica, the government launched an elaborate information campaign about the public share offer, including the distribution of 200,000 copies (for a country of 2 billion inhabitants) of a question and answer sheet that described in basic terms the nature of shareholding and the stock market. A distribution mechanism was developed ad hoc which may be, relatively speaking, the most concentrated network ever assembled for a share issue.[18] In the end, the offering was oversubscribed 2.7 times : "The offer has shown that liquidity is there under people's mattresses."[19] A further public offering of an SOE in Jamaica, namely, the Caribbean Cement Company, also drew a large response, even though it was not fully subscribed. The sale of minority holdings in TELETAS in Turkey which drew a response by the public much larger than expected was also accompanied by response by the public much larger than expected was also accompanied by creative and massive distribution and publicity efforts to compensate for the weakness of the capital market. That lesson was repeated in Kenya, when Barclay's bank (not an SOE and reportedly a sound and profitable private firm) issued new stock to the public. The issue was seven times oversubscribed, subscribers included many first time rural Kenyan purchasers. Ultimately, the shares had to be distributed on a lottery basis. Whether public offerings are possible in other countries lacking organized financial markets (e.g., most of the Sub-Saharan African except Kenya, Zimbabwe, Nigeria and Cote d' Ivoire) remains to be determined. However, in totally undeveloped or embryonic capital markets, they will often, but by no means always, be investors with specific business interests in the field of activity of the SOE to be privatized. As pointed out by Waters:[20] there is no point in complaining that organized local financial markets do not exist in many of the less developed nations. The process of raising funds for privatization can be the vehicle for recognizing the existence of unofficial financial markets, and an incentive to permit the emergence of official ones. It provides an opportunity to create the missing organized financial structures."

An analysis of Asian Stock markets[21] concludes that the Philippines, India, Pakistan and Sri Lanka would need more developed stock markets to facilitate the divestment of SOEs, and it explains that in Bangladesh the sale of enterprises to the private sector helped in the growth of the stock market.

Where funds cannot be raised as readily, creative approaches to increase investor interest in SOEs to be privatized must still be explored.

One additional constraint on privatization in developing countries is that the lack of a secondary stock market renders investment in shares very illiquid.

Payment Terms

Payment terms may be based on standard policies, but often also are the result of ad hoc considerations. Extreme caution must however be exercised when selling shares on an installment basis.

Installment arrangements are described in detail in the offering prospectus of several United Kingdoms SOES, such as British Telecom and British Gas. Payments for British Gas are to be made in three installment Senegal's Law on Privatization specially requires payment in full upon sale unless a special exception is granted by Decree. Security should be taken (it can take the form of bank guarantees, pledges of shares or mortgages). Bangladesh has experienced the danger of unsecured financing and the resulting lack of resources in dealing with defaults. The machinery adopted for installment sale of shares in U.K. provides that shares so sold will be registered in the name of and retained by a custodian bank until fully paid for.

The Brazilian Privatization texts simply provide that alternative forms of financing may be studied. Purchases of shares in French privatizations have been on a cash basis.

The governments of Bangladesh, Canada (and the provinces of Quebec and Ontario), Chile, the United Kingdom, and Togo have all effected sales of state holdings by agreeing to payment over time. Experiences elsewhere have indeed shown that, in case of default, pledged shares may lead to the undesirable result that the privatised SOE then may revert to government ownership. Bank guarantees have been sought by other countries in the sale of SOEs, including Costa Rica and Columbia.

Debt-Equity Swaps

Debt equity swap techniques have been developed by a number of major debtor countries.[22] Basic techniques and their applications, benefits and possible drawbacks, in various countries are described in the literature on the subject. Debt equity swap schemes are in operation in Argentina, Brazil, Chile, Mexico, the Philippines and several other countries. Debt equity swaps are generally designed as debt relief mechanisms. But even though this is not their main purpose, they may facilitate privatization transactions and, in that sense, are a relevant method of financing private investment in SOEs.

Detailed rules or provisions govern the transactions.[23] Those of Chile, Mexico and the Philippines specify the eligible debt, the conversion procedures and eligible investments.

Funds obtained through a swap may under certain regulations cover only a portion of the cost of a given investment.

The rules also specify priority uses (e.g., in Mexico, the highest priorities

and therefore the highest redemption prices go to buyers of privatized state-owned enterprises). Other countries (e.g., Argentina) have restricted the applications to new investment, thus not permitting debt equity swaps to finance acquistions of existing state participations in SOEs.

Not much detailed information is available on debt equity swaps resulting in the acquisition of equity in SOEs, and perhaps only a very few instances have occurred. Three privatizations in Chile (Chiliquinta, Soquimich and Chilgner) were carried out through debt equity swaps under which American creditor banks of Chile acquired part of the participations offered. The increase in the return on marginal investments realized with debt equity swaps may constitute an incentive for investors with regard to privatization.

Recommendations have been formulated to encourage employee buy outs of SOEs, along the lines of U.S. type Employee Stock Ownership Plans (ESOPs), through the application of debt equity swaps. What is essentially being proposed is that equity in SOEs acquired by creditor banks be sold back to an ESOP on a leveraged basis. These conceptually very productive proposals should indeed be carefully examined as part of various possible financial instruments to finance leveraged employees buy-outs or to finance acquisitions of stock of SOEs by other acceptable purchasers.

Other Measures

Other measures to increase the flow of private resources for purposes of privatization would include, inter alia, the following :

1. Tax incentives especially directed at privatization programs. Senegal's law authorizing selected privatizations specifically requires the Commission on Divestment to assess and purpose any special incentives, namely tax incentives, to accompany any privatization. The granting of tax advantages obviously must be assessed very carefully as they in themselves may constitute a substantial budgetary cost and defeat policy objectives.
2. Assistance provided by development organizations. The World Bank, the International Finance Corporation (IFC), the African Development Bank, the Asian Development Bank, and several bilateral development agencies, including USAID with the assistance of the Center for Privatization, have provided direct or indirect assistance in the restructuring and privatization of SOEs.

Once the implementation issues have been analysed and evaluated, the next stage would be to formulate an explicit strategy for the development of privatization, identifying the criteria of choice, setting priorities, drawing up a programme and a timetable.

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