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Working Paper No. 11

# Reforming State-Owned Enterprises: Lessons of International Experience, Especially for the Least Developed Countries

## SME TECHNICAL WORKING PAPERS SERIES

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**Working Paper No. 11**

**Reforming State-Owned Enterprises:
Lessons of International Experience,
Especially for the Least Developed Countries**

# Reforming State-Owned Enterprises:

## Lessons of International Experience, especially for the Least Developed Countries

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Small and Medium Enterprises Branch
Programme Development and Technical Cooperation Division

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# EXECUTIVE SUMMARY

There are 49 countries in the world classified as Least Developed Countries (LDCs). The vast majority of these are located in Africa and Asia, and they are characterized by their extremely low incomes, limited human resource capacities, and economic vulnerability. The central problem for LDCs is the depth and breadth of poverty that exists. Extreme poverty prevents economic development because so little savings remain for the public and private investments that economic growth requires. In this situation, anything that increases the availability of funds for private and public investment is significant. One potentially important source of increased funding for such investments in LDCs are reduced public subsidies to, and increased revenues from, sales of State-owned Enterprises (SOEs).

LDCs have been quite active in privatization, though the SOEs privatised tend to be quite small. LDCs have also tended to exclude the larger, more important SOEs from privatization, thus keeping revenue from privatization at modest levels. Despite the active privatization programmes, therefore, a majority of the public enterprises in most LDCs in Africa have not been privatised, and an even higher percentage of the utilities and other large enterprises are still in state hands.

Since so many, and so many important, enterprises in LDCs, continue to be state-owned, and often heavily subsidized, it is clear that reforming these enterprises continues to be a critical problem, especially given the low human resource and institutional capabilities that define LDCs.

UNIDO has addressed SOE reform issues since its inception, through both technical cooperation and global forum activities. The purpose of this present report is to give officials in developing countries, especially in LDCs, basic information on, and a context for deciding among, the options that are likely to be available to them in dealing with their SOEs. A particular focus of the report is on bringing to the attention of these officials current thinking and "best practices" in the field of enterprise reform. Many countries have had sizeable SOE sectors and virtually all have been forced to implement SOE reform programmes of various types, generally with relatively little success, although there have been notable exceptions. In recent years, however, there has been a host of new experiences, especially with privatization, and studies that have advanced our understanding of what works and why. This experience has almost always been in countries that face far less difficult circumstances than those in LDCs. Nonetheless, much of this experience is relevant to LDCs, even if its application needs to be done with considerable thought to the particular constraints and features of each LDC.

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It is important to keep the SOE reform programme in perspective. The most important driver for private sector development is competitive markets and building a conducive enabling environment. Privatization and SOE reform can play a role in this process but will probably be secondary to other reform activities. The government likely has few administrative and financial resources available to solve innumerable critical problems facing the country. The overall capabilities of the government to undertake a serious privatization and enterprise restructuring programme must be evaluated in terms of these resource constraints and competing priorities. Other countries have made serious mistakes by forcing sales or undertaking expensive restructuring programmes before the country had the conditions, resources, and human skills to do the job properly.

This is not to say that a careful privatization programme or enterprise reform programme should not be done. It is to say, however, that caution should be exercised, given the severe resource constraints that LDCs face, that quality should probably be more important than speed, and that expensive restructuring, in particular, should be avoided. Given limited resources, a pragmatic approach to selecting activities should be taken. Privatization of smaller enterprises operating in competitive markets is almost always possible; small investments for working capital, raw materials, and the like may be cost-effective in some cases, and very large SOE privatizations and restructurings may be warranted, with donor financing and technical assistance. Illustrative options for such an approach are contained in the final chapter of the Report.

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# CHAPTER I:

# Context

## A. Introduction

### 1. Least Developed Countries (LDCs) and Privatization

The central problem for the 49 countries classified as LDCs is the depth and breadth of poverty that exists. In 1999, per capita GDP for all LDCs was $288, compared to $1,326 for the average developing country, and $26,692 for developed market countries.[1] The number of people living in extreme poverty is increasing, with about 50% of the population in LDCs living on less than $1 per day and 80% living on less than $2 per day.[2] And, the situation is not getting better: while per capita GDP for developing countries has increased between 1980 and 1999 by almost 50%, and by 44% for developed countries, LDCs show an increase of only 1%.[3] As a result, income levels between LDCs and the rest of the world are diverging and the income gap is now "wide and glaring."[4]

Widespread, extreme poverty has effects beyond the obvious ones on the poor. LDCs lack the resources to finance the private investments and public goods that are needed for economic growth. In part, this is due to declining ODA and other financial flows, low commodity prices, high debt burdens, diseases, and other reasons, but much of the problem is just the high levels of poverty and the low levels of GDP: little income remains beyond that required for immediate consumption.

The lack of funds for public investment explains why LDCs have poor human resource capacities and are constrained in developing strong institutions, which are increasingly recognized as key to not only privatization, but to economic development, generally:

[1] The Least Developed Countries Report 2002, Escaping the Poverty Trap," Statistical Annex, p. 247. UNCTAD, 2002.
[2] "The Least Developed Countries Report 2002. Overview." p. 8. UNCTAD, 2002.
[3] Op. cit, p. 247.
[4] "Developing Industry: productivity enhancement for social advance," p. 10. UNIDO's Corporate Strategy, 2003.

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> "To ensure long-term, sustained growth it is essential that high-quality institutions be developed. It is the admixture of rules, norms and enforcement characteristics and the interaction that these produce among the economic agents, markets and institutions that ultimately determines economic performance."[5]

Lack of funding for private investments also contributes to the marginalization of LDCs: they cannot take advantage of liberalized trade opportunities if they have no capital or supply capacities to develop, produce, and sell products that those markets want.

LDCs have made serious attempts at economic reform. Most LDCs, for instance, have undertaken structural adjustment programmes that led to some improvements in the macro-economic environment, though these have had little effect on economic growth.

> "For their part, most LDCs have pursued economic reform programmes set out in the previous Programmes of Action, including eliminating or substantially reducing tariffs and other trade barriers, liberalizing currency regimes, privatizing public enterprises, establishing and strengthening institutional and regulatory frameworks and adopting liberal investment policies. The results have been below expectations.[6]"

To overcome this "poverty trap" LDCs require strong economic growth, which in turn depends on their generating the resources to fund both private and public investments. Financing for private firms is necessary to develop the capacities needed to produce and sell products in domestic and export markets. Financing is also needed for public services, such as education and health, that will provide the skilled workers and managers that the economy requires, and for public institutions, such as an impartial and predictable legal system, to provide the governance that a dynamic economy requires.

To increase the pool of financing that is available, debt forgiveness is important, as is increased FDI, but higher domestic savings will also be required. One way to increase domestic financing for these important investments is by more efficiently using government resources. This includes improved public administration, more efficient collection of government taxes and fees, reduction or elimination of subsidies, and sales of public assets. The latter two have been major objectives of various public enterprise reform and privatization programmes among LDCs.

Privatization programmes among LDCs have been mainstays of their economic reform efforts. While little information is available about the LDC privatization programmes, as a group, inferences can be drawn by looking at the evidence from sub-Saharan African privatization[7] since, as shown in the table on page 8, almost 80% (29 of 37) of the African countries that have privatized at least one state-owned enterprise (SOE) are LDCs. 1,660 LDC privatizations in Africa account for approximately 75% of total African privatizations, although they account for less than 30% of the sales value of African privatizations.

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[5] "Developing Industry: productivity enhancement for social advance, p. 13. UNIDO's Corporate Strategy

[6] "Programme of Action for the Least Developed Countries for the Decade 2001-2010", United Nations General Assembly, A/CONF.191/11, 8 June 2001.

[7] Privatization here is defined more broadly than just divestiture, and includes liquidation, restitution, and privatization of management. In Chapter II of this paper, however, privatization is more narrowly defined.

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Calculations based on the information in this table show that:

- the average African LDC (29 reporting) has privatised 57 SOEs, slightly less than the 68 privatizations in the average non-LDC African country (9 reporting).
- the average African LDC (22 reporting) has privatised about 43% of its total SOEs, slightly more than the 36% share for the average non-LDC African country (7 reporting).
- the average LDC in Africa (24 reporting) has generated $109 million in revenue through privatizations, a total of $2.6 billion for African LDCs; non-LDC countries average (8 reporting) a much higher $812 million revenue, for a total of $6.5 billion in revenue.
- the average sales value per privatization in African LDCs was about $1.5 million, and for non-LDC countries, $10.6 million per privatization.

So, while many LDCs have been quite active in privatization, a majority of SOEs in many LDCs in Africa remain state-owned. In addition, most of the privatization has occurred with the smaller enterprises, and relatively few utilities or other large SOEs have been privatized. Nellis says that "...commitment to privatization as the best way to solve SOE problems has been neither widespread nor strong. Most African leaders and officials would prefer that the SOE problem be addressed by means other than ownership change."[8] In Zambia, a country with an enviable record in privatization, there is even sentiment among the public and some officials to reverse privatization already completed.

With a pressing need for additional funds, a large source of funds potentially available for public investment from SOEs, and increasing resistance to privatization, it is clear that reforming enterprises will continue to be both important and very difficult, particularly given the low human resource and institutional capabilities that define LDCs.

## 2. Purpose of the Report

SOE reform is an issue that UNIDO has addressed since its inception. Initially, technical cooperation in this area was concentrated on improving the operations of industrial sectors and subsectors, in which SOEs often predominated, and of individual SOEs or factories. While there were successes, improvements tended to be short-lived. Eventually, UNIDO's focus for enterprise reform shifted to privatization and to enterprise restructuring support for primarily privatized (or privatizing) firms and subsectors. In the late 1990's, the privatization work was discontinued, but projects in enterprise restructuring and *mise á niveau* remain an integral part of UNIDO's work.

[8] Nellis, John, "Privatization in Africa: What has happened? What is to be done?" p. 6, February, 2003, Center for Global Development.

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**Table 1** **Privatization record in Africa 1991-2001**[9]

| Country | Number of transactions | Sale Value (US$ mn) | Share of total SOEs divested |
|---|---|---|---|
| Angola | 57 | 6 | ... |
| Benin | 28 | 49 | 38% |
| Burkina Faso | 23 | 9 | 32% |
| Burundi | 38 | 4 | ... |
| Cameroon | 48 | 244 | 28% |
| Cape Verde | 42 | 53 | ... |
| Central African Republic | 18 | ... | 50% |
| Chad | 35 | 12 | ... |
| Congo (Brazzaville) | 65 | 50 | ... |
| Congo (Kinshasa) | 5 | ... | 4% |
| Cote D'Ivoire | 82 | 622 | 55% |
| Etiopía | 10 | 410 | 6% |
| Gabon | 1 | ... | 6% |
| Gambia | 17 | 2.4 | 85% |
| Ghana | 181 | 936.5 | 69% |
| Guinea | 31 | 45 | 27% |
| Guinea Bissau | 25 | 0.5 | 64% |
| Kenya | 189 | 381 | 79% |
| Lesotho | 10 | 6.5 | 20% |
| Madagascar | 61 | 16.9 | 33% |
| Malawi | 11 | 53.2 | 44% |
| Mali | 59 | 67.4 | 92% |
| Mauritania | 19 | 1.2 | 20% |
| Mozambique | 474 | 135 | 39% |
| Niger | 10 | 1.8 | 18% |
| Nigeria | 30 | 893.5 | 6% |
| Rwanda | 1 | ... | 3% |
| Sao Tome & Principe | 4 | 0.4 | ... |
| Senegal | 39 | 415 | 23% |
| Sierra Leone | 8 | 1.6 | 31% |
| South Africa | 8 | 3151 | ... |
| Sudan | 32 | ... | ... |
| Tanzania | 199 | 287 | 53% |
| Togo | 49 | 38 | 89% |
| Uganda | 102 | 174 | 79% |
| Zambia | 253 | 828 | 90% |
| Zimbabwe | 6 | 217 | 10% |
| **Total** | **2270** | **9111.9** | **Average: 40%** |

Sources: This table is based on a compilation and updating of the data bases conducted by Thierry Buchs, IFC, 2002. They are drawn from World Bank Africa Region Privatization Database, World Bank, 2002; WDI database 1991-2000; IMF Staff Country Reports, 1998-2002; and Table 1, CAMPBELL WHITE & BHATIA [1998], Appendix A.

[9] Nellis, John, "Privatization in Africa: What has happened? What is to be done?" p. 8, February, 2003, Center for Global Development

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This report is an overview of the options available to countries, especially LDCs, in reforming their SOEs. Why is such a report necessary after decades of reform efforts? First, as noted in the previous section, despite the massive privatization effort of the last twenty years, there are many enterprises that remain in government hands, often operating inefficiently, sometimes at great cost to the national treasury. Much remains to be done to improve public enterprises. Second, current thinking about enterprise reform evolves over time, as experience is gained or situations change. Disseminating these changes to policy-makers is important. Third, although developing countries have often invested considerable time and effort in building their capacity to undertake enterprise reform, there can be considerable turnover in the staff of the ministries and agencies dealing with enterprise reform. Occasional updates of the options available and lessons learned can provide useful guidance for new management of these institutions.

The report is intended to give officials responsible for the State-Owned Enterprise (SOE) sector in LDCs basic information on, and a context for deciding among, the options that are likely to be available to them. The report is not designed to provide an exhaustive discussion of enterprise reform, but to describe what the options are, what lessons have been learned about their use, internationally, and the critical issues involved.

The report provides a broad overview of the options available, but also attempts to provide more emphasis on those options and issues that are likely to be most relevant to the situation faced by LDCs. Where possible, conclusions are drawn or options highlighted that are likely to be relevant to LDCs but, of course, these are not intended to be recommendations for application without regard to the specific circumstances in a country.

A particular focus is on bringing to the attention of officials current thinking and "best practices" in the field of enterprise reform. As will be noted later, reform efforts for the SOE sector have been attempted for decades and, until very recently, with relatively little success. In recent years, however, there has been a host of new experiences, especially with privatization, and studies that have advanced understanding of what works and why. This experience has been gained primarily in countries that face far less difficult circumstances than those in LDCs. Nonetheless, much of this experience can be relevant to LDCs, even if its application will need to be done with considerable thought to the particular constraints and features of the each country's situation.

The remainder of this chapter begins with a description of the role and performance of state-owned enterprises. This will be followed by a discussion of the objectives of, an overview of the options for, and a description of the decision-making process involved in, SOE reform. Subsequent chapters discuss in detail the main options for SOE reform including the various forms of privatization (Chapter Two), enterprise reforms that do not involve ownership changes (Chapter Three), and mixed public/private approaches to SOE reform (Chapter Four). The final chapter draws some general conclusions for SOE reform in developing countries, and especially for LDCs.

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## B. Role and Performance of the State-Owned Enterprise Sector

In recent years, state-owned enterprises in virtually every country in the world have come to be seen as problems to be fixed, which is ironic since SOEs had earlier been seen as solutions: when private companies lacked the funds to invest in capital-intensive projects, the government stepped in; when industrial development was proceeding too slowly or in the wrong direction, the government took control of key industries; when private firms were about to fail, the government took them over, in order to preserve employment or for some other public purpose. In these, and other instances, governments nationalized or created enterprises that were expected to do what private firms could or would not do.

The increased reliance on the public sector to produce goods and services was part of an overall trend towards government management and control of economic activities that took hold in the years after World War II. Although economic efficiency was a major objective in public enterprise development, there were commonly many objectives, explicit or implicit, that were to be achieved with this approach. In some countries, this had a strong political dimension: for post-colonial countries, it was a way of expressing nationalism and independence from former colonial masters. In others, there were social, cultural, or equity objectives that could be achieved, such as providing more services to different groups within society. Often, however, it was purely an economic decision: state intervention was seen as a means to insure that savings and investment were channeled to strategic industries that would lead the countries to the strong growth and increased employment that reliance on the private sector had failed to deliver. Whatever the rationale, many different objectives were pursued with SOEs, including:[10]

- Building a country's infrastructure
- Contributing to production and achievement of self-sufficiency in basic goods and services
- Promoting employment
- Reducing mass poverty
- Enhancing national economic development and sovereignty
- Generating surpluses for capital accumulation
- Being economically efficient and financially profitable
- Contributing to government revenues

There were good reasons to expect that reliance on state ownership and control of industrial activity would increase economic growth. Various types of market failures existed, especially in developing countries, that resulted in too few entrepreneurs, inadequate investment due to scarcity of capital and high risk aversion, and poorly developed or monopolistic markets. In principle, these are obstacles that can be overcome by having the state intervene to mobilize investment and direct it into strategic projects or sectors. For countries pondering ways to increase efficiency and economic growth, however, the arguments were not merely theoretical. In the 1950's to 1980's, when most SOEs in developing countries were created or acquired, the experiences of

[10] UNIDO, Industry and Development, Global Report, 1992/93 p. 201.

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the period seemed to confirm the value of increased state intervention: there were many examples of well-run public enterprises throughout the world and there were many apparently positive experiences with state-directed economic growth, both in socialist countries and in capitalist countries, for developing countries to emulate. As a result, many developing countries adopted a strategy of promoting industrialization through the public sector, often at the urging of donors and multilateral institutions.

Unfortunately, the experience of developing countries with the public enterprise sector has been a mixed one. It is certainly true that for many countries - India, Turkey, and Egypt, for instance - state-owned enterprises have been important vehicles for economic development. State-led industrial development did lead to strong growth in many developing countries, in the 1950's and 1960's, and not just in those countries that leaned towards socialism. The Republic of Korea, for instance, has been decidedly capitalist, yet during its initial rapid growth phase from 1960 to 1985, the SOE sector grew twice as fast as the economy as a whole (from about six percent of GDP to about ten per cent, the latter figure being about the same as in India).

However, economic growth could not be sustained over the long-term, and those countries that have relied most extensively on SOEs have generally not seen strong growth rates in the last twenty years and, in fact, have felt it necessary to adopt a more market-oriented approach. China, for example, has experienced the fastest GDP growth of any country in the world in the last 15 years, but as a result of private sector activity, not from its SOEs. The resulting growth of the private sector to about 60 percent of GDP in 2000[11] came however, not primarily from privatization, but from rapid private growth coupled with public sector decline.

Studies of SOEs in developing countries have generally shown their economic and financial performance to be poor. That is, SOEs often incurred sizeable losses, and even when profitable, their rates of return were usually low. The evidence is less clear when assessing the performance of SOEs in achieving their non-economic objectives. What is clear, however, is that the poor financial performance of SOEs caused major fiscal problems for many countries (see Figure One-1 on the following page). Although SOEs were often expected to be a source of revenue for the government, many became instead significant drains on the public treasury. By the mid-1970's, SOE deficits in developing countries averaged almost 4% of GDP.[12] Eventually, governments no longer could afford to continue subsidizing SOEs, which led to enterprise reform efforts, including privatization.

Why have SOEs, which seemed to hold much promise, failed to perform as expected? The reasons are many: Interference by politicians; conflicting objectives, especially to create jobs (which also made it difficult to measure the performance of SOE managers), inability or unwillingness of the government to provide capital for productivity

[11] Including formally registered private businesses, small individual businesses, shareholding companies, foreign firms, private township and village enterprises, and private agricultural entities. Asian Development Bank, Asian Development Outlook 2002 (Manila 2002).
[12] Paul Cook and Colin Kirkpatrick, "Privatization in Less Developed Countries: An Overview", in *Privatization in Less Developed Countries* (New York, St. Martin's Press, 1988), p.14.

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**Figure One-1** **Financial performance of public enterprises in developing countries: Summary of selected empirical studies**[13]

| Region or country | | Summary of findings |
|---|---|---|
| West Africa | (1) | Of the public enterprises in a sample drawn from 12 West African countries, 62 per cent showed net losses, while 36 per cent had negative net worth. |
| North and sub-Saharan Africa | (2) | A survey of 48 public enterprises in North and sub-Saharan Africa showed that in 1984, only 12 of the firms reported net profit margins in excess of 4 per cent. |
| Ghana | (3) | Altogether, about 43 percent of State-owned enterprises in the economy have been shown to operate at net loss in each year during the period 1979-1983. |
| Republic of Korea | (4) | Although the performance of the government-invested enterprises compared favourably with most other developing countries, their estimated 3.7 per cent rate of return on operating capital in 1982 contrasted with a 10.1 per cent return for the Republic of Korea's industry as a whole. |
| Philippines | (5) | The average rates of return on equity and assets of SOEs have been 2.9 per cent and 3.71 per cent respectively. These rates are about 10 percentage points below the average interest rate and lag behind the average return on equity of the top 1,000 corporations from 1984-1987. |
| Indonesia | (6) | The overall returns on asset employed in SOEs was below 2.5 per cent from 1983-1987, and 3.5 per cent in 1989 – about 70 percent of SOEs do not have a healthy financial standing. |
| Thailand | (7) | In 1989, the SOE sector in Thailand returned pre-tax profits of 45.9 billion bath ($1.8 billion) on 312.5 billion baht of revenues – a respectable 14.7 per cent return. Only five state enterprises (officially there are 63 SOEs) lost money. |
| Trinidad & Tobago | (8) | The non-petroleum enterprises (SOEs) were very large dissavers during the year (1985), with expenditure exceeding their revenue by almost $700 million. |

*Sources:*

1. John R. Nellis, "*Public Enterprises in Sub-Saharan Africa*", Discussion Paper No. 1 (Washington, D.C., World Bank, 1986), p. 17.
2. John Nellis and Sunita Kikeri, "Public enterprise reform: privatization and the World Bank", *World Development*, vol. 17, No. 5 (1989), p. 660.
3. H. Akuoko-Frimpong, "*Rebalancing the Public and Private Sectors in Developing Countries: the Case of Ghana*", Technical Paper No. 14 (Paris, OECD Development Centre, 1990), p. 15.
4. Young C. Park, "Evaluating the performance of Korea's government-invested enterprises", *Finance and Development*, vol. 24, No. 2 (June 1987), p. 25.
5. Zinnia F. Godinez, "Privatization and deregulation in the Philippines: an option package worth pursuing", *ASEAN Economic Bulletin*, vol. 5, No. 3 (March 1989), p. 264.
6. *Towards A Competitive Economy: The Emerging Role of the Private Sector in Indonesia* (Manila, Asian Development Bank, April 1991), p. 31.
7. Paul Handley, "Privatized parts", *Far Eastern Economic Review* (27 June 1991), p. 48
8. Frank Rampersad, "The rationalization of the State Enterprise Sector", Trinidad and Togabo Economics Association, Ninth Annual Conference, Port of Spain, November 1991.

[13] UNIDO, *Industry and Development: Global Report, 1992/93* (Vienna: UNIDO, 1993), p. 202.

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improvements, lack of competition, lack of appropriate management incentives, and others. After countless attempts to improve SOEs in a wide range of countries, a general view has emerged that reforming the SOE sector requires drastic measures: either privatization or changes in corporate governance that separate the firm from the state and allow SOE managers to operate with sufficient clarity of goals to pursue the public rather than their private interest, sufficient autonomy to operate efficiently, and sufficient incentives to do so to the best of their abilities.

## C. Objectives of SOE Reform

At the level of the enterprise, SOE reforms are adopted in order to improve either their efficiency or effectiveness. Of course, these two categories contain a host of specific problems that may be of concern to a government. Inefficiency usually goes hand in hand with unprofitability, which may require large injections of public funds that the country can ill afford, but it may lead to other problems as well. Inefficient SOEs may result in: greater protection for the SOE at the expense of competition, both domestic and foreign; a crowding out of the private sector for financing and other resources; a weakening of the financial sector if unwise credit decisions are made in favour of the SOE sector; and expensive and/or unreliable critical inputs (such as electricity), to name a few.

SOEs were originally established for specific purposes, such as to provide goods or services that would not otherwise be available, or to provide them at lower costs than the private sector. Effectiveness in providing quality products, at reasonable prices, with a customer orientation, however, is rare for many of the same reasons that SOEs are inefficient: they face little competition, have conflicting objectives that make it difficult to measure performance, and often do not receive the financing needed for capital improvements, among others.

In undertaking a reform programme, therefore, it is important to be clear about the specific objectives to be achieved. Different problems may call for different solutions. For instance, some objectives may be achieved through changes in management or in the way government supervises the SOE, but if an objective requires capital investments that the government cannot afford, privatization may be the only solution possible.

There likely will be objectives for reform that are broader than those of efficiency and effectiveness of the enterprises. Governments need to take these into consideration as well. Making an SOE more efficient or more effective may not be enough. A strong private sector operating in competitive markets is the key to economic growth, and SOE reforms should contribute to this competitiveness. That is, governments should remove trade restrictions that protect SOEs, insure that SOEs do not compete unfairly with private firms, and restrict SOEs' access to public funds when they operate in competitive markets. In short, governments should view SOE reform in a broader context of private sector development rather than just making the enterprises more efficient and effective.

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## D. Overview of SOE Reform Options

Governments can take many actions to address the problems of SOEs, including:

- An SOE can be sold to private owners (**privatization**).
- The external environment can be changed to provide stronger incentives for the SOE to be efficient (**reforms external to the SOE**).
- The way the government supervises the SOE can be improved (**corporate governance reforms**)
- Changes can be made to the SOE's structure, organization, or operations (**restructuring**)
- Some aspects of privatization can be introduced without changing SOE ownership (**privatization of management**).
- SOEs can also be closed with their assets sold or transferred to other uses (**liquidation**).

These options are not mutually exclusive; they can be used in combination. For example, a large SOE might have one factory liquidated and its assets sold, another factory privatized, a third factory leased out to private operators, and the rest of the operations restructured, with new management hired and a new government body overseeing the governance of the SOE.

LDC officials responsible for improving SOE operations will eventually have to make decisions among the various options. Following is one suggestion for how this decision-making process can be organized logically into a decision tree, the first few branches of which are displayed in Figure One-2. The real world is of course far more complex than this simple linear model would suggest, but it does provide a useful way of organizing the process. The first few decisions are:

- **Who Should Decide**? While major decisions are ultimately the responsibility of the most senior government officials, who should be responsible for the day-to-day decisions: a single SOE authority, or multiple bodies at each relevant Ministry or province? Choosing the right people is the most important determinant of right decisions.

- **Liquidate or Operate**? Liquidation means to sell off the assets piece-meal, with no intention of maintaining an ongoing operating concern. Although SOEs will usually be sold as ongoing concerns, if that is possible, they may be so physically dilapidated or have such poor prospects for profitability that liquidation makes the most economic sense.

- **Public or Private Ownership**? If the decision is to operate, as it presumably will be for the majority of the SOEs, should it be under public, private or mixed (public and private) ownership? This is likely to be one of the most important and controversial choices.

- **Public or Private Management**? If the decision is public or mixed ownership, a related question is who should control the enterprise, where

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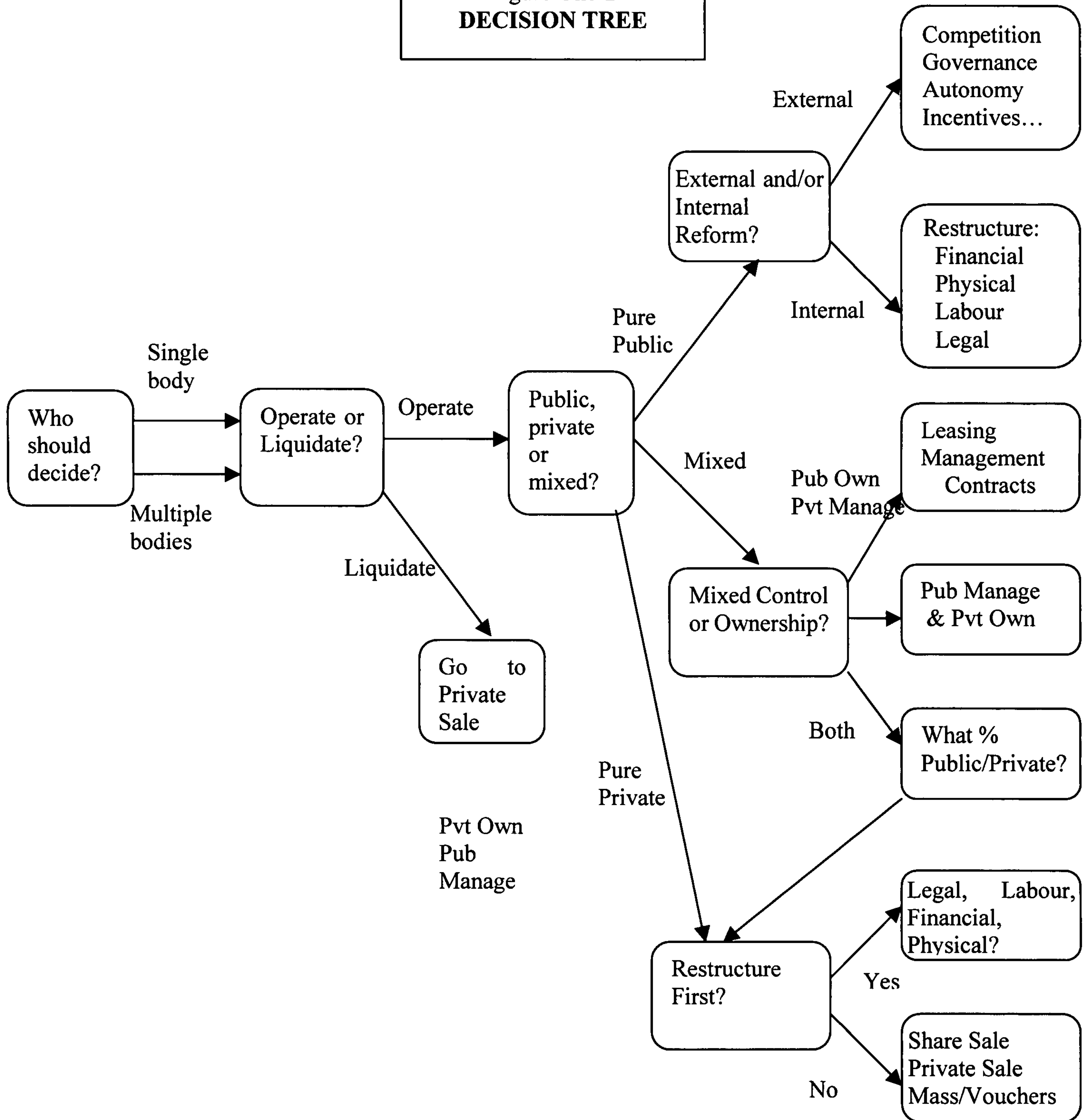
Figure One-2
**DECISION TREE**

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control is most easily thought of as the power to appoint top management. This is obviously important in the case of mixed enterprises (public or private majority?), but even 100% government owned enterprises can be managed privately via leasing (private firm operates, pays the government a specified fee, and keeps any profit/loss) or management contracts (private individuals operate the firm, are paid a specified fee, and the government keeps any profit/loss).[14]

- **External and/or Internal Reform**? If the decision is public management, then should the enterprise be restructured internally (physical, financial, legal or labour)? Or, should the external governance rules and procedures by which the government manages the firm be reformed? In the vast majority of cases, both will presumably be required.

- **Restructuring or Sale "as is"**? If the enterprise is to be privatized, should it be restructured first, or sold as it is? Corporatization (converting from an enterprise operating under state law or a special law to one operating under private corporate law) is a necessary precondition to sale. Cleaning up the balance sheet and dealing with labour issues are often useful. Physical restructuring must pass the test of whether or not the money put into the effort exceeds the resulting increase in the sale price.

These are only a few of the decisions that this paper addresses but they illustrate the approach. More detailed discussion of the options and the process of choosing among them is provided in Chapter Two, for privatization of ownership, Chapter Three, for reform measures under continued public ownership, and in Chapter Four, which addresses the mixed option of public ownership with private management, a possibility that might be the "least-bad" solution for some enterprises, such as utilities, in many LDCs.

The goal is to assist in immediate decision-making. Therefore, more attention will be devoted to issues and options that seem likely to be important over the first few years of the reform process, and considerably less attention to those that are further away. As one example, in many countries a major privatization option is an initial public offering on the stock exchange and a non-targeted survey would give considerable attention to it. Given the state of the legal and financial institutions in most LDC's, however, this option seems likely to be used only rarely, so it is mentioned in this paper only in passing. On the other hand, management contracts may prove to be more useful in some LDCs than elsewhere, and so warrant more attention in this paper than in a more balanced survey.

## E. Pre-Conditions for Reform

Before proceeding to examine the specific reform options in detail, it is worth asking whether the preconditions are in place for any serious reform at all. This is not a

[14] There is ambiguity in the distinction between management and performance contracts. Here, we use the former only in the sense defined in the text above. We use performance contracts as an option under public ownership and control, whereby the government signs an agreement with enterprise management specifying targets whose achievement is associated with incentives.

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rhetorical question. It is worth quoting the World Bank at length: "Failed reforms can be very costly. Money spent to restructure state-owned enterprises and pay off their bad debts (is) wasted if the enterprises fail to improve or, having been privatized, collapse back into the government's arms. More difficult to quantify, but no less important, are the costs in wasted human and political capital. Policymakers who spend months or years designing SOE reform programs when the prerequisites for success are lacking could devote their scarce skills to other issues where success is more likely. Similarly, developing-country leaders and donors who push SOE reforms with a very scant or nonexistent chance of success draw down their political capital without achieving any significant returns."[15]

The point is that privatization and extensive restructuring are administratively difficult and often expensive. Mistakes can be made by trying to rush the process that are costly and that jeopardize the possibility of reforms later on. If this is the case, then efforts should be concentrated on other types of reform, which in addition to being necessary in any event also lay the groundwork for eventual SOE reform. These include improvements to the business environment (macroeconomic reforms, trade liberalization, legal and banking sector reforms, etc.) and to competition policy reforms.

Under what conditions are extensive privatization and restructuring programmes likely to be successful? The World Bank report identifies three:

- "Reform must be politically desirable to the leadership and its constituencies; the political benefits must outweigh the political costs....
- Reform must be politically feasible. Leaders must have the means to enact reforms and overcome opposition, either by compensating the losers, thus winning their support, or by compelling them to comply despite their losses.
- Promises central to state-owned enterprise reform must be credible. Investors must believe that the government will not renationalize privatized firms; SOE employees and others who fear that they may lose out in reform must believe that the government will deliver on any promises of future compensation."[16]

To these political preconditions might be added the administrative precondition that institutions are capable of implementing any selected reforms or privatization.

[15] Mary Shirley and others, *Bureaucrats in Business (*Washington DC: Oxford University Press for the World Bank 1995), Summary, pp. 41-42.
[16] Ibid, p. 33.

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# CHAPTER II:

# Privatization

## A. The Rationale for Privatization

Privatization is used here only in the narrow sense of divestiture, i.e. the transfer of ownership of an SOE or its assets to private owners. Privatization is sometimes used more broadly to include other public/private combinations of ownership and management. In this wider sense it is being used for all types of enterprises in all types of sectors and almost all activities, even many that were once considered to be public responsibilities. In the United States, for instance, private firms now operate prisons and public schools, with government retaining ownership of the assets but privatizing management. These other options are covered in Chapter Four, whereas in this chapter, only divestiture is discussed. Privatization in this narrower sense is particularly relevant when a firm operates in, or could operate in, a competitive market and when the public-purpose justification for an SOE is weak.

Privatization can accomplish a number of objectives; it is not merely a means for governments to get rid of their SOEs, though this is a legitimate objective. Privatization can improve the competitiveness of the firm by bringing in investors with money, technology, and managerial skills that are now lacking. And, by making that firm more efficient, the competitiveness of the entire market and sector that it operates in may in turn become more efficient. Privatization can also contribute to the development of the country's capital markets, especially where privatization takes place through public offerings.

## B. Methods of Privatization

Privatization can take many forms. The most common method is a **direct sale** to private investors. Such sales can be made by public tender or through negotiation with one or a few potential investors. **Public tenders** are the preferred way to divest SOEs because they are transparent and are least likely to result in perceptions of corruption or unfairness that can undermine support for the overall reform programme. Public tenders, if they are widely advertised and properly administered so as to attract many bidders, are

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also likely to generate the highest revenue for the government. **Negotiated sales** are useful when there are few potential buyers or when the SOE's success will depend on having a particular type of buyer. For instance, an SOE may require technological upgrading to survive, and a negotiated sale might be necessary to identify and attract a buyer willing and able to provide this upgrading.

Most privatizations in LDCs are likely to be direct sales, and both public tenders and negotiated sales are possible, though tenders are generally to be preferred.

Privatization also can take the form of a **public offering**, where an SOE is turned into a public joint stock company and its shares sold to the public. Public offerings have several advantages. They may raise more funds by selling shares to many persons than could be raised from one investor or group of investors. They spread ownership of the shares among the public and may, therefore, raise support for the overall privatization or reform programme. They facilitate additional financing by the enterprise since the public offering may create a secondary market for the company's shares. They contribute to the development of the country's financial markets. And, public offerings are the most transparent of all privatization methods.

The drawbacks to public offerings are their cost and complexity, and the fact that they usually require the existence of substantial capital markets infrastructure. Because there can be drastic financial and social costs if the pricing of the shares is too high or too low, valuation of the shares has to be determined carefully. The public offering has to be professionally structured and widely publicized to address both economic and public policy concerns. For instance, will any limitations be placed on foreign ownership of the shares? How will shareholder rights be protected? All this suggests that public offerings are best for large, valuable firms being sold in countries with stock exchanges, legal and regulatory frameworks, and financial market institutions. This is not to say that LDCs might not be able to use public offerings in exceptional cases, especially when a functioning stock exchange exists. There are examples of offerings being made in the absence of a highly developed stock market:

> "...governments committed to reform have found alternative ways to sell PEs [public enterprises] to domestic wealthholders. For example, Turkey used bank branches as a substitute for brokerages in the 1988 divestiture of the Bosphorus Bridge and the Keban Dam, which were heavily oversubscribed and sold to a total of 15,000 domestic investors", "the Chilean privatizations since 1985 have involved the sale of stock to institutional investors and employees equal in value to nearly 10 percent of the domestic stock market capitalization", and in "Senegal, the government was even able to sell a small share offering by newspaper."[17]

And, even in Sub-saharan Africa, privatization via public offerings have taken place. 69 of 2,270 privatizations (which include liquidations, restitutions, and privatization of

[17]Asli Demirgüc-Kunt and Ross Levine, "The Financial System and Public Enterprise Reform: Concepts and Cases" Policy Research Working Paper, World Bank,July, 1994, p. 30-31, citing Gavin, Michael (1993), "Financial Market Development and Strategies for Public Enterprise Reform", manuscript, Columbia University.

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management) or 3% of the total, were done via this method.[18]

An important issue for privatization, especially when the method is via a public offering, is the **presence of a strategic investor** or group of investors. To really improve an enterprise, and to make sure that it is managed in the interests of the owners, there needs to be one or a group of investors who are willing to spend their time and money to closely monitor operations and the performance of the management. If no one person or group owns a large enough percentage of the shares, then this monitoring will not be adequate, since no one will own enough shares to be interested in this effort. Why should someone with 2% ownership waste time making improvements that the other shareholders will get 98% of the benefit from? It should also be noted that a strategic investor willing to exercise control of the company is also likely to be one that can bring in industry knowledge, managerial skills, capital, and technology that are important to upgrade the competitiveness of the firm.

As a result, public offerings should take into consideration **the need for concentrated shareholdings**. One way of doing this is to have a direct sale of a block of stock to an investor or investors who will exercise strategic control of the firm, with the balance of the shares sold in the public offering.

Public offerings are likely to be important options only for the largest, more well-known SOEs (such as the national airlines or utilities) and even then, it would be important to insure the existence of a strategic owner to exercise governance and bring in resources to upgrade the competitiveness of the firm.

A third method of privatization is **the management-employee buyout** (MEBO). Although there are many examples of large firms around the world that are owned by their employees, MEBOs are most useful in privatization for selling smaller firms, firms in which labour productivity is particularly important (and therefore may improve with the incentive of ownership), and companies where other buyers are not likely. Often, employees decide to purchase a business to protect their jobs.

There are several drawbacks to MEBOs. Often SOEs were inefficient to begin with, so privatizing them but keeping the same management and workers may bring little change. It certainly will not bring the capital, technology, and managerial skills that would be expected from a strategic investor. There may be incentives, as well, for employees to reap immediate benefits from stripping assets or increasing wages rather than from waiting for the benefits that may or may not come from increased profitability, especially if the price paid by the workers was low. And employees and workers may lack the skills and financing required to arrange the privatization, in which case the government may have to step in to guide them in the privatization process, in structuring the MEBO, and in helping them to raise the financing. One area in which they do have an advantage, however, is in their knowledge of the potential for the firm. Management, in particular, knows much better than government what the SOE's potential is, and therefore will have an information advantage in negotiations over the value of the firm.

[18] Nellis, John, "Privatization in Africa: What has happened? What is to be done?" p. 21, February, 2003, Center for Global Development.

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Although tenders and negotiated sales should be preferred, where other options are not feasible, MEBOs may have a role to play. In addition, sale of shares to employees, at favorable prices, can be a good strategy where they will not have control of the firm. That is, a firm could be sold to a strategic investor, with 10% or 20% held for sale to workers to provide them with an incentive for greater productivity.

Another method of privatization is **mass privatization**. This is a term that encompasses a variety of specific schemes designed to sell or give SOEs to the general public, using some form of **vouchers**. Mass privatization is primarily of interest to countries in the transition to a market economy, especially countries that want to get SOEs out of the hands of the government as quickly as possible. Experience has shown that it is possible to privatize large numbers of enterprises this way, but the results, at least in terms of the performance of privatized firms, has not been promising. Mass privatization is likely to be of relatively little interest to LDCs.

## C. Impact of Privatization: The Evidence

Should SOEs be kept in the public sector or transferred to private ownership? The primary argument for private operation is efficiency. A primary argument for state control is equity, broadly defined. How should LDCs assess these competing arguments? A starting point is to look at the evidence from international experience.

A consensus on the need for privatization has emerged that is driven largely by observations of the problems of SOEs, and not by much empirical evidence that private enterprises were any better. This may seem surprising at first, but is easily explained by the types of enterprises found in the SOE sector. In any country a particular industry was usually either entirely public or entirely private, so it was difficult to make fair comparisons. You cannot compare, say, Coca Cola and Electricite de France and easily assess their relative efficiencies because the technology is different, and, perhaps more importantly, their markets are different. The price and other aspects of utilities are almost universally regulated by governments, so profit comparisons are meaningless. Though studies were done, they were not sufficiently convincing to rule out the hypothesis that the real evil was not government ownership, but monopoly. That is, both public and regulated private monopolies are inefficient, and it is difficult to generalize as to which is worse, except in particular national and industry contexts.

This difficulty was substantially alleviated by the privatizations of the last twenty years. For the first time, you could compare the same enterprise in the same industry in the same country, before and after privatization. Technical problems of adjusting for changing economic circumstances had to be dealt with, but were largely manageable. Many studies of privatized firms followed, and their results can be easily summarized, because they are almost unanimous. An exhaustive survey published in the American Economic Association's prestigious *Journal of Economic Literature* concluded that:

> "We know that privatization 'works' in the sense that divested firms almost always become more efficient, profitable, and financially healthier, and increase their capital investment spending. These results hold for both transition and non-transition economies, though the results

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vary more in the transition economies."[19]

Does this mean that LDCs should simply privatize as much as possible, as fast as possible? Alas, it is not that simple, for two sets of reasons. First, conditions on the ground in a country may make that difficult and/or undesirable, a possibility that will be discussed later. The second reason has to do with distributional equity.

The non-ideological argument for SOEs has always been based primarily on the fear that private enterprises in the pursuit of profit would exploit both consumers, through high prices, and workers, through low wages and poor working conditions. This fear is obviously much greater in non-competitive markets; hence the prevalence of SOEs in such markets. What has the privatization experience revealed about the reality of such fears?

The equity results are much less clear than the efficiency results. In part this is because the issue is harder to study and much less work has been done. However, the results are clearly mixed. Beginning with the more positive results, in one of the more careful and systematic studies, case studies were conducted of twelve enterprises in Chile, Malaysia, Mexico and the United Kingdom.[20] One feature of this study was that it included only middle-income countries (above $2,000 GDP per capita) so results of a more recent study of Cote d'Ivoire (five case studies plus projections to the entire sector) will be included here.[21] Positive efficiency gains were registered in all but one case, but the study went on to identify beneficiaries of those gains. Who won and who lost among the government, the buyer, consumers, workers, etc? Results are summarized in Figure Two-1 (overleaf). Note the following:

- Negative numbers mean the group lost, positive numbers mean they won, and zero means they broke even.[22] There are far more positive than negative results, meaning that most groups did better.

- Despite the fears of many, workers generally benefited from privatization and in none of the cases lost as a group (though, of course, some individual workers were much worse off, having lost their jobs).[23] At first blush, this is

[19] William L Megginson and Jeffry M Netter, "From State to Market: A Survey of Empirical Studies on Privatization" (*Journal of Economic Literature*, June 2001, pp321-389).
[20] Ahmed, Galal, Leroy Jones, Pankaj Tandon and Ingo Vogelsang. *Welfare Consequences of Selling Public Enterprises: An Empirical Analysis.* New York: Oxford University Press, 1994. The following two sections draw on this volume without further attribution.
[21] Leroy Jones, Yahya Jammal and Nilgun Gogkur. Impact of Privatization in Cote d'Ivoire. Washington, DC: Boston Institute for Developing Economies, January 1999.
[22] To allow cross-country comparisons, results are presented relative to sales in the year prior to divestiture. So as to compare flows to flows, the numerator is the annual component of an annuity yielding the same NPV as that calculated for each company. That is, a value of .10 in the Figure means that net benefits were equivalent to ten percent of pre-divestiture sales, received annually for a period of, typically, 15 years.
[23] A good review of the various effects of privatization, including on labour, is contained in Nancy Birdsall and John Nellis, *Winners and Losers: Assessing the distributional impact of privatization*, Working Paper Number 6, Center for Global Development, May 2002. While acknowledging that a "surprising number" of privatizations do not result in layoffs, they conclude that the available evidence shows that "...in the short run at least, the direct effect of SOE reform and privatization on employment is negative" (p. 53).

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Figure Two – 1

# WINNERS AND LOSERS FROM DIVESTITURE

(ACPE %)

| Country/Company | Government | Buyers | Consumers | Workers | Others | Sub-tot | Foreign | Total |
|---|---|---|---|---|---|---|---|---|
| **Chile** | | | | | | | | |
| CHILGENER (Electricity distrib.) | -1.4 | 2 | 0 | 0.1 | 0 | 0.7 | 1.4 | 2.1 |
| ENERSIS (Electricity distrib.) | -1.6 | 7.6 | 2.2 | 3.9 | -7.4 | 4.6 | 0.6 | 5.2 |
| Telecom | 8 | 1 | 131 | 1 | 4 | 145 | 10 | 155 |
| **Malaysia** | | | | | | | | |
| Malaysian Airline System | 5.2 | 2 | -2.9 | 0.4 | 0 | 4.6 | 17.4 | 22.1 |
| Kelang Container Terminal | 37.6 | 11.5 | 6.2 | 7 | -11.9 | 50.4 | 3 | 53.4 |
| Sports Toto Malaysia (lottery) | 13.6 | 10.7 | 0 | 0 | -13 | 10.9 | 0 | 10.9 |
| **Mexico** | | | | | | | | |
| Telefonos de México | 13.3 | 11.4 | -62 | 15.6 | 28.3 | 6.6 | 43 | 49.5 |
| Aeromexico | 62.3 | 3.9 | -14.6 | 2.4 | -2.3 | 52.9 | -4.6 | 48.5 |
| Mexicana de Aviación | 3.5 | -1.4 | -7.7 | 0 | 3.2 | -2.4 | -4.6 | -7 |
| **Ivory Coast** | | | | | | | | |
| Rubber | 15.2 | 6 | 0 | 2 | 2.4 | 25.7 | 26.1 | 51.7 |
| Rubber | 32.5 | 57.8 | 0 | 0.2 | 1.1 | 91.6 | 0.8 | 92.4 |
| Palm Oil | 37 | 35.1 | 0 | 2 | -8.2 | 66 | 3.6 | 69.5 |
| Electricity | 0.3 | 1.6 | 1.6 | 1.3 | -0.4 | 4.4 | 3.5 | 7.9 |
| Telecom | 5 | 0 | 5 | 1.1 | -0.4 | 10.6 | 6.5 | 17.1 |
| Other Agro-Industries | 12.9 | 30.2 | 0 | 1.4 | -5.5 | 39 | 12 | 51 |
| Other Infrastructure | 6.1 | 16.2 | 5 | 1 | -0.4 | 27.9 | 1.7 | 29.6 |
| Other Tradables | 0.1 | 10.1 | 0 | 0.1 | -1.7 | 8.7 | 8.2 | 16.9 |
| Other Non-Tradables | 3.3 | 12 | 5 | 0.5 | -1.7 | 19.1 | 9.9 | 29.1 |
| Weighted average | 3.7 | 13.8 | 1.2 | 0.7 | -2.3 | 17.1 | 8.3 | 25.4 |
| **UK** | | | | | | | | |
| British Telecom | 2.7 | 3.1 | 4.9 | 0.2 | -0.1 | 10.8 | 1.2 | 12 |
| British Airways | 0.9 | 1.4 | -0.9 | 0.3 | 0 | 1.7 | -0.1 | 1.6 |
| National Freight | -0.2 | 0.8 | 0 | 3.7 | 0 | 4.3 | 0 | 4.3 |

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surprising, but it reflects two sets of realities. First, if you were a union leader, would you rather bargain with a firm that is in the black or in the red? The answer is obvious: profitable, efficient firms can usually afford to pay better wages than unprofitable ones. After privatization, wages generally rose and the resulting welfare gains among those that kept their jobs more than compensated for the losses of those who became unemployed. Second, successful, sustainable privatization programs must maintain a dominant political coalition in favor of privatization and to this end it is desirable that workers as a class not be overly inconvenienced. Accordingly, restrictions are commonly placed on post-privatization redundancies. This is not an efficient thing to do but may be necessary to maintain support for reform by earning workers' support through giving them a share of the net benefits which would otherwise accrue to the buyer, seller or consumer.

- The other group that is typically expected to lose from privatization is consumers. The fear is that the buyers will exploit a monopoly position and raise prices. As can be seen, this generally did not happen in these cases, largely because these countries also established an adequate regulatory regime for setting prices after privatization. The major exception is Mexican Telecom, where consumers lost heavily. This was, however, not due to raising prices above the efficient level, but to raising them to an approximation of an efficient level; previously, telephone prices had been heavily subsidized and among the lowest in the world. Consumers were, nonetheless, worse off.

A third critical category is foreigners, most commonly in their role as purchasers of the enterprises, but also in some cases as consumers. This group needs to be treated fairly but it is not the government's objective to obtain benefits for them. The question is, what is "reasonable"? There can be no definitive answer to this question, but it is quite possible that privatizations where 44 percent of the benefits go to foreigners--as in Mexican Telecom--may cause resentment and political problems for the government. On the other hand, when foreigners get less than 15 percent--as in 17 of the 20 observations--this would seem politically defensible in most countries.

There are many other interesting stories and lessons in these data, but this should suffice to make the major point: privatization can be managed so as to benefit consumers and workers and not just foreign buyers. This is not to say that this positive result is assured. The sample is biased because only companies and countries that think they did a good job agreed to be studied. Nonetheless, the critical lesson remains, that done right, privatization **can** promote both efficiency and equity.

## D. Post-Privatization Problems

Despite the evidence that privatization is a good tool for SOE reform, there are numerous cases where positive results did not occur. Because of data access problems, there are

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not many serious studies, but the available evidence in less developed and transitional countries reveals three major classes of apparent inequities.

- It is widely alleged that enterprises were sold cheaply to politically connected insiders, so they and their patrons benefited at the public's expense. This was most broadly true in Russia, but allegations of this sort are widespread around the world.

- Post-privatization price increases are a common phenomenon, especially in utilities, so the government seller and the private buyer benefit at the expense of existing consumers. Often, other consumers benefit, however, from improved service.

- Workers often lose their jobs. Given the widespread overstaffing in SOEs it is perhaps surprising that this is not more common.

In developed countries there have also been problems, primarily involving ex-post regulation of monopolies. In one, privatization of the electricity industry was badly bungled because foolish and incompatible wholesale and retail price rules were adopted in the regulatory mechanism. The result was blackouts, threats of bankruptcy, a huge political crisis and terrible publicity for privatization. In the UK, Railtrack, which owns and maintains the rail network (but not the trains themselves), was forced into bankruptcy and essentially renationalized, due to a host of problems with service quality stemming from imperfect regulatory incentives to the different parts of the industry. A prerequisite for successful privatization of utilities requires that a sophisticated regulatory mechanism be designed. Some countries have succeeded (especially Chile), but others have failed, to the detriment of consumers.

In both developed and developing countries, anecdotal information on problems resulting from privatization suggest the following. First, it is possible for privatization to reduce welfare globally, especially when the privatized firms are monopolies. Second, this potential is not confined to monopoly output markets, but also can occur when there are imperfections in input markets (capital and labour) or, most importantly, in the market for discretionarily granted government privileges (tariffs, quotas, licensing of competitors, access to under-priced credit, etc.), a condition prevalent in developing and transitional economies. Third, allegations of problems, even if unproven or untrue, lend powerful support to opponents of privatization.

The importance of these problems was measured in 17 countries in Latin America, where citizens were asked if they agreed with the statement: "The privatization of state companies has been beneficial". In 1998 43% disagreed; in 2000, 57% disagreed; in 2001, 63% disagreed.[24] Disenchantment with privatization on equity grounds is by no means confined to the public. Although harder to document, it is probably safe to say that international organizations such as the World Bank have moved from all-out advocacy in the 1990's to a more balanced and nuanced approach today.

[24] *The Economist* (July 28, 2001, p 38).

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## E. Relevance to LDCs

How would these pros and cons balance out for an LDC? A host of local circumstances affect this, but two would seem to be particularly important.

- Given the economic and investment environment, including the undeveloped institutional arrangements in LDCs, investors will be considerably more reluctant to buy SOEs in LDCs than elsewhere. This is certainly true of foreigners, while also domestic entrepreneurs are likely to be fully occupied exploiting short-term profit opportunities and perhaps not too interested in investment in fixed assets with at best medium-term profit potential.

- Government resources are scarce. This is obviously true in terms of money, but perhaps even more importantly, in terms of administrative manpower. Managing and financing SOEs usually consumes a lot of government resources, even if they are operating well. Privatization, on the other hand, generates resources.

These factors have implications for policy, because they apply with different force to two sets of enterprises. One set includes enterprises that operate in competitive markets, mostly small in scale and producing tradable goods; the other set is enterprises in non-competitive markets such as electricity, telecom, and the airline. The former are considerably more appropriate for privatization than the latter (for simplicity, the two sets will henceforth be referred to as "small" and "large", though the key factor is competition, not size).

It is far easier to find a buyer for small enterprises because capital needs are less. It is far easier to organize a sale of a small enterprise because the deal is less complex and because it is not necessary to set up a complex regulatory structure ahead of time. If they are kept state-owned, the best that can be hoped for is that they would be as good as private enterprises. With larger enterprises such as the utilities, however, it is possible that an imperfectly regulated private company might be worse than a state-owned one. Therefore greater care needs to be exercised in privatizing such firms, and this in turn means that they are likely to be privatized, if at all, later in the process.

This is not a recommendation that the small enterprises be privatized and the large enterprises not be privatized. It is only a suggestion to prioritize and start with those that are both easier to sell and unlikely to cause problems if it is done badly. If that goes well, then with that experience in hand, the country could move on to the more difficult cases.

## F. Privatization Issues

Whether privatizing competitive or non-competitive firms, most of the questions are the same, though the answers may be different. To avoid repetition, the major cross-cutting issues are summarized and then discussed in relation to the two sets of firms, as well as to issues specific to only one set (such as regulation).

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### 1. Who should decide?

Before continuing with the decisions themselves, it needs to be decided who should make the decisions. Who should decide what, when and how to sell? Two broad patterns have been adopted internationally. In the first, each parent ministry, local government, or other tutelary body organizes the sale of the enterprises for which it is responsible, typically under some general privatization law. In the second, a small, specialized privatization body handles all sales. Often it is staffed by independent, non-bureaucrats from the private sector and overseen by a Board of Directors including responsible Ministers.

While experience varies with the two models, sale is considerably quicker and cleaner with the second model. Under the first, interested bureaucrats organizing the sale are the very people who do not want to sell, because they fear a loss of power. In LDCs, there may be a further reason. Finding and training a limited number of qualified individuals for one small body is far easier than doing so for a dozen such bodies in different ministries. Further, one would expect foreign donors to be more eager to fund both the body and technical assistance under the second model. While this makes sense on technical grounds, politics may intervene. Are the interests and power of the respective Ministries such that they both want to block, and can block, the creation of such an independent body?

Once responsibility has been assigned, an obvious early step should be an inventory of all relevant firms/assets. Then a strategy needs to be defined and agreed to and enterprises prioritized for privatization or reform within that context. Doing this has consumed a year or two in many countries. The alternative is a rolling action plan, in which decisions are taken now on the basis of available knowledge, and updated as more information becomes available. For example, one could start with the competitive/non-competitive distinction suggested above and identify a few priority candidates for immediate action in each area.

### 2. Political Will and Sustainability

The economics of privatization are simple relative to the politics. It is often said that one key to a successful program is "political will". This means that the government must have both the desire to privatize (and otherwise reform) SOEs and it must have the ability (the resources and the political support to overcome opposition to reform). Is there official support for privatization in the country? Is it effective support? Are there other political voices (be they workers, opposition politicians or bureaucrats) that might oppose the implementation of the strategy? The answers to these, and related, questions will certainly determine the pace at which privatization can proceed.

It is critical to design a programme so that it is sustainable, that is, so that whatever political support there is grows rather than withers away. An all too common story runs as follows: a program is announced with great fanfare, but then a few transactions are completed in a way that is seen by many to be unfair, which then contributes to rising political opposition and a hiatus in sales lasting for many years. In the early and mid 1980's Turkey, for example, was lauded as an early model by many in international

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development organizations: the government announced a grand plan that had political commitment and a well-designed program, but by the end of the decade, not much had happened. They sold a bridge[25], a plant manufacturing telephone equipment; several cement companies (later abrogated on appeal) and not much else. Many countries have made similar mistakes, and LDCs planning to privatize should learn from their experiences.

International experience is quite clear on this point. Three factors are paramount:

- Transparency: To avoid charges of giving away the national patrimony to well-connected individuals, it is absolutely essential that the process and results of any deal are publicly available.

- Equity: anyone who is harmed by privatization will oppose future privatizations. Further, people who oppose it on other grounds will use the plight of the losers to further their own agenda. Given the overstaffing in SOEs, this is a common result. As shown earlier, it need not be. The efficiency gains from privatization are usually more than sufficient that some of those gains can be shared with workers in the form of severance payments and, sometimes, preferential access to minority ownership rights.

- Service Quality: In Cote d'Ivoire, one of the earliest privatizations was of the electricity corporation. This happened shortly after a series of brownouts and blackouts in the capital. Within a year of privatization, reliable electricity service was restored and, ten years later, most people interviewed cited this change as the most critical factor behind their support of privatization. The fact that this change was due to technical factors rather than to new ownership and investment is irrelevant. What matters is that, partly as a result of this improvement in service, the country has had the support needed to sustain one of the largest and most successful privatization programs in Africa.

### 3. Selecting Enterprises

Which enterprises should go first? Since you cannot do everything at once, the government must decide where to start. Even in Germany, with all its resources, the respected Treuhandanstalt privatization agency typically offered groups of only 30-40 enterprises at a time. There are two broad options: the government can decide what it wants to sell or the private sector can propose what it wants to buy. The former is by far the most common. A mixed strategy is also possible; in Poland, for instance, the government had its list, but also welcomed expressions of interest from the private sector. Proposals were evaluated and, if appropriate, were added to the current list. Note that the enterprises were not necessarily sold to the proposer; they were merely added to the list quickly and made available to any interested bidder. This mixed strategy may be appropriate in an LDC, especially since one of the scarcer commodities in the country will be information, and asking the private sector what they are interested in might well be a useful tactic for obtaining valuable information about potential buyers and the

[25]An important bridge to be sure: the one connecting Asia and Europe across the Bosphorous.

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prospects for particular SOEs.

What types of activities should go on the government's list first? Here, international experience varies considerably. Some countries sell the small firms first, on the grounds that you should start with what is easy, learn-by-doing and then progress to the harder ones. Others start with the big companies, say the electricity company, arguing that only something dramatic will make a political statement of commitment and bring in enough money to have a significant impact on the budget. Some start with the profitable enterprises, because it is more likely that there will be many potential buyers. And still others start with the unprofitable enterprises, because there is less likely to be many potential opponents to their privatization. For most LDCs, it may be best to start with enterprises that are selling in competitive markets as the most important criteria for initial privatization, but only a rigorous assessment of the pros and cons of privatization, in light of the specific conditions in each country, can answer this question.

### 4. Speed versus Quality

In making many decisions, the government will have to make a trade-off between speed and quality; that is, between selling quickly and selling the right thing to the right buyer at the right price in a transparent manner. Given the immense uncertainty in the country and the lack of administrative capacity, this trade-off is likely to be particularly large in LDCs.

Exactly how this trade-off is made will have to be decided based on local conditions. However, international experience is clear on one thing: you cannot compromise on transparency. If selling tomorrow means a sale negotiated with a single individual behind closed doors, with no public disclosure, it should not be done. If it means going to the trouble and expense of getting twenty equally informed and independent bidders into the process, with the sale announced widely and the results published, then do it. Other trade-offs are considerably less important. Will the government extract the "best" price? So long as the price is politically acceptable to the public, it doesn't matter too much (see valuation section below), and some discount may be an appropriate price to pay for the information about market demand that the government gains in the process.

### 5. Basic Modality

At the beginning of this chapter, several categories of privatization methods were listed. An early decision is to choose one of three broad modalities:

- **Sale as a publicly listed company on a stock exchange**, with a large number of shareholders (though a small number may hold a controlling interest).

- **Sale as a privately held company** with a comparatively small number of owners.

- **Mass or voucher privatization**: pioneered in British Columbia and widely adopted in Eastern Europe and the successor states to the Soviet Union, this in principle allocates initial ownership rights to all citizens.

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There is much to be said for, and against, each of these models. The advantage of the voucher privatization is that it is widely perceived as fair (in principle) and so helps generate political support for the program. The problem is implementation. Variants of this model worked reasonably well in British Colombia and in some eastern European countries. Elsewhere, especially in Russia, weak legal and administrative institutions led to a widespread view that only the criminals and insiders benefited. If institutions are similarly weak in LDCs and they likely are, then this is a serious drawback. Other circumstances in an LDC might also argue against it. Is the total value of what is to be privatized sufficient to warrant the administrative cost of setting up a mechanism to distribute rights to everyone in the country? Even if it were, is the average citizen sufficiently sophisticated financially to appreciate and utilize those rights?

The advantages of the first (publicly listed) model over the second (private unlisted) model are that the former spreads benefits more widely and helps develop the financial markets. These advantages were seen as quite important in the pioneering UK privatizations of the early 1980s. One problem is the high fixed transaction costs of organizing and administering an initial public offering. These were only a few percent of the sale price of British Telecom and British Airways, but are their firms in the country large enough to warrant the cost? Are the institutions in place to make the public offering appropriate for investors, and is financial sophistication sufficiently widespread that shares would be taken up widely enough to achieve the distributional goals? Is development of the financial markets a high priority?

Depending on the answers to these questions, it may well be that, at least for the first few years of any privatization programme, the most feasible modality in an LDC is sale as a private unlisted company, with public offerings being used in very rare circumstances.

### 6. Selecting Buyers

a) Are There any Buyers?

This subsection is about choosing the best buyer, but a major concern is whether or not there will be any potential buyers, given conditions in many LDCs. The security situation is obviously paramount, and an unsafe environment will likely prevent major investments that require long payback periods. For potential foreign investors there are additional considerations. Is foreign investment to be actively welcomed, and if so, is the policy, legal and regulatory framework adequate to assure foreigners they will be treated equally and that their rights will be protected? If they are not, this will make it especially hard to privatize the larger enterprises. What is the attitude towards investment by expatriate countrymen? This is obviously a potential source of much investment for the country, but much may depend on the attitude of the populace towards returning countrymen. In Vietnam, for instance, though there was resentment from the populace, expatriate Vietnamese investors are now playing a useful role in developing the country.

Private investment likely will be available for short-term trading, service, wholesale, transport, construction and other activities that take relatively little investment or that provide returns on the investments quickly, but longer-term investment is likely to occur,

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for the time being, primarily with donor or government funding or support. For SOEs, then, it will be important to consider which have the best chances of attracting buyers. Industrial SOEs, for instance, that have established markets and which can be made operational without much physical rehabilitation may not be difficult to sell, especially since many may be closed or operating at low capacity only because of a lack of raw materials, working capital, or inexpensive equipment or parts.

Even other SOEs, that on the face may seem difficult to sell, may be privatized through aggressive pricing, sales promotion, and consideration of all the privatization options. Even SOEs that have suffered heavy damage might be saleable if the price is low enough. The more the uncertainty, the less a buyer will pay; or, the more uncertain the environment, the higher the expected return has to be. Often, therefore, the real question is not whether a buyer can be found, but whether any buyer is willing to pay a price high enough to be politically acceptable, an issue discussed in the next section. Further, are there enough such buyers to make bidding competitive and thus more easily made transparent?

Getting buyers interested is also a function of sales promotion and other incentives. The more widely publicized the privatization opportunities are, the greater the number of potential bidders there will be. And incentives may be used to increase the likelihood of buyers making bids. In Egypt, for instance, where the Ministry of Public Enterprise has been criticized for the slow pace of its sales, they have resorted to a variety of aggressive measures to find buyers. These include an aggressive advertising campaign, flexibility in negotiating terms of the sale or lease, a tax holiday, and willingness to accept a price less than the valuation (which is often a politically unacceptable procedure even when economically efficient). It should also be borne in mind that managers and workers may also be interested to buy the business, especially if the likelihood of other buyers is small.

One specific issue that deserves consideration is the use of **debt swaps**. Debt swaps enable buyers, who are owed money by or who purchase at a discount the debt of the government, to exchange this debt for equity in an SOE. This has been used to good effect in various countries, including ones in which obtaining foreign investment was particularly difficult, such as Sierra Leone and Sudan, both countries that have experienced long-running economic and civil problems. In Sierra Leone, for instance, the Paramount hotel was sold to a Saudi Arabian company in February, 1996, in a $1.2 million debt swap. In Sudan, five of the first 29 transactions done in the privatization programme were debt swaps. These included four industrial enterprises, such as Gazira Tannery, and the Friendship Palace Hotel.[26] Although there is sometimes a lack of interest on the part of government officials in debt swaps, since no cash proceeds flow in, the Sudanese experience, in particular, shows that they do provide significant benefits, such as increased employment and investment. Depending on the external debt situation of the country, this might be a useful approach for privatization.

So, the assumption should be that buyers will be available, especially for SOEs that can be operated without too much investment in physical rehabilitation, or other assets that

[26] This information is taken from UNIDO privatization project reports, for projects SI/SIL95/801 and BR/SUD/91/001.

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require a long payback period. The government may be able to spur longer-term investment through aggressive sales promotion and through lower prices and various types of incentives.

b) Price versus Investment

Given interested buyers, how do you select one? The obvious starting point is price: give it to the person willing to pay the most. In selling a private asset this is also the ending point, because the private seller does not care about how the asset will be used. A state seller, however, does care about the resulting impact on employment, investment and other downstream economic variables. Accordingly, many sellers, notably Germany's Treuhandanstalt, entertain bid packages and select the one with the best overall business plan from the point of view of the State. This means that the government would select a buyer on the basis of an assessment of what that buyer would contribute in terms of employment, future investment, exports, technology upgrading, or other factors that the government felt would benefit society, rather than just on the price that the buyer would pay to purchase the SOE. The advantage of this approach is that it does potentially increase the benefits of the sale for the people. The disadvantage is that it introduces an element of subjectivity that reduces transparency and can lead to charges of favoritism if institutions are not strong, as well as perhaps reducing the amount of money the government receives for the actual sale of the SOE.

To deal with the problems of subjectivity, many countries require bidders to submit proposals promising to meet certain post-privatization conditions. Most common is a requirement of a minimum investment or its physical equivalent (for example, this many new telephone connections installed within 3 years or that many kilowatts of generating capacity added after two years). From among those willing to meet these conditions, then, the highest bidder is chosen. This proposal is economically sub-optimal (compared to the German method) because it may preclude selection of those who are willing to provide even more investment. But, this may be a reasonable price to pay for transparency and sustainability.

c) Auctions versus Negotiations

Regardless of whether the selection criteria include other variables in addition to price, there is a choice between negotiating with a buyer and running a formal bid/auction procedure (which is also known as a tender) open to everyone who pre-qualifies. There is some disagreement over which approach is best. One primary argument for bid/auction is that competition will yield a higher return to the seller. Opponents respond that this is not necessarily the case once transactions costs are taken into account: first, buyers will be willing to pay more if they do not have to go to the expense of preparing a complex set of bidding documents with a small chance of being the ultimate winner; second the government must deduct from its proceeds the substantial additional administrative costs of organizing a complicated process; and, third, the government loses the interest on the proceeds over the much longer time frame the bidding procedure takes. Those favoring auctions argue that the government is at a comparative disadvantage in the negotiating process. They further argue that auctions are far less open to charges of favoritism. Pro-negotiation people respond that auctions can also be rigged, particularly in the context of a less-developed country. A final

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argument of those favoring negotiations is that this is almost universally how private sector companies are sold, and there must be a good reason why it maximizes return there. This reason has to do with asymmetric information when selling a complex commodity such as a firm.

How will these arguments balance out? There are pros and cons for each, and both may be used depending on the circumstance. In general, however, the simpler the commodity, the greater the advantages of auctions, and so they may be more important in the small-scale, competitive sector.

### 7. Valuation

How should the enterprise be valued for purpose of sale? There is a lot of controversy over this. This may seem strange, given the previous explanation that the value is set by the market, either via bidding or negotiation. The answer is in two parts. The first is that in a stock-market sale, negotiation is never used and bidding is seldom used. Rather, an opening price is set, applications for shares are solicited at that price, and if the offering is oversubscribed, some rationing mechanism is applied. Therefore, in order to know what price to set the shares at, the government needs to have a valuation done. There are various professional techniques for estimating share value, which can be used to set the initial price, but of course how close the valuation actually is to the market price will only be known after the fact: if the stock offering does not sell, then the valuation was too high and if many more people wanted to buy shares than there were shares available, then the valuation was much less than the market value of the shares. The second part of the answer is that in either negotiations or bidding, an intelligent buyer will generally go in with a minimum reservation price. This is true whether an individual is selling a used car or a government is selling an SOE. Below some price, the seller may not sell. A valuation is needed, therefore, to set the minimum price.

How should the government set a reservation price? The starting point is to recognize that the theoretical reservation price is generally negative; that is, if no one will buy the SOE, the government should be willing to pay someone to buy and run the business. This seems absurd, but the reasoning is simple. An SOE should be sold only if the nation is better off as a result (for example, more jobs and investment). If the nation is better off, then the government should be willing to pay for that gain. It is no different from building a bridge or a road; the government should be willing to pay to benefit the people. This is not to say that the government should actually set a negative reservation price. It is to say, that if bids are low, the government should still be willing to make the deal to improve the people's welfare. Alas, that is only the economic logic. Political logic is quite different. If the price is regarded by the public as "too low," then there will be a political cost to the transaction and sustainability of the privatization programme will be in danger.

What makes a price "too low" politically? This depends on the local mood, but all too often, the concept of book value provides a lower limit. Book value has little relevance to the value of a firm in the eyes of either businessmen or economists, but it does to the public. If the economic value of the firm (and therefore the price that can be expected from selling it) is higher than this, then there is no problem, but economic value is often lower than book value for SOEs. Because the book value of assets is based on historical

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costs (what the assets originally cost less depreciation and amortization) and market value is based on future income from their use (what the buyer thinks he can earn if he buys and uses those assets), there is not necessarily any relationship between the two.

Often this problem is worsened by poor choices that the government, as owner, has taken on behalf of an SOE. For example, decisions are often made on political rather than economic grounds, such as buying equipment from particular sources rather than from sources selling the best available equipment, or choosing a particular location or commodity for its employment benefits rather than because of market conditions. In many LDCs, the physical deterioration of, or damage to, assets will make many factories and items of equipment much less valuable than their book value.

For the more valuable SOEs, at least, it might be useful to have an independent body (possibly an international accounting firm) establish an objective minimum reservation price and publicly announce its findings prior to sale. This would have the further advantage of helping to inform potential bidders.

### 8. Labour Issues

a) Guarantees

The importance of protecting all major stakeholders in order to maintain political support for privatization has been stressed previously, and perhaps the most important group in this regard is workers. In some countries, workers' objections have been overcome by post-privatization guarantees. The Malaysian program, for example, includes the following provisions:

- No workers would be laid off for three years after privatization.
- Wages would increase for three years at no less than the rate of increase in SOE sector wages.
- If an individual worker nonetheless did not want to go with the privatized enterprise, he would be given a job in another SOE or the government at his current wage.
- In return, the union would agree that the new owner could change work rules, and reassign labour to new tasks after training.

A package like this is feasible if redundancies are moderate, say less than twenty percent. Natural attrition (death, retirement, marriage, etc) reduces excess labour naturally and expanded production under private operation usually requires more labour. Further, the relaxation of work rules permits greater efficiency and pays for much, if not all, of the guarantee.

Guarantees are also used, however, without obtaining relaxed work rules. In these cases, employment guarantees can be expensive. One study found that the use of employment

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guarantees reduced the privatization price by 16%,[27] so care must be taken to use them only when

b) Shedding Redundant Labour

In many countries, redundancies are much larger, and sometimes all workers lose their jobs; in this case, the foregoing package is not feasible. The severance bonus is typically formulated as a function of the length of employment, say one month of pay for each year worked. Such a scheme is impossibly expensive when, as in the formerly socialist states, you are privatizing three-quarters of the economy, but in more typical cases where you are dealing with five percent of the economy, it can be manageable.

Such a compensation scheme is unnecessary if there is an adequate social safety net in place (unemployment compensation and medical care) and it is sometimes argued that such a net should be developed or enhanced prior to privatization. This can be feasible in middle or upper income countries with, say per capita GDP above $2000, but this is likely to be unrealistic for for many LDCs, at least in the short-term.

An important issue is the timing of labour restructuring. It has generally been accepted that, if laying off large numbers of workers was likely to be required, it was best done prior to privatization, since potential buyers would be hesitant to acquire companies otherwise. The rationale was that labour legislation or practices, labour union strength, or potentially adverse publicity often made it difficult or expensive for private owners to lay off workers. In some instances, this may still apply, but current thinking is that it is best to avoid layoffs prior to privatization, if possible. Why? Because recent research has cast doubt on the wisdom of pre-privatization downsizing. It appears now that such downsizing by government does not lead to higher prices from the buyers.[28] In fact, it appears that such downsizing often lowers privatization prices, as a result of adverse selection. That is, government downsizing often results in the wrong people being separated. So, prior to privatization, thought needs to be given to the factors that are truly likely to affect the number of bidders and the prices they will be willing to pay. If particularly onerous or unpredictable termination requirements justify, it may still make sense for the government to undertake the terminations. Or, if overstaffing is extensive and privatization uncertain or still far off, government may need to undertake pre-privatization downsizing to minimize its operating losses. Otherwise, however, it is probably best to let the new owners determine how to restructure the workforce.

c) Workers as Owners

Should workers be made owners? The answer is in three parts. First, workers and managers can always bid or negotiate for the firm as part of the normal selection process.

A second possibility is that workers be given presumptive right of first refusal to acquire the firm at some discounted rate. The experience of Yugoslavia and of majority worker-

[27] Chong, A., Lopez-de-Silanes, F., "Privatization and Work Force Restructuring around the World,." p. 9. World Bank Policy Research Working Paper 2884, September 2002.
[28] Ibid, p. 14.

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owned firms in mixed economies is not encouraging. The biggest problem is usually lack of investment. Faced with a choice between higher wages on the one hand and retained earnings and investment on the other, worker-owned firms may opt for the former. Banks are accordingly reluctant to lend, and the result is under-investment and stagnancy. Rural cooperatives (for realizing economies of scale in sale of output and purchase of inputs) are often successful and this is sometimes cited as evidence that worker ownership can work. However, this is quite different, because the bulk of the owners earn a living, not from the cooperative, but from their own private farms, and thus have every incentive for the cooperative to be efficient.

The third possibility is that workers be given the right to buy a modest minority (say five to fifteen percent) share in the privatized entity, often with some incentive (interest free loan for deferred payment or discounted purchase price). This is a widespread, but by no means universal, feature of privatization programs, and is sometimes felt to be useful in motivating workers to be more loyal and productive. The drawback is that the majority buyer is usually willing to pay proportionally less for such a firm, because of the potential problems associated with worker representation on the board.

## 9. Pre-Privatization Restructuring

What should be done to the enterprise itself prior to putting it up for sale? The answer varies with the type of restructuring. Labour restructuring was dealt with above.

**Legal restructuring** means converting the company to a limited liability company or whatever other form of organization other private enterprises operate under. This is always necessary.

**Financial restructuring** can take several forms. The most important involves the question of whether the government should take on much or all of the firm's debts, and sell only the assets or, sell "as is". On purely economic grounds this makes little difference. As a first approximation[29], if the firm has $1000 of debt, then the buyer of the firm is willing to pay $1000 less on an "as is" basis as compared to a debt free firm. The government should also be indifferent: in one case it has $1000 in debt but $1000 to pay for it; in the other it has neither. Who cares? There is one reason to care. We pointed out earlier that it is desirable to have a politically acceptable price, and selling the firm debt free accomplishes this, at no cost. That is, selling the firm debt-free increases the price announced publicly as the sale price, and reduces the likelihood of charges of giving away the national patrimony. (This is also another reason that government may want to lay off excess workers prior to privatization, since this would likely increase the price the buyer would be willing to pay).

Another form of financial restructuring is to clean up the balance sheet by writing off obsolete assets, bad receivables and the like. This is useful in so far as it clarifies exactly what it is the buyer is to obtain title to, but otherwise it simply changes the book value. That has no impact on the intelligent buyer, but is again useful in justifying the sale price

[29] The most important second-order effect is interest rates. If the debt on the books is at a concessional rate below what the buyer would otherwise have to pay, then the buyer is willing to pay more. If the rate is higher, then he is willing to pay less.

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to the public. That is, these steps reduce the book value, and thus lower the public's impression of a politically acceptable price, but have no impact on what a buyer is willing to pay.

A related form of financial restructuring involves clearing inter-company payables and receivables. This was a major problem in the former Soviet Union, where companies often bought and sold on credit and no one could pay their debt until others paid them. In mixed economies a similar problem arises when, say the enterprise has been selling to government bodies, which have chosen not to pay. A potential buyer is uncertain as to just what these receivables are worth, and clarifying this is important.

**Physical restructuring** involves investment in the firm prior to sale. The argument is appealing: no one will buy the firm as it is now, or will only pay a very low price, but if we invest in new equipment, we can get a decent return. The counter-argument is illustrated by the following question. If bureaucrats spend $100,000 fixing up an enterprise, will the buyer be willing to increase his bid by more or less than $100,000? The answer depends on whether or not the bureaucrats will spend the money more or less wisely than if the entrepreneur buys the firm and fixes it up himself. If the private sector is really more efficient than the public sector, then the answer is obvious, and the government can only lose by physical restructuring. There is one important exception to this conclusion. If the privatization is not going to take place for a year or two, then any investment will earn a return starting a year or two earlier and may more than make up for imperfect bureaucratic economic management. Given the limited resources, and the physical condition of many SOEs, it would seem prudent to be very cautious in making any major expenditures for pre-privatization restructuring. If at all possible, major expenditures for restructuring should be postponed until they can be made by private owners.

### 10. Golden Shares

It is not uncommon, especially for public offerings in the utility sector, for the government to retain a single "golden share", allowing it to block certain strategic decisions of the privatized entity. For example, these might include changing the line of business, merging with or selling to a foreign firm, or changes in the dominant investor. The advantage of such shares is that it can support the pursuit of the national interest while still allowing sale to private investors. The disadvantage is that it reduces the price the buyers are willing to pay. Early on, there was much controversy over the use of such shares. With hindsight, they don't seem to have made a lot of difference one way or another.

### 11. Restitution

When an SOE was previously in the private sector, but nationalized under conditions other than voluntary sale, then additional complications arise. This is not a particularly rate occurrence. In Africa, for instance, 47 of 2,270 privatizations were done through restitution to former owners.[30] One can presume, as well, that there were others that

[30] Nellis, John, "Privatization in Africa. What has happened? What is to be done?", p. 21. Centre for Global Development, February, 2003.

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might have been returned to former owners but were not. Should the enterprise be restored to the original owner? If not, should compensation be paid? If the answer to either question is yes, then what should be the terms and conditions of said compensation or restitution? Given that nationalization of existing enterprises has occurred in many LDCs, this may be a very relevant issue. If so, then two examples of the difficulties and opportunities may be useful.

When Germany was unified, some 10,000 of the former German Democratic Republic's SOEs had prior ownership claims. One observer claims that: "The establishment of ownership through reinstitution of the previous owner, became the bottleneck of privatization and successful restructuring in East Germany."[31] This may be an overstatement, but all observers agree that it was a substantial problem for the Treuhandanstalt. At the other extreme was one of the world's largest, earliest and most successful privatization programmes in which Pakistan in the early 1980's quickly restored several thousand rice and other small mills to owners from whom they had previously been taken.

Why did prior private ownership create an obstacle in the first case and an opportunity in the second? The answer is simple: the passage of time. In Germany, as throughout Eastern Europe, some 50 years had passed from nationalization until restitution was considered. In Pakistan it was only two years. In Germany, therefore, it was often difficult to establish who the original owner was, due to death, immigration, destroyed records and intermediate sales. In Pakistan, no such difficulties arose; the previous owner was normally well-known to all.

Improvements to the property also raise difficult questions. Prior to the unification of Yemen, South Yemen nationalized, without compensation, agricultural land that was then put into state farms. Later, the state made substantial investments in irrigation facilities, reservoirs, farm buildings, equipment and other assets. Upon restitution, the former, and now again, owners not only refused compensation to the state for improvements, but often took other land that was part of the larger state farm as well as equipment. How the competing claims of various parties are balanced in restitution cases, is a very complex issue.[32]

So, the first question in restitution, and historically the most difficult, is the filing and validation of ownership claims. Once this is accomplished, what is to be done? The simplest alternative is to just give it back, as in Pakistan. It can always be argued that this is unfair: the enterprise has deteriorated, so compensation should be paid to the original owner; or, additional investment has been made, so the owner should pay something. Exactly how this should be sorted out in any particular country will take considerable thought and planning, much of it by legal specialists. However, from an economic point of view, is there not an opportunity here? If some of the SOEs could be quickly restored to previous owners, it would take some problems off the government's hands, and to the extent those owners have emigrated, result in the return of scarce talent

[31] Gabriel Issa, Restitution or Compensation for Expropriated Property? (Paris, The American University of Paris, Thesis, Spring 1995), p 2.

[32] Tissa J.M. Jayasinghe, *Final Project Report: Republic of Yemen: Support to Privatization, UNIDO, 1998.*

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and capital. Also, a policy of restitution is a strong signal that property rights are now to be protected, which should make it easier to privatize SOEs and, generally, to promote investment, including foreign investment.

## G. Competitive versus Non-Competitive Sectors

Most of these issues above apply to competitive and non-competitive sectors alike, but the likely choice varies across these two sectors. In general, the competitive firms will be easier to sell. Because they are smaller, it is more likely that there will be buyers. If there are many interested buyers, it is possible to use competitive bidding, and thus enhance transparency. Because they are smaller, it is easier for the administrators to prepare bidding documents and administer the sale. Most importantly, because they are competitive, it will not be necessary to create a regulatory infrastructure prior to sale.

The latter task has many components, but the most important one is setting the price of the output, to prevent a private monopolist from exploiting consumers. The traditional way of doing this was "cost plus" ("legitimate" costs plus a "reasonable" return on investment). The problem is determining what is "reasonable" and what is "legitimate". The enterprise has far more information than the regulator, far more resources to spend on influencing the process, and every motivation to exaggerate costs and demonstrate the need for a high return, so the outcome is almost universally biased in favor of the enterprise to the disadvantage of the consumer. Further, if costs are passed through to the consumer, what is the incentive to keep costs down? Cost inefficiency is thus prevalent in cost-plus regulated firms, which of course is one of the evils of public operation that one is trying to avoid. In the 1980s, the British developed an alternative, called RPI-x (prices could increase at the Rate of Price Inflation, less an allowance for productivity gains). This has the advantage of leaving any cost saving with the firm and thus provides incentives for cost reductions. The problem is that "x" is periodically adjusted, and when it is the regulator looks at profitability. If the enterprise has cut costs and made money, then the regulator is likely to adjust "x" upward in the next round, thus reducing the price increase and diluting the incentive to cut costs. Another method, used with some success in Chile, is benchmarking, in which a technical committee periodically looks at best-practice around the world, and calculates a fair price if those optimal practices were followed. This, however, is technically quite demanding.

The problem is not that the government will have to make decisions about, say, the price of electricity. This will have to be done whether the electricity firm(s) is/are in public or private hands. The problem is that with privatization, the government will have to commit now to prices (or at least a set of rules for determining prices) in the future. Who would buy an enterprise if the government said: we reserve the right to set whatever price we like in the future? Given that even California and the UK have had trouble doing this right, is it judicious for an LDC government to attempt it?

If the answer to the foregoing question is in the negative, then the implication for privatization policy is clear: Start with the competitive sector. If private sector development is indeed a priority, a start should be made soon, with an announcement of intent. If developing political support and transparency are important, then the start should be small, beginning with the simplest cases before moving on as fast as

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accumulated experience allows.

If this analysis is broadly correct, then at least the most important SOEs (electricity, telecom, etc.) in many LDCS will remain in government hands for some time. How can they be reformed? This is the issue discussed in the next two chapters.

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# CHAPTER III:

## Enterprise Reform

### A. Introduction

In Chapter Two, privatization is presented as one effective option for improving the SOE sector. However, for a variety of reasons, it may not be possible or desirable to privatize SOEs such as when the SOE is a monopoly and the institutional pre-conditions to regulation are not in place, when there are likely to be no buyers for a valuable SOE, or when political considerations preclude privatization.

As noted earlier, governments' experiences with reforming the public sector have not been very positive, which is why privatization became so widespread. Still, when SOEs are not going to be privatized, or when privatization will be postponed for a lengthy period, the government may need to take steps to make the SOE more efficient. This is particularly important if, as experience has shown, it will be difficult to privatize quickly the key electricity, communications, water, transport and similar sectors.

Enterprise reform, without changing ownership, consists of activities that are both external and internal to the SOE. External activities relate to improving the environment in which the SOE operates, e.g. through providing incentives for the SOE to operate efficiently. Internal activities are in two major areas: changing the roles and relationship of the government and the SOE, and undertaking various types of restructuring to improve the strategy, management, labour skills, technology, or other operational elements of the enterprise.

### B. Reforms External to the Enterprise

#### 1. Promoting Competition

**Competition is the most important element in increasing efficiency of state-owned enterprises, and is key to the success of both privatization and of restructuring** that takes place without ownership changes. As noted in the previous section, privatizing firms into competitive markets leads to the greatest benefits, while privatizing firms into non-

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competitive markets is not only more difficult, it is likely to lead to less improvement in efficiency and even, conceivably, to reduced welfare benefits to society. The same is true for firms that are restructured but remain state-owned: the greatest benefits of restructuring occur where firms are forced to compete aggressively.

A lack of competition may be the result of the existence of natural monopolies, of market power obtained from technological, locational, or other advantages, or merely as a result of a paucity of competing firms due to small market size, lack of an entrepreneurial tradition, or high investment requirements. There are also various governmental barriers to market entry, such as expensive and lengthy business registration and reporting procedures and high taxation.

The existing degree of competition has several implications for the reform process. These include:

- The absence of competition is one indication that privatization may not be advisable, and that government-sponsored restructuring may be preferable. If privatization is to take place, it may need to be postponed until measures to deal with the fact that the market is not competitive are taken. This is why utilities are often among the last SOEs to be privatized.

- When competition is absent or weak, government must take steps to insure that the **SOE does not abuse its market power**. If an SOE is operating in a non-competitive market, government must carefully consider its pricing and service policies to insure that these are appropriate and do not harm consumers or distort the incentives of other sectors and companies using these products or services. This points to the importance of reforming SOE monopolies.

- It is especially important to insure that **SOEs do not "crowd out" private sector firms** as a result of privileges resulting from their government ownership or sponsorship. Funds that the government borrows to support SOEs, for instance, are funds that are not available for private sector investment. In many countries, the price and availability of financing for commercial firms has been severely affected by government borrowings for the public enterprise sector. This also points out that one of the priorities for reform should be the financial sector.

- The government should strongly emphasize the development of competitive markets, not only to improve the impact of its privatization and restructuring efforts, but as the central component **for private sector development**. A full range of activities is ultimately required to promote competition: barriers to entry and exit must be removed, unfair trade practices must be outlawed, restrictive trade policies should be relaxed, and a legal framework to provide adequate enforcement of property rights must be put in place. Enterprise reform (as well as privatization) can play an important role in private sector development by upgrading SOEs so that they increase the competitiveness of

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markets, while at the same time insuring that SOEs operate so as to avoid crowding out the private sector. Often, monopoly enterprises can be unbundled to create competition in at least some of their activities. A particularly important opportunity is provided by the rapid change in technology in telecommunication. The private sector is perfectly capable of providing these services if allowed to and, in particular, if interconnection with the land grid is actively facilitated. Many developing countries have seen dramatic improvements in SOE telecom performance as a result of such competition. In Indonesia, for example, the waiting time for a hard-line telephone fell from five years to a few days.

- The relationship between competition and restructuring is a mutually reinforcing one. The existence of competitive markets makes SOE reform easier and increases its impact, and the successful restructuring of the public enterprise sector contributes greatly to the increased competitiveness of markets.

**2. Imposing a Hard Budget Constraint**

An almost universal feature of public enterprise sector reform programmes is the requirement that restructured firms be responsible for their own financing, with government disavowing any role or responsibility at all. Historically, one of the reasons for SOE inefficiency was the certainty of SOE management and employees that the enterprise would continue to exist regardless of its performance. Government had deep pockets and would subsidize financial losses.

Imposition of a hard budget constraint forces financial discipline on the SOE. Knowing that the government will not step in to cover shortfalls or to keep the enterprise from failing, employees have a strong incentive to make the company profitable and to insure positive cash flow.

Although a hard budget constraint is extremely important, it is also a difficult policy to enforce. There is often considerable pressure on the government to continue to support an SOE or, at the least, to prevent it from failing. State-owned enterprises often have an influential constituency that is able to bring political pressure or public opinion to bear on policy makers. Even if government officials are able to say no to providing financing directly, there are indirect methods of facilitating financing that may be politically irresistible to pressured officials: government can guarantee loans for enterprises, prevail upon the financial sector to provide loans that they would not otherwise make, provide preferential tax or utility rates, or reserve public procurements for SOEs. Note that such indirect subsidies may be even more harmful than direct credits, by crowding out private firms and raising the barriers to entry for new firms. Still, it is particularly difficult to enforce such a policy when the result might be the closure of some key public utility.

In addition, SOE management may be able to overcome the hard budget constraint even when government tries strongly to enforce the policy. Such measures rely on increasing cash flow without necessarily making real attempts to improve profitability. An SOE may

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just stop paying many of its bills, especially ones to the government, such as payroll and other taxes, or for servicing of existing debt. It may sell assets, perhaps even those necessary for the operation of the business. It may take advantage of an underdeveloped financial sector's inexperience to obtain loans that it does not deserve. And enterprises may provide financing to each other through barter and inter-company credits. In Eastern Europe, for instance, many firms were able to overcome their hard budget constraints for long periods of time, by maintaining the trading relationships that they had during the centrally planned period. That is, networks of large public enterprises that had done business with each other for years, continued to sell to each other on credit, knowing that the credits might never be repaid. While it had been expected that the hard budget constraint would force the inefficient firms to fail, and allow the stronger ones to survive, the inter-firm arrears made it possible for all firms to survive much longer than would otherwise have been the case. Perhaps worse, those firms that were most efficient continued to deteriorate as a result of the unpaid debts owed to them by the weaker firms.

In short, imposing a hard budget constraint is critical but much thought needs to go into the design of the policy to insure that it can be enforced. How might this be accomplished? One possibility is to let one or two small and inconsequential enterprises actually go bankrupt and shut down. Once managers and workers actually see that the government means business, they are more likely to actually endeavor to put their own house in order. Another idea is to provide incentives for improving management in the form of performance contracts, discussed later.

### 3. Improving the Business Environment

The impact of restructuring will also depend on the general business environment in which SOEs operate. To a great extent, governments create the environment that enables businesses to flourish. The role of governments is to create a level playing field for the private sector, and set and enforce the rules of the game.

Following are some of the pre-requisites that will affect not only the impact of restructuring but the process of restructuring as well.

- Macroeconomic stability. A key to economic growth is prudent economic management that avoids volatility and uncertainty. Policies that lead to high inflation, excessive taxation, distorted factor prices, or lack of foreign exchange discourage business formation and investment.

- Legal and Regulatory Framework. Business, like society in general, needs to operate under the rule of law. Laws provide a measure of certainty, and reduce the possibility of arbitrariness, by stating explicitly the rules that govern businesses; they define many of the rules within which enterprises, banks, and other economic actors interact; and they provide mechanisms for clarification and enforcement of rights. Without adequate business laws, there would be chaos. Debt collection, or contract enforcement, would be difficult; peaceful settlement of disputes would be impossible; and all businesses would fear the arbitrary or unexpected actions of government. Bankruptcy laws and

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enforcement are particularly important to insure SOE efficiency, as is the regulatory framework, particularly the government's capacity to regulate, for privatized firms.

- Financial System. An efficient financial system can greatly affect the impact of restructured enterprises. For SOEs with hard budget constraints, financing institutions serve two purposes: providing the credit they need to operate and grow, and enforcing discipline on firms that borrow. As firms compete among themselves for loans, it puts pressure on them to be more productive, and in order to service the debt, borrowers need to focus on profitability and cash flow.

- Physical Infrastructure. Certainly, the competitiveness of enterprises depends on the infrastructure in place. An otherwise efficient SOE may be uncompetitive if transport, utility, or other infrastructure is poor or too costly. Roads, railways, airports, and docks may determine the economics of industries, sectors, or individual products. "Transport costs in Africa are a greater barrier to exports than the tariffs they face in importing countries. Sub-saharan Africa's average freight costs are more than 20% higher than those of other countries. For some goods, such as clothing textiles and footwear, in which Africa is potentially competitive, average transport costs are between 15 and 20 per cent of the value of output. Once the terms of the Uruguay Round Agreement are fully implemented, the average tariff on all imports into the USA is less than 4 per cent."[33] Of course, since much of infrastructure is typically in the SOE sector, this is precisely why SOE reform and privatization are so important.

Of course, political stability, personal safety and security, and social, cultural, and historical characteristics also affect the business environment and the ability of an SOE to operate efficiently and effectively.

## C. Internal SOE Reforms

### 1. Corporate Governance Reforms

Corporate governance refers to the procedures and instruments used to insure that enterprises operate efficiently and in the interests of the owners, which in the case of public enterprises is the government. Governance thus is on the interface between the enterprise and its external environment. The central role of government is to insure that public policies and legislation are in place that will provide incentives for both the government entity that controls the enterprise and for enterprise management to be efficient. That is, the government needs to establish an appropriate governance structure, hire good managers to operate each SOE, and insure that those managers have enough

[33] UNIDO, "Finding the Right Track for Industry in Africa: Some Policy Issues and Options", 2001, p. 5 (with citations from original World Bank sources).

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autonomy to exercise their managerial skills. At the same time, though, governments have to put in place internal incentives and monitoring procedures so that managers will use their autonomy and skills to achieve the government's objectives, not their own. Doing this is a complex process that involves clarifying objectives; establishing an appropriate governance structure; hiring and motivating managers, and aligning their interests with those of the government; and establishing monitoring and control systems to assess their performance in achieving the government's objectives.

a) Clarifying Objectives

It is virtually impossible to improve the performance of an enterprise unless there is a clear understanding of what the enterprise is expected to achieve. While it is important for the government to indicate the broad objectives for which the SOE exists (e.g., economic development, regional development, employment creation), it is even more important to translate these broad objectives into more specific ones that can serve as the basis for evaluating SOE performance. To the greatest extent possible, these **objectives should be measurable and quantifiable**, as well. As the saying goes, "What can be measured can be improved." And, while there may be several objectives that are important, these should be kept as few as possible, and priorities should be established; where achievement of a non-commercial objective will incur costs, these costs should be made explicit. This is a crucial point, since one of the difficulties in reforming SOEs has been the existence of multiple objectives, many of which are not quantified nor measured and which make it impossible to accurately evaluate the performance of SOE management. In the central planning process in the former Soviet Union, for example, factory managers were evaluated primarily on their ability to produce their assigned quota of products. Since other goals were often not explicit and costs not of concern, this led to perverse results: factories would stockpile huge amounts of materials that would not be needed in the near future while other factories were unable to operate for lack of those materials; shoe manufacturers would sometimes produce huge quantities of shoes in small sizes and few or none of the larger sizes, since output goals were based on numbers of shoes (without regard to sizes) and smaller shoes used less input materials.

For most industrial enterprises, the paramount objectives will be related to **efficiency**, especially maximizing profitability or minimizing losses. Other objectives should not interfere with the achievement of the efficiency objective unless explicitly authorized, and even then the net financial costs should be quantified and compensated for in some manner. Even better, where industrial SOEs have significant non-commercial objectives, those objectives should be transferred to other government departments or agencies, as soon as possible. Too often, the pursuit of social goals is used as an excuse for poor commercial performance. A strong case can be made, however, that the best way for an SOE to promote social welfare is to generate a profit so as to provide resources to (or not divert resources from), say, the Ministries of Health and Education.

b) Establishing an Appropriate Governance Structure

Historically, governments have been intimately involved in the operations of the public enterprises that they control, often on a day-to-day basis, and usually with very poor

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results. A major objective of enterprise reform, therefore, is to place the responsibility for management in the hands of professional managers, those who presumably have specialized skills, aptitude, and experience to enable them to operate a business profitably and to achieve the other objectives set for the SOE. However, government still must exercise its ownership role to insure that management performs well, and a structure to oversee strategy and monitor the performance of management is needed.

Although there are various approaches to internal governance, there are two basic SOE models to choose from: one with and one without a strong board of directors. First, is the **Board of Directors model**, on the pattern of private enterprise. Under this model, there are three levels of internal governance: at the level of owners (government), strategic directors, and senior operational managers. Each usually consists of different, though sometimes overlapping, individuals and each has its own specific responsibilities and authority.

At the top, the government entity responsible for the SOE exercises the ownership function. The major responsibilities include determining the objectives that the SOE should achieve, appointing the strategic directors, and periodically reviewing the overall performance of the enterprise vis-à-vis the objectives that they set. If the government is not satisfied with performance, it can replace those directors, or establish a different governance structure.

Those at the strategy level are responsible for the hiring and firing of senior managers, for deciding on the overall strategy for the SOE and establishing specific policies to achieve that strategy, and for putting in place accounting, budgeting, and other systems to monitor the performance of management in carrying out those policies and achieving the objectives. A Board of Directors, though appointed or elected by the government, may consist of representatives from private sector firms and associations, financial institutions, NGOs, labour unions, and other groups. This provides specialized skills and experience, as well as different perspectives that can be useful in supervising the enterprise. A banker, for instance, can provide expertise in financial matters, while a labour union official can provide guidance in developing labour policies.

Under the second model, the Board is dispensed with (or made a formality) and their functions described above are vested in the **responsible government body**. One advantage of the Board model is that it parallels private management practice. One disadvantage is that, even in the USA, boards have not proven very effective in controlling managers, at least until a bankruptcy or other disaster strikes. In a public sector board, it is all the more likely that the chief executive officer will control the board (rather than vice versa), because the board members are often not qualified businessmen, typically have ministerial or other full-time responsibilities, and so have neither the time nor the background to question an experienced manager.

How might these competing factors balance out in an LDC? If, on the one hand, the directors are likely to be politicians rather than technocrats or businessmen, while the government control was exercised by a handful of experienced and motivated people as suggested earlier, then the non-Board option might be preferable. On the other hand, if directorships were given to local businessmen while government oversight was exercised

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by traditional ministries and other bodies, the Board solution might be best. It all depends on local conditions.

The following list of responsibilities has been suggested as identifying the key functions for whichever body supervises the SOE. They include:

i. "Set objectives;
ii. Evaluate performance according to those objectives;
iii. Reward and penalize the chief executive officer according to that evaluation;
iv. Appoint the chief executive officers;
v. Provide resources (finance)
vi. Conduct long-range planning and co-ordination among units;
vii. Do (almost) nothing else."[34]

Thus, except for six very specific tasks, none of which are at the operational level, enterprise management should be making all important decisions for the SOE. Within the limits given to them, they make decisions about use of resources in order to meet the goals. That is, they manage the production, marketing, accounting and finance, personnel, and other operational functions of the business. Their perspective is generally a short-term one, focusing on what needs to be done in the coming weeks and months, or in the next year or two. Although senior management may participate in long-range planning, it is generally the responsibility of the supervising body to insure that the short-range goals are aligned with the medium and longer–term strategies they develop.

Although the levels of internal governance are generally accepted, there is a wide range of **institutional arrangements** that have been used. At the ownership level, the government entity may be a sectoral ministry, a holding company (either sectoral or cross-sectoral), a specialized ministry for public enterprises, or a specialized public enterprise unit. While all of these organizational units may have an ownership role, in some cases ownership lies with another government entity and these units provide only technical support or advice.

At the operational level, enterprises need to be commercialized and, usually, corporatized. **Commercialization** means that the enterprise is treated like a commercial enterprise, rather than a public agency, by adopting business practices and principles while **corporatization** means that the enterprise becomes a legal entity separate from, though owned by, government. That is, SOEs become a for-profit or non-profit corporation, with the shares owned by the government. Through commercialization and corporatization, SOEs clearly establish their separation from government, specify their property and property rights, and install the accounting and other systems that enable them to keep track of their assets and liabilities, and to monitor their operating performance.

[34] Leroy P. Jones, Industry and Development, UNIDO, 1983, p. 8, citing Oliver Williamson, *Markets and Hierarchies* (New York, Free Press, 1975), pp. 132-154; and Elliot Jaques, *A General Theory of Bureaucracy* (London, Heinemann, 1976) pp. 62-86.

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What form of governance structure works best? It depends on the country and the situation. **Some lessons of experience**[35], however, suggest the following:

- The ownership function should probably not be exercised by sectoral ministries. In Egypt, for instance, ownership of enterprises was taken away from the Ministry of Industry and other sectoral ministries for supervision and eventual privatization. This not only enables the new government owner to concentrate on reform of the SOEs—privatization or restructuring—but enables the sectoral ministries to concentrate on their core responsibilities, such as policies for industrial development, rather than immersing themselves in the minutiae of SOE operations.

- Holding companies have not proved to be very effective owners of SOEs. These institutions, which are set up to directly control a number of SOEs, are intended to provide a more business-like supervision of SOEs, while at the same time insulating the SOEs from political pressures. However, generally but especially in developing countries, they have tended to develop their own weaknesses, including growing into unwieldy bureaucracies and retaining for themselves authority that could better be decentralized to the SOE management.

- A better institutional setup for most developing countries is likely to be one that involves the establishment of a public enterprise unit that would be responsible for public enterprise reform. Such a unit would be responsible for pushing the public enterprise reform process, coordinating government efforts in this area, and providing technical expertise in monitoring and providing information about SOE performance. It is best if the unit also exercises ownership as well as supervises the SOE sector, although it is possible for it to provide only supervisory and advisory services to the government, with ownership vested elsewhere. This is similar to what was suggested in the previous section on privatization, and consideration might be given to having one elite body responsible for both tasks.

The **public enterprise unit** should be kept relatively small and should have a core technical staff whose responsibility is to insure business-like supervision of the SOEs under its control, without excessive intervention in the management of the enterprise. In some countries, it may be effective to have this technical staff assume the role of strategic control as well as overseeing the ownership functions. That is, rather than relying on appointed directors, the public enterprise unit staff itself would be responsible for hiring and firing management, establishing budgeting and monitoring systems, and evaluating managerial performance.

The location of this public enterprise unit can also be a critical factor, especially in developing countries. Rather than having it within one ministry or agency, it can be useful

[35] Mahmood Ali Ayub and Sven Olaf Hegstad, *Public Industrial Enterprises: Determinants of Performance*, The World Bank, 1986, p 45-55.

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to "...have it report to an inter-sectoral committee, to organize it as a quasi-governmental unit, and/or to attach it to the Prime Minister's/President's office. This type of solution has several advantages:

i. it increases the status and importance of the unit to levels commensurate with the size, importance, and complexities attached to the public enterprise sector;
ii. it creates a unit with a direct link to the country's political leadership and which can concentrate all its attention on public enterprise issues without being distracted by other ministerial tasks;
iii. it will be easier to create a less political leadership and more enterprise/industry-oriented culture in a unit operating "half outside" the normal industries.
iv. it may, in certain situations, be a more politically acceptable solution, since no existing functional ministry will gain power over others.
v. it avoids undue concentration of power in one functional ministry." [36]

As noted above, it is possible that the strategic governance can be done by traditional government bodies. There are a variety of reasons, however, why it may be preferable to have an independent non-governmental body fulfill this role. Direct government oversight may lead to continuation of the political interference in enterprise operations that is common when the SOE is directly controlled by a ministry. There is often a lack of Government officials competent to do this type of work, and officials with technical skills who are assigned to these functions are therefore not available to work in other, perhaps more important, public sector jobs. And even competent officials often lack the business acumen and skills necessary to provide guidance to a commercial enterprise.

c) Attracting and Motivating Managers

In addition to having an effective governance structure, an efficient SOE requires professional managers whose personal incentives are such that they will benefit by achieving the objectives set by government, and who have the latitude and authority to make important operational decisions.

The lack of good managers in public enterprises can be a major problem due to a variety of factors, including a general shortage of good managers in a country, management posts being filled by political appointment rather than on merit, the use of government bureaucrats as managers, and poor pay or working conditions in the SOE.

If enterprises are to remain state-owned for a long time, it is important that these problems be addressed, though this can be very difficult. Some of the problems may be beyond the control of SOE managers and directors, especially those related to the pool of managerial talent available. Too, government fiscal conditions and civil service or other rules may make it difficult to raise pay levels.

[36] Mahmood Ali Ayub and Sven Olaf Hegstad, Public Industrial Enterprises: Determinants of Performance, The World Bank, 1986, p.52.

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Nonetheless, attracting and retaining good managers is critical to the success of SOE reform. This was pointed out in an assessment of the role of **managerial turnover** and **managerial incentives** in bringing about enterprise restructuring in privatized companies in the transition economies. Assessing the implications of six empirical studies that had been done to test the importance of the two factors, the authors say:

> "We find that [management] turnover and incentives, considered together, are an important determinant of restructuring. Management turnover on its own also has a significant effect on restructuring...." and "...the results leave us in no doubt whatsoever that turnover is much more effective in producing restructuring than are changes in management incentives. What explains this great importance of management turnover? This points to the importance of human capital that is new to the enterprise, an interpretation that is further bolstered by the findings that management turnover also contributes to enterprise restructuring in state-owned enterprises, that is, it is not dependent on the strong monetary incentives that come with private ownership." [37]

Some of the barriers to attracting good managers can be overcome with an improved governance structure, since an incorporated enterprise overseen by a board of directors rather than a government ministry may provide protection from political appointments and enable the SOE to replace government bureaucrats with professional managers. Certainly, however, finding a way to consistently attract and retain good managers requires a solution to the low pay levels that are often found in SOEs.

A possible solution to this problem is the establishment of incentive programmes that reward managers for results. Tying increased compensation to performance may make it politically or administratively easier to justify the increased budget, and it may even be feasible to generate the funding for the additional compensation from the managerial performance itself. For instance, higher compensation based on a percentage of increased revenue or profits could be paid out of those earnings (assuming that cash flow increases along with revenue or profits).

The establishment of incentive programmes not only may help to insure that SOEs have good managers, they also are key to insuring that managers focus on efficiency and on achieving the objectives set by government. The external factors discussed previously are particularly important in providing incentives for SOE management to make the enterprise profitable. If management is convinced that their jobs and income are dependent on profitability of the SOE, and if they understand that they will have to compete against efficient private firms without being supported by the government, this will go a long way toward focusing efforts on efficiency and profitability. In addition to these external incentives, a system of targeted incentives for individual managers can also be useful in aligning their interests with those of the government.

[37] Simeon Djankov and Peter Murrell, "The Determinants of Enterprise Restructuring in Countries in Transition: An Assessment of the Evidence", The World Bank, 2000, p.16.

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Such incentives can be negative (firing managers for failing to reach performance targets) and positive (providing additional compensation for meeting performance targets). Designing a workable incentive scheme can be a difficult task, for three reasons:

- It is difficult to precisely define measurable targets that match the broader objectives of the government and to foresee all the consequences of establishing a performance target. For example, tying managerial bonuses to profits may lead to a short-term orientation on the part of management at the expense of long-term viability, to arbitrary changes in accounting procedures (e.g., selecting depreciation methods that reduce reported expenses), or to fraud that inflates profits and, therefore, manager's bonuses. It is also possible that an incentive system may have other unpleasant consequences such as generating resentment from workers, government officials, or the public due to the high level of compensation.

- Even with measurable targets, the data needed to evaluate performance is often lacking. This is the result of inadequate financial statements and accounting systems in many SOEs and generally poor economic data in less developed countries.

- It involves negotiations between the supervising body and senior management, with management having a clear advantage in terms of information. That is, managers know much better than the supervising body what is possible and can negotiate for targets that are easy to meet. It is even possible that an incentive system could be established that provides incentives for *reduced* efficiency on the part of managers.

It is important, therefore, that care be exercised in the design of the incentive system for management. While difficult to do, it is still crucial that the broader objectives of government be translated into performance targets agreed to by the Board and by management, and a series of incentives for meeting those performance targets be established.

Of course, having professional managers intent on making the SOE profitable will not be of much use if they lack the authority to properly do their job. This means that government or Board of Director interference in the day-to-day operations of the SOE needs to be minimized. The reason for having professional managers is their particular expertise in running a business, or in restructuring it to make it more efficient, so they need to be given the autonomy to use their best judgment in managing the SOE. This means that the choice of products, markets, prices, distribution channels, advertising and promotion, production technology, personnel, and the like need to be made by management, within the budgets and other limitations agreed to, or imposed by, the Board or government. There are, of course, major decisions with long-range financial implications—building of a major new factory, for instance—that management cannot take without approval, but otherwise management should be free to make operational decisions without interference.

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d) Monitoring Performance

The heart of delegating autonomy is in establishing *ex-post controls* in place of *ex-ante* controls. That is, rather than telling managers, in advance, what to do, governments allow managers to do what they deem best, and then evaluate their results. To do this, however, requires a system to monitor and evaluate performance.

There are various types of targets, or indicators, that can be monitored and measured. These include process indicators (e.g., install a second assembly line), and physical, marketing, and socio-economic ones. Physical indicators are useful to measure the efficiency of production operations or levels of output. Marketing indicators, such as market share and sales growth, give an indication of the effectiveness of sales effort, and the validity of product features, quality, and prices. Socio-economic indicators (e.g., jobs created) can be used to assess the achievement of non-commercial objectives such as local or regional development.

The most important of the SOE's performance targets are, generally, financial ones, especially profitability and return on equity (though these have to be carefully assessed, in constant prices, if the SOE operates in non-competitive markets). Comparison of profit figures—against planned profits, prior year profits, and industry standards—are especially important, since they summarize the overall effects of various managerial actions and decisions. Of course, there are numerous other financial indicators, such as the Debt Ratio, the Cash Ratio, Sales to Total Assets, Return on Total Assets, and Inventory Turnover, that can be used to measure leverage, liquidity, and profitability performance. Care must be taken in their use, however, to avoid perverse effects on management incentives, as discussed in the next section

Financial indicators are not only, as a rule, the most important indicators, they are also among the easiest to use, although their value depends greatly on the SOE having a reliable accounting system that collects financial and managerial information, and preparing timely financial statements using generally accepted accounting principles. Since this is important for many purposes, not only for monitoring of SOE management, the introduction of such a system should be a priority if one does not already exist.

The amount of control that needs to be exercised depends greatly on the risk to government from the SOE operation, and the competitiveness of the markets in which it operates:

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**Levels of Financial Control**[38]

| Financial Control Public Tools | Financially Independent Public Enterprises | Financially Independent Enterprises in Monopoly Markets | Public Enterprises Dependent on Government Finance |
|---|---|---|---|
| Strategic Plan | * | * | * |
| Annual Operating Budget | | | * |
| Capital Investment Plan | | * | * |
| Quarterly Financial Reports | * | * | * |
| Report on Capital Projects | | * | |
| Audited Financial Statements | * | * | * |
| Management Audits | | * | |
| Price/Tariff Assessments | | * | |

As shown in this table, where an SOE is autonomous, no financial responsibility accrues to the government, and where the SOE operates in a competitive market, adequate performance assessment may only require using the quarterly and annual financial statements of the company to compare against previously negotiated performance targets, as stated in budgets and corporate or strategic plans. SOEs that are independent, receive no financing from the government, but which operate in uncompetitive markets may, in addition, need to prepare additional reports that enable the Board and government to assess its effects on markets; and an SOE still dependent on government finance will require additional data to assess and control the financial implications to the government of SOE ownership.

e) Performance Contracts

One approach to governance reform that has become very popular in recent years is performance contracting, which attempts to combine the major reform elements described above into one contract between the government and SOE management. The practice of performance contracting began in Europe in the 1960's and spread to developing countries in the 1980's. A recent World Bank study found 565 performance contracts in 32 developing countries, and an additional 103,000 contracts in China, as of June 1994.[39]

[38] Ayub, Mahmood Ali and Hegstad, Sven Olaf (1986), The World Bank, Washington DC, USA, p. 30.
[39] Mary Shirley, "Why Performance Contracts for State-Owned Enterprises Haven't Worked," Public Policy for the Private Sector. World Bank, August 1998, p.1.

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While performance contracting varies from country to country, and even from contract to contract of an SOE, it is essentially a control mechanism that attempts to clarify objectives, establish performance targets, monitor performance, and evaluate results in comparison to the targets, in exchange for rewards for performance and substantial management autonomy—exactly those reform elements called for in the previous section. Performance contracting involves a process of negotiation between government and SOE management to arrive at a detailed agreement that defines the rights and responsibilities of each party. Performance contracts often contain, in addition to the objectives, targets, incentives, and monitoring and evaluation procedures, a statement of the resources available for management to use, methods of dispute resolution, and reporting requirements. There may be very detailed requirements or prohibitions for either party. For instance, in the performance contract signed with the Senegal Electricity Company, the government agreed that it would force other SOEs to pay their electricity bills.[40]

Much was expected of performance contracts in developing countries, since they seemed a logical solution to the problems that SOEs faced, and since such contracts work in the private sector. Unfortunately, they have not worked well. A World Bank study of twelve companies in Ghana, India, Korea, Mexico, the Philippines, and Senegal "...found no pattern of improvement associated with the performance contracts in productivity or profitability trends....". Another study of manufacturing firms in China "...showed that the increasing use of performance contracts in China could not stem the fall in productivity among state enterprises. More important, the study found no robust, positive association between performance contracts and productivity." Taken together, the studies showed "...no evidence that performance contracts had improved efficiency."[41]

Does this mean that performance contracting will not work? The answer is no: a properly designed and administered performance contract can improve efficiency. For example, the World Bank study concluded that a "good" performance contract for a Chinese SOE would result in a 10% productivity growth rate, and 38% of firms in the study did show improvements where the "...performance contract provided sensible targets, stronger incentives, longer terms, and were based in more competitive industries."[42]

Unfortunately, negotiating a "good" performance contract is difficult for most governments to do. Shirley notes that for a performance contract to improve efficiency, it must: (1) reduce the information advantage that managers enjoy over owners (2) motivate managers through rewards or penalties to achieve the contract's targets and (3) convince managers that the government's promises are credible.

To reduce the information advantage, government needs to provide the bureaucrats negotiating the contract on behalf of the government with "power, resources, and status"

[40] Mary Shirley, "Enterprise Contracts: A Route to Reform?" *Finance and Development,* September, 1996, p.8.
[41] Op. cit, p.2
[42] Shirley, Mary M. and Lixin Colin Xu, 2000. "Empirical effects of Performance Contracts: Evidence from China " reported in "Privatization in Competitive Sectors: The Record So Far", Sunita Kikeri and John Nellis, The World Bank. October 29, 2001, p. 43.

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commensurate with the task. To motivate managers, the government must set incentives—positive and/or negative—that are appropriately targeted (e.g., high enough to result in efficiency improvements) and that are actually applied. To make government promises credible, the contract should provide means for enforcing government compliance. These requirements, though reasonable on the surface, often require resources, skills, information, and political will that are in short supply within government. And the contracts must be written to motivate management. "...Mexico promised its public enterprise managers greater autonomy and at the same time exacted greater accountability, in performance agreements between the government and the PEs [public enterprises]. But implementation of this component was delayed by more than three years, and when it was implemented its performance was disappointing. Managers saw the performance agreements as an instrument of control rather than a contract leading to autonomy."[43]

While these conditions are necessary for construction of a good contract, they are not sufficient. A good contract should reward socially desirable and **only** socially desirable behavior. The key efficiency condition for socially desirable behavior is that revenues increase by more than costs (or costs decrease by more than revenue). Most contracts violate this condition. That is, while they do reward actions that increase revenues by more than costs, they also reward actions that increase costs by more than revenues.

The problem is rooted in the almost universal multiple indicator systems that asymmetrically weight benefits and costs. To see this, assume a simple system that rewards profit, labour productivity (output per worker), and sales. Improvement in each of these decisions individually is clearly a good thing, but in combination the effect can be perverse. Assume that a manager increases output by $2000 and inputs by $1000. All three indicators improve and he is rewarded, as he should be. But what if the reverse happens and he increases revenues by $1000 and inputs by $2000. He should be penalized but he is rewarded because two of the three indicators rise (only profit falls). Since it is much easier to accomplish the second kind of action than the first, managers will be excused for often taking the easy way out and getting rewarded for reducing efficiency. Since most existing contracts contain this type of flaw, most contracts will reward many cases of declining productivity. It may thus not be a bad thing that existing contracts often do not include incentives. If they did, things might be even worse than they are.

What is the solution? If performance contracts are to be used, they should be drafted only by people with some training in performance evaluation. The current situation is analogous to untrained people doing project evaluation and not knowing to discount future benefits and costs.

### 2. Enterprise Restructuring

So far, it has been noted that there are a variety of steps that can be taken to, first, provide a climate in which SOEs will receive better incentives and, second, improve the governance structure and procedures, both of which should lead to increased efficiency and effectiveness of the enterprises. There is a third group of activities that also can

[43] The World Bank, *Industrial Restructuring: A Review of World Bank Operations*, June 26, 1995, p. 63.

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contribute to the reform of the enterprise, through direct changes to the enterprise operations that are, collectively, known as enterprise restructuring.

a) Types of Restructuring

Restructuring is a term that is used to describe many different activities, including the following:

**Legal restructuring** occurs when the legal form of organization of state-owned enterprises is changed. Often SOEs are unincorporated government entities that are supervised directly by government officials, perhaps the staff of the Ministry of Industry, or the Ministry of Finance. Incorporating them as separate legal entities (joint stock companies, nonprofit corporations, associations, etc.), even if they remain wholly owned by the government, provides several benefits. First, it makes it possible to more clearly define property and property rights vested in the SOE; as an unincorporated part of government, SOEs often did not bother to maintain records on assets or to differentiate whether assets they were using were theirs or belonged to the supervising ministry or some other owner. As part of the process of incorporating, lines are drawn between the SOE and others. This also facilitates the sale or transfer of the SOE in any eventual privatization. Second, incorporation makes it easier to commercialize the SOEs' operations. That is, once it is clear what is part of the SOE and what is not, it is possible to establish accounting and financial control systems to track assets and liabilities, revenue and expenses. Third, incorporation provides for better corporate governance. After incorporation, a board of directors can be appointed to supervise the enterprise. The Board of Directors can consist of many individuals, private and public sector, who can bring special expertise to the process of developing the firm's strategy, setting policy, and overseeing management.

Legal restructuring may also consist of changing the legal form of an incorporated SOE. For instance, a non-profit corporation—or a departmental enterprise—might be converted to a joint stock company, so that potential investors could be offered shares in the company, or a new joint venture with investors could be established.

**Financial restructuring** occurs when the amount, type, or mix of an SOE's financing causes problems with its operations. Usually, this means that the SOE has too much debt, but it may also be that it has too little: a lack of financing may prevent the firm from growing or from buying the equipment or services that would enable it to be more productive. It is also possible that the enterprise has enough financing, but the wrong kind. As much as possible, financing should match the purpose for which it is used. That is, expenditures that will generate cash returns quickly (e.g., purchase of raw materials for production) should be financed with short-term financing, and expenditures that will take a long time to pay for themselves (e.g., building a new factory) should be financed by long-term debt or equity. An inappropriate financial structure can cause both profitability and cash flow problems.

Financial restructuring begins with a detailed analysis of the company's operations and its financial statements. Eventually, a decision is taken as to what the financial structure of

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the company should be, and what is required to achieve this improved financial structure. This may require borrowing more funds, obtaining new investment, replacing one type of financing with another type (i.e., arranging new long-term loans and paying off short-term loans), or negotiating better terms for existing financing. However, financial restructuring of public enterprises commonly takes place not merely to achieve a more efficient or profitable financial structure, but because accumulated debts are just too high to be serviced. In that situation, financial restructuring may require bankruptcy or some other government intervention to cancel some or all of the debt, to postpone repayment or lengthen the repayment period, or to otherwise make the debt easier to service. (Of course, governments could also pay the debts the SOEs incur, but this subsidization of SOE losses is what has caused many of the problems that led to the privatization era).

**Operational restructuring** consists of making major changes in the way that the enterprise does business. This may include, in addition to extensive cost-cutting activities, changing the company's overall strategy, the manner in which it is organized and managed, the mix of products or services sold, the markets and the distribution channels used to get the products to those markets, the production process, and other major elements of the operation. Operational restructuring may also include **physical restructuring** or **rehabilitation**, which involves large investments in plant, equipment, or other assets to replace or repair obsolete, damaged, or deteriorated assets.

Enterprise restructuring, then, refers to a wide range of different activities that are designed to change and improve an enterprise. It may include all three types of restructuring described above, or it may involve only one—unless otherwise defined, however, enterprise restructuring always includes activities related to operational restructuring.

b) Objectives of Enterprise Restructuring

The ultimate objective of restructuring state-owned enterprises is, of course, to improve their effectiveness and efficiency, but translating this general objective into concrete plans for the restructuring of each enterprise is difficult. A number of factors need to be considered:

- How long will the SOE remain state owned? If an SOE is to be privatized in the short or medium term, then restructuring activities should be confined to those that will make it saleable or which will likely increase its value. Therefore, the government would likely want to concentrate its actions on legal and financial restructuring, with operational restructuring restricted to low-cost or obligatory changes. That is, the SOE should be commercialized and corporatized, and the debts that will not be transferred to the new owners would be written off or transferred to another government agency. Improved housekeeping or cleaner production techniques, or reductions in the workforce could be introduced to make immediate efficiency improvements at very little cost. And, operational actions to make the SOE more attractive to potential buyers, such as laying off all workers prior to the sale to give the new owners flexibility in hiring, may also be warranted.

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If, on the other hand, the SOE is likely to remain in the public sector for a long time, then more extensive operational restructuring can be considered. In this event, plans for long-run sustainability and profitability need to be carefully considered. Operational restructuring, therefore, may include large-scale physical rehabilitation, opening of new factories, and other costly changes.

- Why does the SOE exist and how important is it? Government owns and operates the SOE to achieve specific goals, economic, political, and social, and the restructuring should be designed with those ultimate goals in mind.

- What is the current condition and outlook for the SOE? The objectives of restructuring will depend on how valuable the SOE is or can be, and what its current physical and financial condition is. Restructuring of a firm that has financial problems and is physically dilapidated may focus on immediate survival objectives such as obtaining working capital or replacing obsolete or missing equipment, while restructuring of a more stable firm would likely focus on longer-term issues such as technology upgrading, market expansion, or improving the capital structure by issuing additional equity shares.

- What are the resources available for restructuring? Restructuring encompasses many different possible activities, some of which may be relatively inexpensive, others of which may require huge sums of money. Early on in the process, there should be a determination of what is likely to be available for reform of the public sector generally, and for the restructuring of each enterprise. For SOEs that are likely to remain government-owned for a long time, there may be justification for large capital expenditures, especially for the most important SOEs, but will the funds actually be available? If not, it is better to recognize this quickly and adjust the restructuring objectives to emphasize low cost improvements from the beginning. For example, if funds to hire consultants will not be available the restructuring process should be built around improvements that can be obtained by SOE staff themselves.

- It is critical that any restructuring programme begin with a clear statement of the objectives that are expected to be achieved.

c) The Process of Restructuring

Enterprise-level restructuring of a large enterprise is a complex task requiring individuals with skills in financial analysis, organizational development, human resource development, production management, marketing, and other functional business skills. It requires individuals who know the industry: the products, the competitors, the buyers, the suppliers, and the technologies. Often, it is preferable to hire consultants to assist enterprise management in the process of restructuring, since enterprise managers may not have all the skills required or may not have stayed abreast of developments in the industry. Consultants can be expensive, however, and if necessary restructuring can be undertaken by enterprise managers without outside assistance. Regardless of whether consultants are used, however, enterprise management should form a Restructuring Team that will be

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given responsibility for preparing the restructuring plan and, perhaps, for implementing that plan, as well.

UNIDO's approach consists of three phases:

*Phase I: The Diagnostic*

The starting point for restructuring is usually the **Preliminary Business Appraisal.** This appraisal is designed to focus on assessing the SOE's problems, conditions, and main strengths and weaknesses, in order to rather quickly make some important decisions:

- What immediate actions should be taken?
- What resources are needed to perform these actions?
- Are the SOE prospects bright enough to justify further consideration of restructuring?
- If not, what should be done with the SOE? (Liquidation or other alternative)
- If liquidation, what should be done about the social, financial, and legal issues surrounding liquidation.

The Preliminary Business Appraisal consists of a data collection stage in which the restructuring team undertakes an analysis of background documents, a detailed financial analysis, a review of the SOE's operations and physical facilities, a comparison of SOE performance measured against some non-financial performance indicators. With this information, professional judgment is used to prepare a set of conclusions and recommendations about how to proceed.

If the decision is made to go ahead with the restructuring, a more detailed diagnostic is undertaken. The major components of the full diagnostic are an analysis of the business environment that the SOE operates in (the social, macroeconomic, financial, and legal environment, as well as physical infrastructure); an analysis of the size, relevant characteristics, and trends in the industry, sector, and subsector that the SOE operates or will operate in; an assessment of the SOEs' markets, actual and potential, and its competitiveness in those markets; and a functional audit, which is a combined assessment of the organizational, financial, and production capabilities of the company.

*Phase II: The Restructuring Plan*

Once the diagnostic is completed, this information needs to be carefully analyzed so that choices can be made about the company's long-term strategy. What products will be sold, in which markets, using what pricing strategy, distribution channels, and advertising and promotion strategy? Where and how will products be manufactured, and at what cost? How will the company be organized, staffed, and financed in order to support the marketing and production plans? What will be

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done to insure that profitability can be maintained through continuous improvement, as markets and competitors change? These elements of the company's business plan—or corporate plan or long range plan—comprise the strategy that the restructuring plan will then try and put in place.

The **restructuring plan**, then, is a document that provides a time-bound schedule of activities whose implementation will result in the company eventually operating in the manner described by its long-term strategy. The restructuring plan will describe the changes that are going to be made in the SOE's organizational and legal structure, production processes, marketing approach, work force, training programmes, financing structure, and the like. It will indicate when these changes will be made, including intermediate steps, and the cost of the changes. That is, financial projections will be included showing the source and use of financing required to implement the restructuring plan, as well as pro-forma balance sheets, and projected cash flow and profit and loss statements showing the results that are expected from implementing the restructuring in the manner indicated in the restructuring plan.

While the restructuring plan will be prepared by enterprise management, possibly with the assistance of outside consultants, the government owner should be consulted periodically. If the SOE is independent and subject to a truly hard budget constraint, and if there are no financial implications for government, then the restructuring plan may not need government approval, though it likely would require approval of the Board of Directors, if one exists. The restructuring plan can also be useful for those outside the company—creditors, suppliers, or potential joint venture partners, for instance—so it should be written with a view to who is likely to read it.

#### *Phase III: Implementation of the Restructuring Plan*

The *development* of the restructuring plan is a strategic exercise, requiring good data, knowledge of the sector and subsector, and strong analytical skills. The *implementation* of the restructuring plan, however, is a managerial exercise, requiring the marshalling, organization, and management of resources needed for restructuring. The restructuring activities are spelled out in the restructuring plan, so implementation consists of carrying them out. This requires, essentially, that a good manager at a very senior level, or the CEO personally, be in charge of the implementation to insure that the restructuring exercise is credible to the entire staff; that an information campaign is enacted to keep staff informed and motivated about restructuring; that mechanisms to insure integration of outside experts into the process function smoothly and do not disrupt normal operations; and that systems to monitor the progress and results of restructuring are in place.

### 3. Unemployment and Labour Issues

A particularly sensitive and important issue in enterprise reform is that of labour redundancy. State-owned enterprises commonly have many more workers than they need,

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and the workers may lack the skills or motivation that the SOE requires to be efficient. (This issue is also critical when privatization is planned, and involves additional questions, such as whether to lay off workers prior to privatization, whether to lay off all workers and allow new owners to make their own selection, or whether to adjust the purchase price of the SOE to reflect the costs of maintaining unneeded workers for a period of time).

Should government lay off employees who are not needed? The answer is "yes, if possible." For efficiency purposes, it is important to lay off unneeded workers. Keeping workers not only adds to the costs of operations, it also works against other internal efficiency-inducing restructuring. That is, if two persons are doing a job that only needs one person, the SOE is incurring costs for that extra person and, in addition, the worker who should be doing that job alone is not getting the experience of doing so. Changing the SOE "culture" to emphasize efficiency is difficult when workers can see that overstaffing is high, and that no one needs to work at full speed. Keeping unneeded workers in an SOE is also not good for society when alternatives for re-training and/or re-deployment exist.

Despite this, there may be sound reasons not to lay off workers even though efficiency would seem to require it. These reasons have to do with the **political or social consequences of redundancy**. From a political point of view, layoffs of employees, especially massive layoffs, may arouse such opposition—from workers, from labour unions, from politicians, or from the public—that the political costs of redundancy are just too great. Layoffs of workers may cost the government important political support from labour unions or it may strengthen the opposition political parties. Public opposition to layoffs may endanger the support for the entire enterprise reform programme, or worse.

Another reason that workers are not laid off, despite the efficiency improvements that would result, is that the social costs may be too high. Workers in SOEs usually are not well-paid, but at least it provides them a job and some minimum amount of income and other benefits. When workers are laid off, they may lose status, as well as the means of supporting themselves and their family. In turn, this can lead to social chaos—protests, strikes, violent demonstrations—if the number of layoffs is large. Avoidance of large-scale societal unrest was the justification for failure to deeply restructure Chinese SOEs for many years.

How can the government overcome the opposition to labour redundancy? The most important step is to provide some **financial support** to the laid off workers. If the country has an existing unemployment compensation, pension, or welfare scheme, then no new infrastructure may be required. If not, however, there may be a need for a special fund or programme to be set up to provide this financial compensation. The most important considerations, then, will be which workers to lay off and what compensation they should be paid.

It is important that the workers that are laid off are not the ones that the enterprise will most need to become efficient. This means that a careful analysis of the labour requirements of the SOE needs to be made, taking into account the particular skills that will be required by the restructured enterprise. Then, the skills, experience, age, and other relevant characteristics of workers need to be matched against the labour requirements in

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order to make a determination of which workers to keep and which to lay off. It would be ideal if the selection of persons to be laid off were made by the individuals who will be responsible for operating the restructured company. Assuming that their incentives are based on the SOE's performance, these managers would then have good reason to choose workers who will most contribute to the efficient operation of the SOE.

Research also indicates that layoffs that are based on some skill measurement approach are likely to produce better results than other schemes, voluntary or involuntary, such as early retirement programmes or separation based on age.[44]

There are various types of benefits that can be given as compensation. In higher income countries, with the relevant institutions, compensation can be in the form of severance payments, retirement benefits, periodic unemployment compensation or welfare payments, and health care benefits, among others. For LDCs, however, where such institutional infrastructure is lacking or already overburdened, it is best to keep the benefits in a simple form, such as a lump sum severance payment. This could be made by the SOE at the time of severance, so the administrative burden would be small.

A word about voluntary retirement or termination: schemes to get workers to retire or quit, rather than to be involuntarily terminated, have a lot of appeal, since such workers will, presumably, not generate additional opposition for the restructuring or enterprise reform programme. They have two flaws, however. One is that they may well be considerably more expensive than an involuntary severance programme and, two, because they are offered to all employees, or all employees within a particular category, they may lead to a loss of more productive workers, rather than the ones that the SOE management would prefer to see leave.

How much should the compensation be? This depends on three factors: What minimum amount is needed, in fairness to the workers and to forestall the political or social problems associated with redundancy discussed earlier? What maximum amount is desirable to avoid giving redundant workers incentives not to work? How much can the government afford? There are no formulas for determining the correct level of compensation to pay to redundant workers. Obviously, the government should be as fair to the workers as possible, recognizing the human costs that unemployment will impose on the individuals and their families. The government should also weigh the political and social consequences of paying too little compensation, which could lead to labour unrest, political opposition, and public opposition to economic reform. At the same time, there are two good reasons for keeping the payments low:

- In all countries but especially in LDCs, society's needs are great and financial resources are finite. Money that is spent on separation payments is money that will not be available for hospitals, roads, land mine clearance, education, and other governmental expenditures. Are funds available for severance payments and, if so, how much?

[44] Chong, A., Lopez-de-Silanes, F., "Privatization and Work Force Restructuring around the World", p.10. World Bank Policy Research Working Paper 2884, September 2002.

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- The compensation paid to laid-off workers is not intended to substitute for a job, but to insure some minimum social protection until the workers are able to find a new source of income. If the compensation levels are set too high, they may discourage, or at least not provide adequate incentives for, workers to do whatever is necessary to find a new job or other source of income. (A lump sum payment is particularly effective as an incentive to find new work, since the worker keeps the money even if he begins work at a new job immediately. Unemployment benefits, on the other hand, may discourage the worker from looking for work since the benefits end once a new job is found).

In short, there is no easy answer to the question of how much to pay redundant workers. It likely will be some trade-off between what the government can afford and what it believes is justified by fairness to the workers and the political consequences of not providing an adequate income floor for the workers. Nonetheless, care must be taken in the design of the final offer, since misjudgement can be very expensive.

What other support can be given to redundant workers? The most common type of non-financial support has already been referred to: **re-training programmes**. Redundant workers and society benefit when the workers are employed again. The fact that lay-offs are occurring in the SOE often means that there are many other unemployed workers with similar skills looking for work in that sector, so it can be extremely difficult to find a similar job. Retraining for work requiring different skills, perhaps in a different sector or different geographic region, may be required.

How well do retraining programmes work? According to one review of labour redundancy programmes:

> "Systematic evaluations are lacking in developing countries but anecdotal evidence shows that retraining programmes in particular often founder because of timing delays, weak institutional capacity, and low educational levels. In Bangladesh, Brazil, and India, for example, the demand for retraining was far lower than expected (with less than a 20% take-up rate), and most surplus employees had left their jobs well before the retraining programmes became operational. But if properly designed, retraining can have important social and economic benefits by ensuring that workers with several remaining years of productive life are equipped with the right skills to become gainfully employed elsewhere in the economy. Better results can be achieved by ensuring that retraining is demand-driven, not supply-driven (for instance, by giving workers a choice between training and severance and building in a cost-sharing element), that it is targeted to those for whom it is most cost-effective, and that non-governmental and private institutions are involved in the delivery of services."[45]

[45] Sunita Kikeri, "Labor Redundancies and Privatization", *Public Policy for the Private Sector*, The World Bank. January 1999, page 3.

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A related programme involves promoting **self-employment for redundant workers**. That is, various types of assistance are provided to enable laid off workers to create businesses that will provide income for them and their families and, it is hoped, jobs for employees. Usually, such programmes involve entrepreneurship training, in which the potential entrepreneur is given instruction in the basics of business start-up and management, and helped to prepare a business plan to guide the start-up process. Financial assistance is also sometimes a component of the programmes. An especially useful form of assistance occurs when SOEs contract out (see Chapter Four) services to redundant employees. Since the hardest part of business for most entrepreneurs is selling, helping employees to establish businesses where some sales are guaranteed is extremely helpful.

While entrepreneurship training, financing, and similar programmes are found in many, perhaps most, countries, their effectiveness has been mixed. OECD notes that self-employment assistance programmes for the unemployed in OECD countries have "proven to be a cost-effective alternative to income support"[46] while their impacts are limited since only 5% of beneficiaries participate and since "the self-employed do not hire large numbers of additional workers."[47] Still, self-employment is one option that can be considered for those redundant workers who have entrepreneurial interests.

How else can opposition to labour redundancy be overcome? As noted earlier, opposition to employee lay offs comes not just from the workers themselves, but labour unions, political groups and others that stand to lose in the process of enterprise reform or who have misunderstandings about the consequences of reform. One way to address this problem is through transparency, by providing information about what is being done and why, and involving others in the process. For redundant workers, this means giving them information about their entitlements and alternatives. For labour unions, this means giving them information about why enterprise reform is necessary, about the likely consequences of enterprise reform, and the benefits to them of having restructured enterprises. It may also be important to involve labour unions in the process of developing the redundancy and safety net programme. For the general public, it will also be important to make them aware of the enterprise reform plans and the consequences. So, a public information campaign that provides information about enterprise reform and explains why employee lay offs are necessary, combined with more detailed information targeted to groups such as workers and labour unions may help to overcome some of the opposition to reform.

It should also be noted that enterprise reform is not as threatening for labour as is commonly supposed. Even privatization often provides a positive benefit for labour, resulting in higher wages for employees. For instance, a study of 218 privatized firms in Mexico showed that restructuring resulted in a 54% increase in average output, while cutting the work force in half. Yet, this increased productivity led to large increases in wages of the remaining workers.[48] Quite often, there is even an actual increase in the number of workers within a short time of privatization as a result of restructuring that then

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[46] OECD, Fostering Entrepreneurship, Paris, 1998, p. 25.
[47] Ibid, p.86.
[48] Rafael La Porta and Florencio Lopez-de-Silanes, "The Benefits of Privatization: Evidence from Mexico", Public Policy for the Private Sector, June 1997. p. 3.

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increases sales and leads to the need for more workers. So, while it is usually true that some workers, and in some cases, many workers will lose their jobs, as a group, labour benefits from having well-managed, efficient enterprises that can compete. This information needs to be disseminated to workers, unions, and the public.

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# CHAPTER IV:

## Other Options

### A. Overview of Options

The previous two chapters dealt with the most common ways of dealing with SOE problems, involving reforms both with and without a change in ownership of the firms. However, there are other options possible, which combine public and private strengths and weaknesses in different ways. Examples include management contracts, leasing/renting, concessions, franchises, contracting out, and Build-Own-Operate-Transfer (BOOT). (The definition of the terms varies from country to country and from sector to sector within countries, so it is always important to understand how a term is being used.) It is also possible to sell assets of the firm, which may include full liquidation and closure of the SOE.

On the next page is a decision tree that shows the options and the different characteristics that can be combined (ownership, purpose, use, whether the change is to the entire SOE or a part, and the assumption of risk) to produce the options. Deciding on the options that can be used involves a series of questions:

- Who Owns the Assets? Ownership can be with the government, the private sector, or the private sector initially and the government later. This third possibility results in (see the bottom arrow of the decision tree) a **BOOT**.

- Under private ownership, the question is whether the private firm is providing a public or private good. If a public good, the option for use is a **franchise**, and if a private good, the option is a **concession**. In either case, the government gives a private firm rights to do something that provides them a basis for a business, but the ownership of the business itself is by the private firm. That is, the government owns the rights, which it can transfer to the private firm, but the firm itself owns the resulting business.

- As the decision tree shows, when government is the owner, there are four possibilities, which vary according to these questions: Does the government require that the SOE or its assets be used in specific ways? Is the entire operation of the SOE included, or only a part? Who has the operating risk (i.e., who gets the profit or loss)? In an **asset lease**, ownership of the asset remains with the government but a private firm leases it and uses it in any way it wants. In the other three options, the private firm must operate to provide specific

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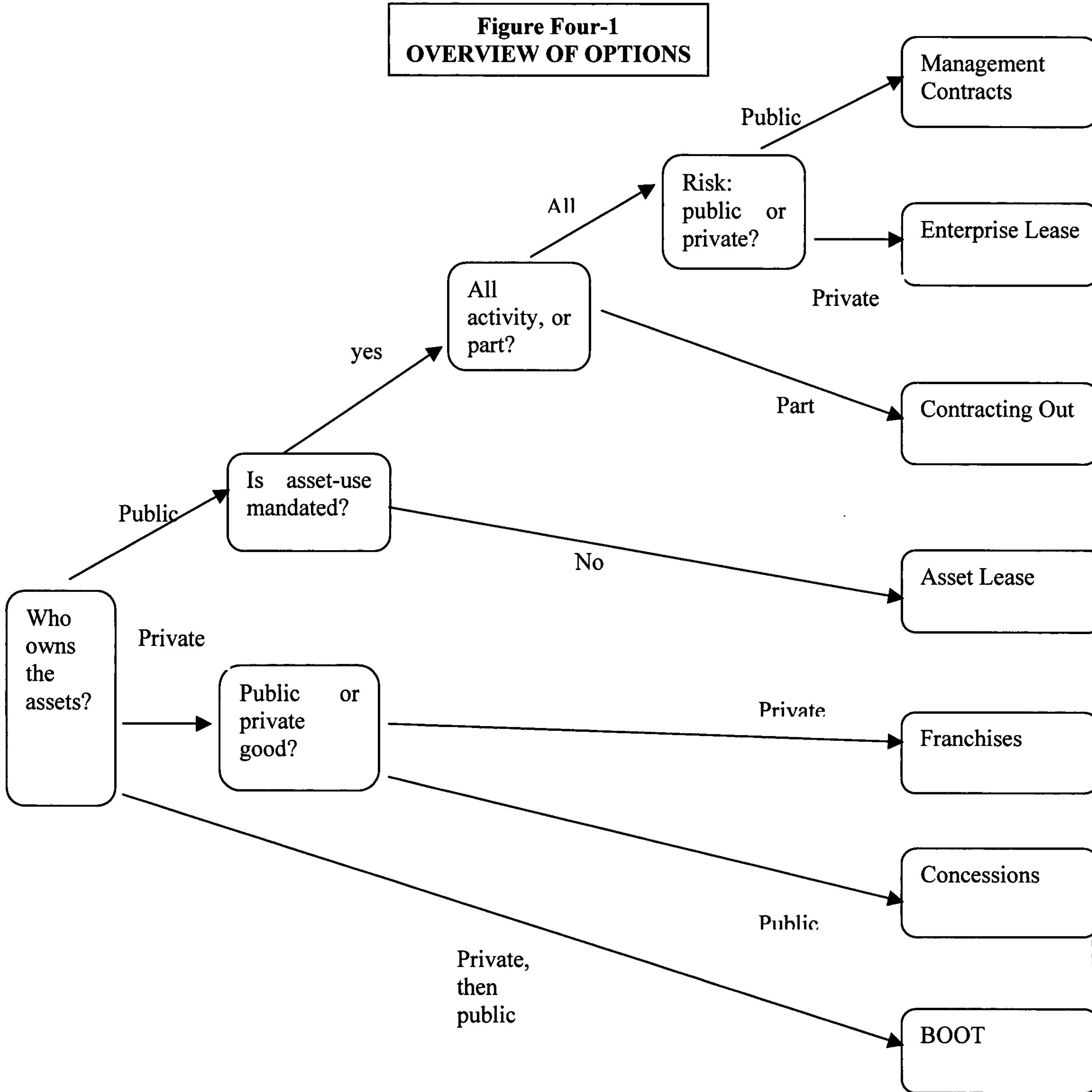


**Figure Four-1**
**OVERVIEW OF OPTIONS**

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services or products that the government specifies. If only a portion of the SOE's work is to be done by a private firm, this is called **contracting out**, and the private firm signs a contract with government to provide the specified services on behalf of government. If the services of the private firm encompass all the operations of the SOE then the choice is between management contracts and enterprise leasing. In a **management contract**, a private firm contracts with the government to manage the SOE. So, the private firm receives a fee for its services and any profit or loss remains with the government. In **enterprise leasing**, the private firm takes operational risk for the SOE. Usually, it pays a specified fee to government to have control of the SOE and its assets, and any profit or loss accrues to the private firm. The distinction between management contracting and enterprise leasing can blur, because under both forms risk and profit can be shared along a continuum (for example, a management contract with a fixed fee plus some form or profit-sharing incentive).

## B. Management Contracts and Enterprise Leasing

In Chapter Two, it was noted that it is difficult to privatize monopolies, especially in LDCs, and Chapter Three pointed out that reform of these activities under government operation is also difficult. What about a compromise that privatizes management, but not ownership? That is the appeal of management contracts and/or enterprise leasing.

What has been the international experience with these modalities? A World Bank survey could find only about 200 such activities worldwide, but found that about three-quarters improved profitability and productivity[49]. What distinguished more successful contracts from less successful cases? They concluded that contracts worked better in competitive markets (such as hotels, which were about one-quarter of the total observations) and that enterprise leasing was superior to management contracts because the former provided superior incentives.[50] This is doubly discouraging for their application in LDCs: first, because the most difficult problems will be in non-competitive sectors; and, second, because it is much harder to negotiate a lease agreement than a management contract because either the government has to pre-commit to a price for 5-10 years in advance, or the private buyer has to accept a return which varies with the future decisions of the government.

Still, this study was done some time ago, and other partial evidence suggests that the option not be discarded out of hand. For example, in Cote d'Ivoire: "The leased water company improved technical efficiency, increased new connections, became more efficient

[49]Hafeez Shaikh and Maziar Minovi, "Management Contracts: A Review of International Experience" (Washington, DC: World Bank. Cofinancing and Financial Advisory Services Discussion Paper Series No. 108, 1991).
[50] Their definition of management contract included what we have called enterprise leasing, as well.

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in billing and collection of receivables, and reduced the number of expatriate employees by 70%".[51]

So, consideration of management contracts should be given, perhaps under agreement with an international donor. For example, a donor government could be approached to see if they would arrange (and finance, as part of their foreign aid package) a project in which they would evaluate the national electrical utility and propose a management contract for, say five years, with training of local personnel as a key element of the contract.

## C. BOOT[52]

A Build, Own, Operate, Transfer (BOOT) is an arrangement whereby the government agrees with a private firm that it should develop a project that the firm would take full responsibility for, including owning the project, obtaining the financing, constructing any necessary facilities, and then operating it. The private firm would charge fees for use of the services produced by the project, from which it would expect to get its return on investment. After some specified period of time, say 20 years, the private firm would transfer the project to the government, which would then become the owner.

Build, own, operate, transfer projects were a popular vehicle for implementing infrastructure projects in the 19th century (most notably for the Suez Canal and many railways). They fell into disuse but were rediscovered in the 1980's as a vehicle for inducing foreign investment and expansion of capacity. The advantage to the government is that it has obtained benefits for society without having to use government funds or administrative capability to develop and operate the project. BOOTs are commonly used to generate new capacity in electricity, transportation and telecommunications, although they can also be used for other physical infrastructure such as roads, bridges, and parking garages.

Pakistan was one of the more prominent adopters of the method. By the late 1980's, electricity demand was far outstripping capacity, with load shedding at about one-quarter of peak demand, and this was placing a major constraint on overall growth of the nation. But, the government was facing both balance of payments and fiscal difficulties and could not finance expansion of capacity. Beginning in 1988, a series of BOOT contracts were negotiated. These were extremely successful in overcoming the investment constraint, and by the late 1990s there was actual excess capacity. On the downside, there were widespread accusations of insider deals and charges that negotiations favored the owners at the expense of consumers.

Similar results were obtained elsewhere at least in Asia. Early contracts were typically negotiated with a single supplier, while later ones were usually bid, with competition shifting the net gains from producers to consumers.

[51] Sunitia Kikeri, John Nellis and Mary Shirley, Privatization: Eight Lessons of Experience" (World Bank: Outreach #3 Policy Views from the Country Economics Department July 1992).
[52] Minor variants include BOT (Build, Operate, Transfer) and BLOT (Build, Lease, Operate, Transfer).

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Are BOOT projects a desirable part of the development mix in LDCs? Presumably, the first priority is to get existing infrastructure working, but for new projects they might well be considered. As always, it is critical to be sure that contracts are negotiated in a transparent fashion with due attention to political sustainability. Both negative and positive lessons can be learned from Pakistan.[53]

## D. Concessions and Franchises

These differ from BOOT only in lacking the transfer provision. Why choose one rather than the other? One argument sometimes made for BOOT is that the credibility of government's commitment to a government regulatory regime is greater for a shorter period and thus a buyer is more willing to enter into such a deal. An argument against is that there are perverse incentives as the transfer point nears and the concessionaire can make money by neglecting maintenance. Both of these arguments are probably secondary. On the economic side, benefits in the distant future are not worth much so the concessionaire is not giving up much. However, the real advantage of the Transfer aspect is probably political. In many countries it is politically acceptable to say that there is a temporary problem which foreigners will be allowed to help with, but ownership will revert to the nation when the crisis has passed, but politically unacceptable to simply say that a key sector will be owned by foreigners.

## E. Other Options

The other methods listed at the outset would seem to have less current applicability. Contracting out applies to minor services that would not seem to be a priority. Nonetheless, this should certainly be considered in lieu of giving additional responsibilities to SOEs. That is, if a new service is needed, do not assign this new responsibility to government without first considering the possibility that private firms, existing or still to be created, might be given that responsibility. Asset leases might well be temporarily appropriate if there are some resources belonging to a non-operating enterprise that is expected to be revived. For instance, if an SOE has equipment that it will not need for several years, it could be leased to a private firm.

Finally, although not on the decision tree, liquidation could be an important option, especially for unused assets and unviable enterprises. Many SOEs will have equipment, inventory, or other assets that could be sold. This would provide some income to the SOE and would re-deploy unproductive assets to better use. Some SOEs may be simply unviable—they cannot be sold and are too inefficient or deteriorated to be worth trying to save. Sale or closure, with any useful assets transferred to other government units, may be the best option. Such activities may also provide the credibility that serious efforts at reform bestow on the government, even if the scale of their efforts is relatively small. For

[53] A UNIDO manual on developing a BOT programme is available as a sales publication.

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example, "In Togo, although public enterprise reform proceeded slowly, the selling or leasing of assets in some ten public enterprises was an important sign of government commitment to private sector development."[54]

[54] The World Bank, *Industrial Restructuring: A Review of World Bank Operations*, June 26, 1995, p. 62.

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# CHAPTER V:

## Summary and Conclusions

The goal of this report is to provide an overview of options for dealing with SOE problems, and explaining their pros and cons in light of international experience. The previous four chapters outline options available to governments in dealing with their SOEs, and provide guidelines for dealing with various issues. This chapter provides some ideas for a sequence of activities that might be followed to implement an SOE reform programme. These should be considered only as illustrative or indicative, and subject to considerable modification in their actual application in any particular country.

To begin with, the agenda is important:

- SOEs which are neither reformed nor privatized create a drain on state resources, which hampers public sector development.

- SOEs which are neither reformed nor privatized provide shoddy and unreliable critical services in electricity, communications and transportation, and thus hamper private sector development.

- Smaller SOEs are often not operating and have significant assets tied up that could be either rehabilitated and used, or re-deployed for use by private sector firms and entrepreneurs.

At the same time, the agenda is a difficult one:

- Reforming SOEs is not easy anywhere. Fifty years of reform efforts around the world have resulted in a handful of well-run SOEs and tens of thousands that probably are not.

- Privatizing SOEs is not easy anywhere. Privatizing monopolies is particularly difficult because of the need to pre-commit to a long-run regulatory regime. Privatizing anything is difficult because of the necessity to do it in a way the public feels is equitable.

- The above challenges are even more pronounced in LDCs with their many urgent needs and a scarcity of trained people, institutions and resources to

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address those needs.

Nonetheless, steps for dealing with the SOE sector in an LDC need to be considered. Following is an illustrative sequence that might be followed in an LDC, assuming that no active reform programme now exists:

1. First, the **role of SOE reform in the overall development programme of the country** must be determined. SOE reform may have only a modest initial role, and therefore reforms that could be made to enterprises may not be a high priority, given other needs. The most important driver for private sector development is competitive markets and building the enabling environment. Privatization and reform of SOEs can play a role in this process, but are secondary to the objective of creating markets and an enabling environment. The SOE sector needs to be addressed, but with cautious use of resources. Funds spent on SOEs may be better used to promote new businesses, encourage foreign investment, or build the institutions a vibrant private sector will require.

2. The **overall capabilities of the government** to undertake a serious privatization and enterprise restructuring programme need to be considered. Other countries have made serious mistakes by forcing sales or undertaking expensive restructuring programmes before the country had the conditions, resources, and human skills to do the job properly. This is not to say that a careful privatization programme or enterprise reform programme should not be done. It is to say, however, that caution should be exercised, that quality should probably be more important than speed at this point, and that expensive restructuring, in particular, should be avoided.

3. Within this context, it is desirable to enunciate a **vision for SOE privatization and reform**. This might be as simple as: "Given other urgent national problems, dealing with SOEs is a low priority. In the short run, our only goal is to get a few key enterprises up and running, namely...". A more proactive vision might be something like: "In keeping with our strategy of private-sector led growth, it is the long-run policy of the government to privatize all SOEs (except, perhaps, some very short list). Short-run implementation of this goal will be constrained by administrative capacity. We will therefore begin by selling the easier enterprises first, that is, those that are small in scale and competitive or potentially competitive. Key non-competitive enterprises such as electricity will be reformed." Innumerable other formulations are obviously possible.

4. The question needs to be answered: **Who Should Decide?** It is suggested that an inter-ministerial group be given responsibility for ultimate oversight of the SOE reform. They can then appoint a small group (an SOE reform unit) to be their secretariat, and to be responsible for monitoring the SOE sector, perhaps in the President's office. They could work with, but not be under the control of, the line ministries presently responsible for SOEs. Their

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first task would be to undertake an inventory of the SOEs, and establish a database on them (names and contacts of managers; plant locations, addresses, and contact numbers; products, markets, major customers; financial statements, if available; important issues—former owners for restitution, environmental issues) and other databases (potential buyers, potential valuation specialists, consultants). The SOE unit should be given a budget and be authorized to make specific improvements to SOEs up to a certain limit, and beyond that would require specific authorization from the inter-ministerial group.

5. A decision is needed on whether or not limited **foreign aid** should be used to provide technical assistance to this office. Is there in fact a trade-off? Some countries may provide assistance for this purpose, but not for others. To find out, countries with best-practice SOE sectors (Singapore, Republic of Korea, Chile and France, for example) could be approached to see if they could make some of their experienced experts available to work with and help train staff in the new office.

6. The same applies to **support to key SOEs**. Could teams from best-practice firms worldwide be induced and funded to provide technical assistance? Management contracts for these firms could be considered, with training of national replacements being a key performance indicator.

7. A **quick analysis** could determine any urgent issues that need to be addressed relative to the SOE sector. Are there SOEs that are huge drains on the public treasury? Are there important SOEs whose poor performance is clearly hurting the country's development? For instance, if the garment industry is unable to operate because of a lack of wool or cotton, it may be necessary to quickly restructure or privatize those key textile SOEs. (On the other hand, of course, there may be better alternatives, such as importing the textiles or promoting the establishment of new private textile firms in the country). Are there SOEs with valuable assets that are not being protected and secured? Actions to address these problems, if they involve small costs, could be taken immediately. If the financial requirements are large, of course, a more thorough analysis must be undertaken first.

8. Once urgent matters are addressed, the group should develop an **overall SOE reform strategy**, in cooperation with the line ministries and other relevant participants. This is not intended to be a huge document, but instead a practical Action Plan. It should, however, be the result of considerable thought, particularly to the role that SOE reform will play in the overall economic development process.

9. It will be essential to **identify assets that are not being used** by the SOEs. SOEs often have idle equipment. Such equipment might be useful to an entrepreneur who wants to start or expand his business. Auctions could be organized on a regular basis for equipment or other assets the government

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owns that are not being well-used. Such auctions should be widely advertised to get potential entrepreneurs (or anyone, for that matter) to come and buy the assets. If it is not used now, but may be needed in the future, equipment could be leased to the private sector in the interim, thereby generating both output and revenue to help get the SOE back on its feet.

10. **No cost or low cost improvements** should be made immediately. Many SOEs, for instance, may have existing managers with little to do at the moment, especially if the SOE is not operational. They could work on immediate improvement measures. Perhaps the SOE can become operational merely by obtaining raw materials. Perhaps it can raise working capital by selling off unused assets or inventory. The onus should be put on management to come up with ideas for making low-cost changes that will make an immediate improvement on the SOE.

11. **Restructuring teams** should be formed at each SOE, and be asked to begin collecting data, brainstorming improvements, and eventually writing a business plan for the business. Also, the SOE reform unit could arrange workshops, on restructuring, on business planning, etc. and invite restructuring teams from each SOE to participate and learn. The idea is that, with relatively few resources, this could galvanize the management of each SOE to use their currently unused talents to begin making improvements to the SOE, and to begin planning for longer-term restructuring.

12. The **private sector** could be requested to **suggest SOEs for privatization** with responses being added to the database of potential buyers and potential SOEs for sale. A pragmatic approach would be desirable —when it appears that there is interest in an SOE, it should be decided how best to sell it now. Also, it appears advisable to start with smaller, competitive SOEs where there seems likely to be most interest on the part of buyers.

13. Advantage should also be taken of the experience and capital accumulated by **expatriates** who might want to return.

14. The initiation of a **public information campaign** is key. When a privatization transaction is taking place, every step should be publicized in the media to let the public see what is being done. This has many advantages, and one of them is that if the privatization does not work, for whatever reason, at least the public will understand that it was done properly and nothing was hidden.

15. For SOEs that will be sold in the medium or long-term, **full-scale restructuring plans** should be developed. These must include an initial diagnostic, a calculation of restructuring costs and an implementation plan. However, implementation of costly restructuring programmes should be avoided as much as possible, with emphasis placed on low-cost operational improvements rather than on purchase of facilities and equipment.

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16. Also, the rudiments of **performance contracting** could be applied. If a firm is not operational, management could be given a target date for preparing and costing-out a restructuring plan. If a firm is operational but has no accounts by which to manage intelligently, a date could be set by which accounts must be prepared. If it is operating with accounts, simple targets could be established for improvement in profitability if competitive, or increased output if non-competitive. These could be associated with some form of incentive for target achievement. This might be as simple as public accolades for success. It might be stronger, taking the form of monetary incentives or the promotion to more important positions for managers who do achieve their targets.

In summary, there is a strong need for **prioritization at various levels**.

- First, SOE reform needs to be assigned its proper place in an overall development strategy. While there is no doubt about the desirability and urgency of SOE reform, its costs and benefits need to be carefully weighed against other urgent demands on scarce resources.

- Second, while enterprises of overriding importance (e.g. for public service provision, for producing essential consumer goods or intermediate inputs, or out of superior social and political objectives) deserve to be addressed first in terms of either privatization or restructuring, they are also likely to be the ones requiring the most resources, financial and administrative. While one or a few immediate demonstration programmes for them may be possible, it is likely that the first SOEs to be actually privatized or restructured will be smaller ones, preferably ones operating in competitive markets.

- Third, while long-term reform and restructuring plans need to be drawn up, there is a host of short-term measures that can be taken to use idle equipment, motivate SOE staff and provide incentives towards improvement action.

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