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PRIVATIZATION
THEORY AND POLICY*

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* The views expressed in this paper are those of the author and do not necessarily reflect the views of the Secretariat of UNIDO. This document has not been edited.

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CONTENTS

PREFACE

This report was commissioned by the United Nations Industrial Development Organization (UNIDO). The contract signed between the author and UNIDO stipulates the following terms of reference:

"The study will specifically:

1. Analyse the theoretical foundation of privatization in mixed economies and pay special attention to theoretical arguments such as "public interest", "principal-agent" and "ownership economic efficiency" theories;

2. Assess the reasons for privatizing public enterprises in developed and developing countries;

3. Discuss the alternative methods of privatization and their pros and cons;

4. Discuss the recent experiences with privatization in different countries with distinctly different socio-economic organizations and levels of development, and include examples from developed and developing countries, as well as from at least two countries with former centrally-planned economy;

5. Indicate the similarities and dissimilarities among these three groups of countries and draw action-oriented policy conclusions;

6. Analyse quantitative methods which are conducive to privatization decisions irrespective of political parameters, and discuss the conceptual as well as practical considerations for a cost-benefit analysis of privatization;

7. Make recommendations related to future policy actions in developing countries and countries with formerly centrally-planned economy.

"A brief but up-to-date bibliographer reference related to methodological and practical issues should also be appended to the paper."

The report's content corresponds fully to the seven points of the terms of reference, but its organization differs slightly in sequence. The theoretical underpinnings of privatization (point 1) is covered in Section I. The reasons for privatizing public enterprises (point 2) is discussed mainly in Section II. The alternative methods of privatization (point 3) are dealt with in Section III. The recent experiences with privatization and their comparison (points 4 and 5) are elaborated in Section IV. The quantitative foundation of privatization decisions (point 5) is provided in Section V. Section VII concludes with recommendations with respect to future policy actions (point 7). Selected recent literature on the subject is given in Section VIII.

Addendum

This report, which was first submitted to the System of Consultations Division of UNIDO on January 1992, was issued on April 1992 (IPCT.156(SPEC.)). The author was given the understanding that it was distributed widely and well received and that a revised and expanded edition was in order.

This report is now revised and extended at the request of the Division. Since the privatization process is on fast track especially in Eastern European countries, the case studies on Hungary and Czechoslovakia have been brought up to date and the case of Poland has been added. Chapter IV now also includes the case of Mexico which is an example of the successful process of privatization. The report also contains a new chapter which focuses on international co-operation and privatization in general, and UNIDO's present and future role in providing technical assistance on privatization in particular. Finally, the chapter on the recent literature on privatization has been amplified and brought up to date.

INTRODUCTION

1. Privatization is a recent phenomenon. Although the substitution of private for public provision of various goods and services is not a recent phenomenon, the techniques that are utilized, the activities that are considered and the fervor with which it is embraced world over make privatization a distinct feature of the economic policies of the eighties. When growth in industrialized countries began to deteriorate in the late seventies and early eighties and recovery was slow to follow, the pendulum of thought shifted from one of considering the public sector a major contributor to growth to one of its expansion strangling the vigorous performance of the economies. Questions began to be raised about the efficiency and effectiveness of public sector activities, and pledges were made to reduce the size and scope of government.

2. A similar shift took place in many developing countries as well, resulting partly from the wider macro-economic problems that have afflicted them and partly from the policies recommended by international aid organizations. After the Second World War and in line with the then prevailing views on economic development, these countries, desirous to accelerate their economic growth in an orderly manner, had adopted a two-pronged approach towards their goal. One was to plan the economy: to set up guidelines for the private sector, and draw up plans for the public sector to follow. The other was for the public sector to engage directly in economic activity by means of State-owned enterprises (SOEs) and thereby expand their economic frontiers as full or partial entrepreneurs in the production of goods and services. Public production was viewed as essential given the

underdeveloped nature of resources and markets. The scale of investment required for growth often exceeded the capital-raising capacity of the indigenous private sector. Moreover, public ownership was looked upon as a means towards achieving social policy aims, such as a better distribution of income and resources, generation of employment or prevention of rising unemployment. Occasionally the SOEs competed with private enterprise; but in more cases than not they were monopolies. Over the years they came to be plagued with inefficiencies and survived only with subsidies and transfers from the central government budget; the monopolies, in addition, were allowed to fix input and output prices. These measures meant that the SOEs survived at the expense of consumers who ended up paying higher prices for inferior goods.

3. The SOEs fascinated the economists for quite some time and numerous volumes have been written in their favor or against. Today it is generally accepted that their impact on the economy has been more negative than positive. They became a fiscal drain on the budget, hindered the expansion of the private sector, and precipitated the deterioration of the general welfare of the country.

4. Can the situation be reversed? What are the remedies? What are the options available to the countries? Privatization has been the answer that has lately been given to these questions: let the government pull back its frontiers, and let the private sector assume the responsibility of producing goods and services efficiently.

5. Begun in the early eighties, today privatization is in progress the world over; State enterprises are being privatized in developing and developed countries alike with varying degrees of vigor and success. Undoubtedly, the leader in this arena has been Great Britain, followed by numerous others. France and Spain in Europe; Brazil, Chile, Honduras, Mexico, and Jamaica in Latin America and the Caribbean; Japan, Thailand, Singapore, Malaysia, Sri Lanka, Turkey in Asia and the Middle East have become notable proponents of privatization, some with concrete and successful results in the transfer of the assets of public corporations into private hands, others still faltering in the execution of officially accepted policy 1/. With the events in Eastern Europe in 1989, privatization has acquired a novel dimension by becoming the major policy component of the transformation of the centrally-planned economies into market economies.

1/ The 1989 World Bank Report states some 83 countries as having adopted the privatization policy with varying degrees of width and depth. See Techniques of Privatization of State-Owned Enterprises, Washington, D.C., 1988 (3 vols.).

6. Since privatization is a recent phenomenon, all doubts and misconceptions surrounding it need to be clarified to assure that it succeeds and the technical assistance given to that end is operationally useful. Prima facie, it is an easy concept to understand: it is the sale of government assets to private citizens. Yet it extends beyond this simple notion into broader and more complex issues involving the opening up of State monopolies to private competition, even privatizing some public services - such as public utilities or health care - which were the undisputable domain of the central or local governments, and resolving complex issues surrounding property rights.

7. While privatization continues to be a complex issue in mixed economies, it acquires additional dimensions in countries where economies were centrally planned. To convert these economies to the market economy model has been creating, and will continue to create for some time to come, several paradoxes that must be faced both at the theoretical as well as the policy level. To reduce the role of the State, reformers of the previously centrally-planned economies must take unprecedented "state" action. Not only must they build from scratch a reasonable facsimile of market economies, but they also must dismantle an economy that was centrally planned and very complex. In other words, construction and destruction will have to be carried out concomitantly.

8. Dismantling the public sector in these economies is like a double-edged sword. Privatization is a sine qua non in the long and arduous task of building a market economy from the wreckage of central planning. Yet the smooth and efficient progress of privatization itself requires that such a market economy exists even in a mixed form with its corresponding institutions of market pricing, financial institutions, a stock exchange, foreign-exchange markets, as well as a certain degree of free trade. Moreover, to function efficiently market economies rely on rules and institutions governing property and contracts, accounting and bankruptcy, taxation, pensions and unemployment systems, labour, regulation of banks and financial markets. The centrally-planned economies have only just begun to think of most of these issues in their attempts of a transition to a market economy.

9. Issues related to policies or practice of privatization both in mixed and ex-centrally-planned economies are addressed in this paper. However, the economic rationale of privatization must be fully understood prior to the discussion of policy issues. Section I deals with this aspect.

I. THE ECONOMIC RATIONALE OF PRIVATIZATION

10. Privatization can be justified on purely empirical grounds: public enterprises have performed dismally compared to private enterprises, especially in developing countries. This conclusion is reached when one scans through the vast literature on the subject matter. 2/ Hence, the more extensive public ownership of productive assets, the less efficiently will the economies perform. The question is why. The answer can be given via the combined theory of property rights, or principal-agent theory, and public choice.

2/ The empirical literature on the comparative efficiency of public and private enterprises is rather extensive. Because of the difficulty in accounting for many variables, other than ownership, that affect economic performance, such as market structure, regulatory framework, technical progressiveness of the industries etc., it is difficult to draw a very firm generalized conclusion. In addition, research has been hampered by data and methodology limitations and has concentrated its work on using easily observable variables, such as profitability, which may create a bias in favour of private ownership. On the whole, however, the findings suggest a greater internal efficiency in private firms than in public. The suggestion is especially valid when competition in product markets is effective. Studies of the U.S. electric power industry, where two types of ownership many times exist side by side in similar market conditions, have found public sector utilities to exhibit higher as well as lower internal efficiency. Nor do the lead to the conclusion that allocative efficiency is necessarily improved by public ownership. Obviously, regulatory environment, including lower input prices facing public utilities and tariff structures, has had a marked influence on the outcomes. See e.g. R. Millward, "The comparative performance of public and private ownership", <u>The Mixed Economy</u> E. Roll ed., (London, Macmillan, 1982); A.E. Boardman and A.R. Vining, <u>A Comparison of the Performance of Private, Mixed and State-Owned Enterprises in Competitive Environments</u>, Columbia University, Faculty of Commerce, (New York, 1987); Edison Electric Institute, <u>Analysis of the Differences among Alternative Forms of Utility Ownership in the USA</u>, (Washington, D.C., 1985); L. de Alessi, "Ownership and peak load pricing in the electric power industry", <u>Quarterly Review of Economics and Business</u>,(1977); and S. Peltzman, "Pricing in public enterprises and electric utilities in the United States", <u>Journal of Law and Economics</u>, vol. 14, (1971).) In other industries, such as refuse collection, the findings support the proposition that private firms exhibit greater internal efficiency. Here competitive forces may have been the significant factor, since competition acts as a mechanism that weeds out the less efficient firms. (See e.g. H.M. Kitchen, "A statistical estimation of an operating cost function for municipal refuse collection", <u>Public Finance Quarterly</u>, vol. 4, No 1, (1976); E.S. Savas, "Policy analysis for local government: public versus private refuse collection", <u>Policy Analysis</u>, vol. 3,

A. Principal-agent theory

11. The property rights, or principal-agent, theory is based on the argument that changes in the allocation of property rights alter the structure of incentives faced by decision makers in the firm and hence lead to changes in both managerial behaviour and company performance. Accordingly, a principal (or group of principals) seeks to establish incentives for an agent (or group of agents), who takes decisions that would maximize the principal's objectives. The setting up of such an incentive structure needs to take into account the divergent objectives of principals and agents and the differences in the availability of information to both. Company management can be regarded as agents for shareholders in the case of private ownership, and for the department (or ministry) of government in the case of public ownership. Privatization will immediately result in both a shift in the objectives of principals and the incentives to be offered to the management. As a result both the allocative efficiency in the market - producing the maximum level of output, given cost - as well as the internal efficiency of the firm - minimizing the cost, given the level of output - will be altered. A trade-off will ensue between both efficiencies. The theory recognizes that managerial incentive structures and economic performance are influenced, in addition to ownership, by the degree of competition in the industry and the regulatory constraints within which the firms operate. Thus, privatization cannot be assessed properly without taking into account these additional influences.

(1977); and B.J. Stevens, "Scale, market structure and cost of refuse collection", Review of Economics and Statistics, (1978).) The analysis of the economic performance of airline, ferry and gas and electric appliance industries and of refuse collection in the United Kingdom leads one to conclude that private firms exhibit greater internal efficiency than their public sector rivals. It has been found that nationalization has led to the deterioration in the productivity of the British steel industry. These studies too back the conclusion that where competition is effective, private enterprise performs better on both internal and allocative efficiency grounds. (See e.g. R. Pryke, "The comparative performance of public and private enterprise", Fiscal Studies, vol. 3, No 2, (1982); P.J. Forsyth, "Airlines and airports: privatization, competition and regulation", Fiscal Studies, vol. 5, No. 1, (1984); C.K. Rowley and G.K. Yarrow, "Property rights, regulation and public enterprise: the case of the British steel industry 1957-75", International Review of Law and Economics, vol. 1, (1981); and K. Hartley and M. Huby, "Contracting-out in health and local authorities: prospects, progress and pitfalls", Public Money, (September 1985).) These conclusions do not preclude the existence of efficient public enterprises; if they are efficient, however, this is generally the exception rather than the rule.

12. Simply put, the agency problem simply runs as follows: the principal (owner, shareholders) of a firm contracts an agent (manager or managers) to run the firm. The principal's objective is to choose that incentive scheme which will maximize his expected utility function subject to the constraint that the agent himself will want to maximize his own expected utility function given a specific State in the world. The principal does not have access to shared information, so he faces difficulties in providing appropriate incentives to the manager and in monitoring his performance. The question is determining the optimal incentive scheme for the principal to lay down for the manager. The agent, in turn, will seek to maximize his own expected utility function, given the incentive scheme, subject to the constraints that:

- The principals maximize their profits;
- Principals change, since shares are marketable (take-over threat); and
- Control of the company can be lost, if creditors succeed in managerial changes in the event of a default (bankruptcy threat).

13. Each has implications for the internal efficiency of the firm in varying degrees of subtlety. Dispersed shareholding, where interests of principals do not necessarily coincide, may lead to suboptimal monitoring, since information is not without cost. This means that managers may not always act in the best interest of the shareholders. However, since shares are marketable, the price of the share will reflect the management's performance vis-à-vis the optimal contract, i.e. its degree of success in attaining the highest degree of internal efficiency. This may bring about a take-over threat with post-take-over increase in internal efficiency, a rise in the share price, and hence lead to capital gains. Such a threat, therefore, will act as an incentive that deters management from pursuing policies that are not in the interest of shareholders, i.e. it will enforce internal efficiency. 3/ The effect of bankruptcy on incentives for internal efficiency is ambiguous; managers, faced with a bankruptcy threat, no matter what decisions they may take, will be induced to enjoy their discretion in the short run without any concern for the internal efficiency of the firm. Bankruptcy will have a substantial role to play only in times of depressed demand or intense market competition.

3/ This link between internal efficiency and take-over threat may not be as strong, if one considers that take-overs may originate also from a desire to maximize managerial utility and to increase market power. That is not to say, however, that take-over threats have no role to play in promoting internal efficiency. See Vickers, op. cit., pp. 19 ff.

14. There are substantial differences between private and public ownership of a firm that are conducive to greater efficiency under the former. The most obvious differences in the principal-agent relationship in case of public ownership is that the objectives of the public sector are different; shares are not marketable; and there is no direct equivalent to the bankruptcy and take-over constraint on financial performance. Governments do not typically seek to maximize profits. Rather it is assumed that they seek to maximize economic welfare, however defined, and act in the best interest of the general public. In this respect public ownership is viewed as a response to the failure of private markets to secure efficient outcomes and as providing a first-best solution to the agency problem. 4/

15. If management monitoring is assumed to be equally effective under both systems of ownership, then one can argue that public ownership can have the advantage of correcting the deviations in managerial decision making and setting appropriate incentive structures for the managers of publicly-owned firms. However, under public ownership information gathering for the purpose of monitoring the managers' performance is entrusted to a single body, whereas private ownership typically involves the participation of many individuals and institutions that are frequently specialists in the given task. This latter is conducive to the discovery of a greater volume of relevant information. Thus, information gathering becomes more efficient under private ownership, hence may provide the more effective method of control, and assure a greater degree of internal efficiency.

B. Public choice theory

16. The principal-agent theory, given its tenets, may very well be considered as the micro theory of privatization. However, as explained above, monitoring is not the exclusive prerogative of a single departmental body. Other groups are also involved, and their behaviour can be best understood within the tenets of public choice theory, especially if the above discussion is to be extended to a macro level.

17. Two additional distinct groups now come into play: politicians and bureaucrats. Then four categories result in the hierarchy of monitoring public enterprises: the general public, elected politicians, non-elected bureaucrats, and the managers of publicly-owned firms, each with their distinct expected utility functions which they aim to maximize and none having access to identical information. The result is suboptimalities, i.e. internal inefficiency of the firm.

4/ Although market failure provides the rationale for public policy remedies, yet the remedies themselves may fail for reasons similar to those of market failure. See C. Wolf, Jr., "A theory of non-market failure: framework for implementation analysis", Journal of Law and Economics, vol. 22, (1979).

18. Because of the asymmetries in information, the politicians may find that improving the economic efficiency of the firm may not improve their electoral prospects; rather they may find it to their advantage to set the prices at below marginal cost so that their chances of electoral success are enhanced. In the utility function of the bureaucrats the size of the departmental budget and the rents that accrue to them occupy a predominant role. Since payoffs are an increasing function of the budget size, the bureaucrats' interest would lie in procuring as large a budget as possible. They may be aided in their endeavour by the politicians themselves, since the welfare of ministers/secretaries can be expected to be positively linked to that of the bureaucrats. The consequence is internal inefficiency. The public managers themselves can secure higher pay, greater power and prestige than their private sector counterparts by forming coalitions with politicians and bureaucrats. As a result, social objectives get to be replaced by political objectives, political interventions are made in managerial decisions, and imperfections ensue in the incentive structures of publicly-owned firms. All the above suggest that public enterprises are likely to have higher costs and lower productive efficiency than comparable enterprises in the private sector. 5/

19. If differential information required in the monitoring of public enterprises by different groups each seeking to maximize its own objective give rise to productive inefficiencies in democratic societies, public choice theory tells us that public ownership in dictatorships, otherwise command economies, can be expected to be higher than in democracies when one takes into account the sources through which information is received which is required for monitoring. 6/ These are basically the news media, the political entrepreneurs themselves, the bureaucracy, and the individual's own experience. In a democratic society, the freedom of media is provided constitutionally which makes a unique bias improbable. in addition, the individual will have access to simultaneous information from various sources. In a dictatorial regime, the optimal rule is media censorship, since thereby information flows can be controlled and biases can be generated in the interest of the politicians and bureaucrats. There will be no tendency to identify and inform

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5/ The literature on the subject matter is extensive. The following selective works provide comprehensive analyses: Thomas E. Borcherding, ed., Budgets and Bureaucrats: The Sources of Government Growth (Durham, NC, Duke Univ. Press, 1977); Albert Breton, Economic Theory of Representative Government (Chicago, Aldine, 1974); Ramón Cao-Garcéa, Explorations towards an Economic Theory of Political Systems (New York, Uni. Press of America, 1983); and Dennis Mueller, Public Choice (Cambridge Univ. Press, 1979).

6/ For details on this point see Cao-Garcéa, op. cit., pp. 89 ff.

the public of government inefficiencies or of wrongdoings. There will be no incentive for the ruling coalition to implement programmes of cost effectiveness. All the information in the system will be designed to maximize the preferences of the dictator and his supporting coalition. There is no possibility of counterbalancing information, as is the case in democracies. Information will be received from one single biased source. Thus the citizen will lack information on a frame of reference to evaluate the performance of the public sector. Further, even the dictator himself will lack many of the necessary information to evaluate the technical performance of his officials, simply because such information will not be produced in the system, since nobody will have the incentive to collect it.

20. The bureau in a dictatorship has monopoly power over the supply of technical information with regard to its internal activities. The bureaucrats, therefore, will bias the information they produce to the dictator and request size increases to effectively carry out the assigned tasks. There will then be more people producing a given level of output, reducing the average work effort of the bureaucrat, and possibly leading him to have his agency perform activities of his private interest without reporting them to the dictator. The information is produced by the same bureaux that are subject to supervision. Bureaucrats thus can doctor the signals in their own interest, and since information from external sources is suppressed, there is no other source with which the generated information can be contrasted. The dictator is therefore more limited in monitoring his bureaucracy than his democratic counterpart. Bureaucrats lose their incentives to promote efficiency and reduce the level of productive efficiency. Government officials tend to take advantage of the situation to improve their own well-being. All this leads to the deterioration in the productivity of the public sector.

C. Competitive forces

21. Section A elaborated the impact of ownership on internal and allocative efficiency. Competitive forces are another factor that act upon industry performance and improve the internal and allocative efficiency of public enterprises in mixed markets. For one, competitive forces break the monopoly of information as discussed earlier. Secondly, they allow the freedom of entry into markets. This entry threat compels the firms to produce at minimum cost. Moreover, competitive forces create incentives for the introduction of new products and techniques and thus are conducive to innovation. All these compel the publicly owned enterprise to streamline its costs, adjust its production to consumer wants, and be competitive in the prices it charges. Thus, the competitive process acts as a discipline for lethargic managers; it effectively regulates company behaviour; consequently is at the heart of much debate on privatization policy.

22. This is not the place to elaborate upon theories of competitive forces and their impact on welfare; all these make up a great segment of the entire micro-economics literature. Suffice it to state that it is an incentive system and a discovery mechanism in a world of imperfect information that constrains the design of incentive contracts and leads to inefficiency. Competition, by making incentive schemes more responsive to effort and allowing for payments according to performance, promotes efficiency and thus helps reduce the existing inefficiencies.

D. Regulatory policy

23. Regulation under asymmetric information is yet another branch of the principal-agent literature that examines the optimal design of incentive contracts. It comes into plan when, because of market failures, the need arises to influence private sector behaviour and constrain its economic decisions. 7/ The problem here is one of the regulators designing incentives for efficiency which, given the asymmetric of information, i.e. imbalanced knowledge about industry conditions between the regulating agency and the regulated firm, will induce the firm to behave in the public interest. The managers will have to be motivated to exploit their superior information to advantage despite the problem of imperfect monitoring. Regulatory policies that aim to equate price to unit cost become efficient only if the firm's cost or the extent of its cost reducing efforts is known to the regulator. Otherwise the firm extracts a profit from its informational advantage, and allocative and internal efficiencies are not achieved. 8/ It can, therefore, be expected that the presence of better informed regulatory bodies would yield high social returns.

7/ Again, this is not the place to elaborate upon the vast literature on regulation, its theories, the reasons for its need, and the principles guiding its policies, which constitute yet another large segment of micro-economics literature. For a survey see, B. Caillaud and others, The Normative Economics of Government Intervention in Production in the Light of Incentive Theory: A Review of Recent Contributions (Stanford, Standford University, Technical Report 473, 1985).

8/ See D.P. Baron and R.B. Myerson, "Regulating a monopolist with unknown costs", Econometrica, vol. 50 (1982) and J.J. Laffont and J. Tirole, "Using cost observations to regulate firms", Journal of Political Economy, vol. 94 (1986).

E. Concluding remarks

24. This section has examined the influence of private and public ownership on enterprise performance. It has concluded that private ownership, in general, is more conducive to efficiency, but that the comparisons of performance under both types of ownership need to take into account the institutional environment - competitive forces and regulatory framework - as well as the market structure of the industries in which the firms operate. At the root of the greater effectiveness of private ownership lie systems of information gathering and monitoring. Imperfect and asymmetric information among categories of principals and agents constrain the design of incentive schemes. The constraint is the strongest when there is monopoly of information as is the case in dictatorships. In contrast, competitive forces reduce the asymmetric and make possible incentive schemes which are more sensitive to effort and thereby promote efficiency. In consequence, regulatory forces to enhance competition would be conducive to greater internal and allocative efficiency.

II. POLICY PARAMETERS OF DIVESTITURE

A. General remarks

25. The theoretical arguments of the previous chapter demonstrate clearly the relative inefficiency of SOEs with respect to their counterparts in the private sector. This inefficiency can be stated in very simple terms as consumers ending up paying higher prices for inferior goods. Moreover, the fiscal drain on the budget that results from the internal inefficiency of publicly-owned firms distorts the overall allocation of resources in the economy in addition to distorting the allocation of resources within the total budget: government revenues get to be diverted from other high priority areas, such as infrastructure development, health, and education, to covering the deficits of the SOEs.

26. The reasons for the inefficient operation of the SOEs are numerous. The most important ones are briefly:

- Inadequate planning, lack of feasibility and market studies resulting in ill-conceived investments;
- The impossibility of bankruptcy, hence lack of a financial discipline similar to that imposed on the private sector;
- Favorable financial treatment relative to private enterprise;

- Lack of skilled managers and administrators as much as or more than in the private sector;
- Centralized decision making leading to inefficiencies;
- State intervention and interference into day-to-day operation of the enterprises;
- Unclear, multiple, or conflicting objectives; and
- Political patronage which obstructs the efficient operation of the firms.

27. The consequence has been, especially in developing countries where SOEs have infiltrated all segments of the economy, the deterioration of the general welfare of the country. In an attempt to reverse the situation and to have governments pull back their frontiers many countries have privatized, i.e. let the private sector assume the responsibility of producing goods and services efficiently. This has provided a series of benefits which can be grouped under four headings:

- Increase in the quality of goods and services available in the market and a response to consumer needs and demands;
- An end in costly deficits to keep inefficient SOEs afloat resulting in reduced budget deficits;
- Creation over the long run of a greater number of jobs and opportunities by allocating resources through the free market; and
- Creation and/or fortification of a middle and entrepreneurial class who are the backbone of democracy and political stability.

B. Basic conditions for privatization

28. The road to privatization is rather complex, nor is privatization the solution to every ill. 9/ Privatization will also not come about by itself, the exception being instantaneous privatization attempts that occurred in Eastern Europe after the demise of their command economies.

9/ The inappropriate use of privatization techniques in the past have yielded more unwanted results than it tried to solve. See H. Nankani, "Techniques of privatization of State-owned enterprises", World Bank, Selected Country Case Studies, vol. II (Washington, D.C., 1988, technical paper No 89), esp. pp. 15-17, 39-41, and 145-146.

29. Generally, privatization requires a strong political will and the highest commitment from policy makers. Political leaders must make the hardest political and economic decisions while in office when their future is determined by the votes they can muster. But given the expected benefits of privatization, the decision to privatize is a critical and valid test of their right to leadership and of their long-term vision. Privatization also requires the receptiveness and understanding of business leaders. Its success depends upon their willingness to take risk and upon their faith in the future of their country. The same applies to workers who will be put in jeopardy by the short-term job losses privatization could entail. Privatization also requires the collaboration of the private and public sector in creating a politico-economic environment where the private sector can function efficiently. The overall policy environment, which involves market forces, regulation, and protection of property rights, is crucial to the success or failure of privatization. In countries where property rights are not conducive to privatization, the political will is likely to be frustrated unless the legal system, and more specifically property rights, are altered to enable the transfer of public ownership into private ownership without legal impediments.

30. Assuming that political will and commitment are not lacking, the following rules must be followed in any attempt to privatize:

- The conceptual arguments and the empirical evidence that demonstrate the superiority of private supply must be presented clearly and various pressure groups, professional organizations, and all spectrum of political parties must be targeted for this presentation;

- The debate regarding the choice between public and private finance must be separated from the choice between public and private supply;

- The decision regarding private versus public supply must not rest in the hands of bureaucrats and business representatives whose vested interest are against privatization;

- The necessary macro-policy decisions related to market regulation or deregulation must be put into effect concomitantly with privatization.

31. This last point is especially critical for the success of privatization. Policies and actions conducive to a favorable environment must accompany privatization; otherwise the transfer of ownership from the public to the private sector can run the danger of failure. Thus, privatization must not be considered simply as a change in property rights, but must embrace a set of macro-economic policies, political tact and willingness.

C. Objectives of the government

32. The government objectives underlying a privatization programme vary widely among the countries and may include some or all of the below: 10/

- Budgetary relief from the financial burden of SOEs, such as subsidies and debt services requirements, as well as relief from the administrative burden;

- Increased efficiency of SOEs which is achievable even through partial privatization;

- Implementation of policies stated at the time of creation or the acquisition of SOEs;

- Undesirability of competition with the private sector;

- Greater revenue from State assets;

- Improved business conditions resulting from the promotion and development of private firms;

- Increased competition through the sale of production units singly or in small groups; and

- Development of wider business ownership and encouragement of wider distribution of share ownership.

33. Whatever the objectives, any action to privatize must take into account that what is involved is not a mere sale of shares to new owners. Privatization does not permit dogmatic treatment and every case needs to be examined on its own merits. Privatizing a national airline or electricity-energy complex will have to obey a different set of rules than privatizing small- or medium-size manufacturing enterprises, since industry and market conditions and technology for the two vary significantly. Granted, privatization techniques are, as a rule, a function of government objectives, but the conditions of the candidate SOE, its sector, and finally country characteristics play a dominant role in the use of one technique or another. The case might be made that certain SOEs, however inefficient they may be, may be considered essential to national defense. Public utilities, when privatized, may quickly convert to monopolies unless a set of ancillary arrangements accompany the act of privatization to redesign the regulatory policies.

10/ These are clearly stated in C. Vuylsteke "Methods and implementation", World Bank, op. cit., vol. I, (Washington, D.C., 1988, technical paper No 88) pp. 57-58 and detailed in E. Berg and M. Shirley, "Divestiture in developing countries", World Bank (Washington, D.C., 1985, Discussion paper No 11).

34. Moreover, despite the desirability of a wider spread of share ownership, public offerings are a near impossibility where financial markets are absent or weak. As a result privatization might lead to private monopolies and thereby defeat its very purpose.

35. Whichever modality is chosen in the final analysis, emphasis must be placed on simplicity, flexibility, speed, and transparency.

36. There will always be constraints to privatization. One is the absence of financial markets as mentioned earlier. In this case the modalities and alternatives of privatization will take different forms, such as sales of assets to employees as opposed to pricing and issuing of shares in the stock market for public purchase.

37. A second constraint is the employment effect of privatization. It is commonly assumed that privatization will generate employment losses especially in those SOEs that are overstaffed. Two qualifications are in order in this respect. For one, the job losses in question are a short-term phenomenon; when long-term indirect employment creation that results from privatization is taken into account there may occur an overall employment expansion in the economies. 11/ The second qualification is that under the current structural adjustment programmes, which call for SOE restructuring, employment trimming will take place in any case even when SOEs continue under public ownership. The issue should in fact be addressed not as a consequence of privatization, but as employment consequences of SOEs restructuring irrespective of ownership. 12/ Nonetheless, it is an extremely sensitive issue and conducive to political opposition to privatization.

38. A third constraint to privatization is the excessive indebtedness of SOEs. When the debt burden is well above the value of the assets of an SOE, no known method would actually accomplish privatization, unless the governments review and resolve the debt problem irrespective of privatization.

39. Finally, the desirable level of private ownership suggests wide variations in government policies. Whether privatization is to be full or partial will depend upon policy decisions constrained by the socio-economic set-up of each country. The avoidance of concentrated ownership, restrictions on foreign ownership, avoidance of private monopolies would all willy-nilly require different policy measures and privatization techniques.

11/ This point is dealt with in detail in Section V.C.2 where direct and indirect employment effects are discussed.

12/ See The World Bank, op. cit., vol I, p. 4.

III. METHODS OF PRIVATIZATION

A. Introduction

40. Implicit in the discussion so far has been the concern with whether or not free market forces are operating in a given country. Privatization is the transfer of ownership and control of an enterprise or activity from the public to the private sector. The emphasis is on activities and not just on public enterprises, and the inclusion of control as well as ownership clearly signals the recognition of the question at issue.

41. While one can accept the principle that the goal of privatization is the promotion of free market forces, one may not accept, in all cases, that the first best policy to achieve this objective is the sale of public enterprises. Much depends on the stage of development of the country in question as well as the conditions of the industries involved. Nevertheless, a generic plan of action can be developed which would be applicable by and large in all cases. Granted, variations will have to be introduced into the generic model, but these variations should not alter drastically the logical steps discussed here. 13/

B. The privatization process

Stage I. Consensus building

42. Once a government makes a broad policy decision to adopt privatization as its platform, efforts must first be concentrated on developing an agreement among the key support constituents on the rationale, objectives and basic elements of the programme. The support must be enlisted of opposition parties, labour unions and potential national investors via negotiations, public forums etc. where they must be made fully aware of the benefits of privatization.

13/ The sequence of events that should precede actual privatization have already been put forward in several publications. Three are worth the mention: The World Bank, op. cit., Technical Paper No 89, pp. 4 ff.; Touche Ross, Transforming State-owned Enterprises (no date); Gordon O.F. Johnson, Country Privatization Strategy Guidelines (Washington, D.C., USAID, 1989).

Stage II. Legislation/organisation

43. The present jurisprudence must be quickly reviewed and the existing legal impediments to privatization must be eliminated. An organization entrusted with the power to privatize must be set up. Its mandate cannot be less than to overview the privatization process, and prepare and implement all the technical criteria. Such organization should be headed either by a minister or by an individual to be made responsible to the Cabinet. Its basic specific functions should be to:

- Conduct studies related to selecting the enterprises;

- Value the assets of the enterprises;

- Prioritize the SOEs to be privatized;

- Prepare proposals with respect to legal and financial requirements.

Stage III. Discussion at the Cabinet level

44. Upon recommendations of the organization in charge of privatization the Cabinet should review the candidate enterprises and select those that meet the crucial criteria of:

- Overall policy concordance;

- Profitability of the SOE;

- Management skills of the SOE;

- Potential benefits to consumers;

- The need to restructure the SOE before its privatization and the financial requirements;

- Employment implications and employment alternatives.

Stage IV. In-depth review

45. The final selections by the Cabinet should then be referred to the privatization organization for an in-depth review and for the preparation of the modus operandi of the privatization process.

Stage V. Final choice

46. Upon the recommendation of the privatization organization the Cabinet should declare its option for each SOE, and determine the methods of privatization.

Stage VI. Implementation

47. The privatization organization then should prepare detailed business plans and prospectuses and enter into negotiations with the potential new owners of the SOEs.

Stage VII. Regulatory framework/public policy

48. The activities at this stage should actually be carried out concomitantly with Stage VI and should be the inherent responsibility of the government and the legislative body. Among the activities of this stage are:

- Review and redefining of property rights;
- Regulatory framework for the control of private "natural monopolies";
- Investment areas open to foreign capital and profit repatriation mechanisms and guarantees;
- Redesigning of incentives to efficiency and productivity;
- Safeguards against re-nationalization.

C. Privatization alternatives

1. Divestiture

49. Divestiture can include the outright or partial sale of State holdings to private sector interests or the liquidation of the assets of some public enterprise. The pure sale of share interests in the type of activity normally is defined as privatization in the sense that what was formerly public now becomes part of the private sector portfolio. Liquidation is also privatization, for although in the process of liquidation no new private entity results, the assets themselves become part of the stock of private assets.

50. While divestiture policy may have short-term goals like budget relief, the fact that the plan for privatization is executed in a concentrated and programmatic way indicates something more than an incremental policy responding to an ongoing evaluation of individual State-owned firms.

51. Partial divestiture may respond to a very different philosophy and to very different objectives. Why does a government sell off some shares in public enterprises but not all? Frequently, small sell-offs to multiple

shareholders respond to a desire to promote capitalist values in the "little man" - very often the trade union or cooperative sectors. On the other hand, a small sell-off to a single shareholder might have a very different motivation, such as bringing in an important client or supplier or creating profit-oriented pressures within the board of directors.

52. In the first case (bringing clients and suppliers) private sector participation could simply ensure greater control over the whole production chain, and may actually reduce the free play of market forces. By such a process, the public enterprise would firm up its implicit contracts and amplify its vertical integration. In the second case (bringing profit-oriented pressures into the boardroom) market forces are strengthened, at least as long as peace is maintained among the partners.

53. Likewise, asset liquidation may have different effects on the workings of the national market, depending on the particular situation at hand. Logically, the State would sell off a hopelessly unprofitable enterprise that nobody wants to touch. The product would be produced and sold at market values and supplied according to how much the consumer wants to buy. Resource allocation is improved, and the taxpayers probably get a break. A second scenario might yield a different result, however, depending on the market structure of the product. Assume, for instance, that the State liquidates its interest in the market to a sole private supplier who can now proceed as he likes. Such a possibility should not be set aside as the exception that proves the rule. In many modernizing countries, particularly with small local markets and imperfect competition, it is common for an industry to be dominated by a duopoly or an oligopoly in which the State plays a leading role in price setting and market division.

54. The sale of equity can be via offers for sale or by tender. In the former method shares are offered at a set price; in the second bids are invited for shares above a given minimum price. Subsequent values of the shares are determined through trade in the capital markets. Because of the difficulty of correctly establishing the market value of a public enterprise in the absence of relevant information, both methods can give rise to problems. Underpricing of offers could lead to oversubscription which calls for some rationing scheme. A price significantly below the subsequent market price would give the lucky applicants the opportunity to realize substantial capital gains after the privatization. This problem, however, can be circumvented by selling the shares in lots to let the market determine the trading price before the majority of the shares are placed. Should oversubscription be the case in tender offers, excess demand can be rationed by allocating the shares to the highest bidders, and the share price becomes the striking price. Undersubscription sets the value of the share at the minimum price, and the underwriters take up the remaining shares.

55. Other arrangements of divestiture can take the form of worker participation and equity for debt swaps especially where domestic capital markets are not sufficiently developed. In the case of worker participation, workers of the public enterprise would receive shares in the enterprise with the understanding that they would repay the government or relinquish a claim against it over a specified period. In this case the government would continue to bear part of the operating risk even after privatization, for in case of failure the government will not have received full payment.

56. The debt/equity swap involves the sale by a foreign creditor of the enterprise's debt to a third party who is interested in acquiring an equity portfolio. The swap usually is made at a discount in the secondary market. All parties involved benefit therefrom. The bank participating in the arrangement reduces its portfolio of troublesome loans; the debtor government converts the debt into domestic currency to be used in private investment; the external debt is reduced without spending scarce foreign exchange; and the investor benefits from the reduced effective exchange rate. Thereby the privatization process is eased significantly. 14/

2. Contracting

57. Contracting out or the granting of operating concessions may be considered to be one of the more feasible options for privatizing the economies of the developing world. Here, the State retains its authority over a sector or industry, and may retain ownership of capital assets, but the contractual relationship with a private operator injects into the relation elements of profit maximizing and cost minimizing, at least when the Government seeks these goals. This option is even more feasible when private companies prefer to act as contractors or concessioners. They avoid certain risks, may make no capital investments, and can nevertheless profit from their expertise if the contract itself gives premiums of this type.

58. Some multinational corporations have discovered the advantages of contracting long ago, particularly in developing countries. An well-known international hotel chain does not own hotels; it merely runs them, standardizes them, advises on their design and construction, and incorporates them into its world-wide reservation system. Other companies, whose comparative advantage is technological know-how, have favoured technical assistance contracts over direct investment, because the contract enables them to profit from their knowledge without suffering much capital risk in the process.

14/ Such swaps have been made quite frequently especially in Latin America.

59. Governments increasingly favour contracting out for different reasons. The riskiness of asset ownership is hardly a consideration for them, due to their wide diversification. On the other hand, since the private sector has a comparative advantage in managerial skills and perhaps in technological knowledge, Government can reduce the costs typical of its own management difficulties. Contracts also have the virtue of being renegotiable, which reduces the costs of errors in decision making. Furthermore, legal restrictions may require (or be deemed to require) government direction in a given sector, such as health, education or public utilities.

3. Attrition

60. The least noticeable form of privatization is one in which the Government simply changes its way of initiating new projects and allows the private sector to invest in areas that were formerly exclusive to the State. By a process of attrition over time, the State is expected to control fewer and fewer transactions.

61. This type of privatization should be expected to occur naturally in countries undergoing industrialization, because the very process of economic development should create new private actors capable of engaging in activities in which in an earlier stage they could not. Privatization by this sort of attrition depends largely on the lobbying skills of the private sector itself. It is likely that the Government will fail to notice the new capabilities of the private sector until the private sector begins to toot its horn.

62. It is difficult to conceptualize the measurement of privatization by stealth or attrition. We would have to have some way of deciding which private investment would have been governmental under a former economic regime. It would be easier to depend on aggregate statistics that would show, netting out divestiture, whether the public or the private sector was growing in importance in the national product.

4. Competition

63. The previous discussion make it clear that promoting competition is at the heart of the privatization debate. Those who resist privatization in general do not question its objective - creating free markets and efficient production - but question whether divestiture of public enterprises is the only way of attaining the objective. In some cases the goal may be to improve management of public enterprises or to increase the competitiveness of the markets in which they operate. Thus, if privatization policy is to be judged by the direction of such policy, it seems reasonable to examine this sort of shift.

D. Privatization in centrally planned economies

1. Some special issues

64. The preceding discussion has the implicit assumption that privatization takes place in a mixed economy where, however meek it might be, there is in fact a private sector and, however weak it might be, there is a functioning capital market. Privatization in these economies is essentially a matter of redefining the boundaries of private and public sectors.

65. Privatization in centrally planned economies, or command economies as they are sometimes called, acquires new dimensions. Market economies rely on institutions and rules that have been established over a century or more. Property and contract laws; accounting and bankruptcy rules; tax codes; labour laws; bank and financial market supervision are the most obvious ones. Thus, there already exists a legal and institutional market economy framework in the so-called mixed economies. Privatization in such economies, therefore, does not require the creation of a new legal-institutional framework. In contrast, in (ex-)centrally planned economies such a framework will have to be put in place prior to or, at least, concomitantly with privatization Consequently, a rapid privatization is bound to be an exception rather than the rule. A single decision of "let us privatize" will not ensure the transformation of a socialist economy to a capitalist one.

66. Major challenges and dangers face the (ex-)centrally planned economies. A recent article summarizes them as follows: 15/

- Exactly how can a central planning apparatus be dismantled with a minimal disruption?
- In what sequence should price controls be abandoned to avoid serious inequity and possible violence?
- How should a nation go about privatizing an economy comprised entirely of State enterprises and State-owned assets?
- Which comes first, privatization of capital markets?
- Is political and public support best gained by selling or giving away enterprises, and to whom - managers, workers, or the public?
- How much, if any, should foreigners be allowed to buy?
- What are the appropriate monetary and fiscal policies during this extended period?

15/ See E.S. Savas, "The Rocky Road from Socialism", Privatization Review (Spring 1990) p. 18 ff.

2. Factors affecting privatization

67. Should these challenges be met, then specific factors affecting privatization will surface. These are sui generis.

Problem of ownership

68. In centrally planned economies the control of the companies is in the hands of managers and workers who own them in all but legal name. To be able to sell the companies the State has first of all to seize the control back which is tantamount to renationalization, an impossible task. Hence, privatization efforts require that existing managers, not the State, formulate the plans to privatize.

Identification of assets

69. Property rights are so blurred that it is impossible to distinguish the companies from the entanglement of suppliers, local government services, and enterprise supplied amenities. It is difficult to know when the enterprise or the Government begins or stops.

Irrational organization

70. The companies are too vertically integrated to be economically viable; they rely extensively on a single monopoly supplier for most inputs; and they are so concentrated in one spot that any factory closure is bound to devastate the local economy.

Government bureaucracy

71. The Government bureaucracy has been so stretched that the execution of privatization plans hinges upon the creation of new agencies from scratch. These are short of staff who, in addition, are reluctant to approve any deals for fear of being politically charged.

Valuation of assets

72. With no real asset valuations, cash-flow analysis or marketing plan, nobody has an idea of the worth of a business. The lack of real accounting means that none, least of all the managers or bureaucrats who run the businesses, knows for certain which firms add or subtract value.

Financial markets

73. Even the most daring privatization attempt will not be able to create a genuine market economy unless an efficient financial industry is also at hand. Private banks and stock exchanges are basically missing in these countries, so are the skills to run them.

3. Sequencing of actions

74. The special characteristics of the (ex-)centrally planned economies are bound to affect the determination of sequencing the actions to be taken in the transition to a market economy. In other words, should privatization precede or follow the economic reforms to transition? There could be no single formula for this, nor is there a consensus of opinion. The pros and cons of each sequence is worth a brief discussion. 16/

75. The economic reforms to the transition to a market economy entail, among others, the free determination of prices by market forces, currency convertibility, liberalization of trade for a competitive production and exchange of goods, and acceptance of foreign capital. Should these take place before or after the State enterprises are privatized or restructured?

76. If privatization precedes the freeing of prices, then in the absence of market determined prices it becomes impossible to ascertain the enterprises that are worth saving. On the other hand, if prices are freed while State monopolies are not dismantled, then excessive profits continue to reward existing inefficiencies.

77. If trade barriers are lowered prior to privatization, then sudden introduction of free trade will have the advantage of forcing the State monopolies to be competitive in world prices and would help correct the price distortions of central planning. But, given the inefficiencies of State enterprises, they may not be able to face this sudden foreign competition, the market may be bombarded with foreign goods, and the result may very well be a general collapse of output and employment.

78. To have financial reform precede privatization and establish efficient banks and capital markets is desirable, so that capital can be allocated to the right enterprises, rather than to the wrong businesses which has often been the case in centrally planned economies. On the other hand, it appears rather difficult to create an efficient banking system, when the existing banks hold a large amount of bad loans which are unidentifiable, since it is impossible to know for sure the genuinely profitable enterprises.

79. Moreover, privatization creates opposition to the reforms. This comes from all interested parties who stand to lose from the process, such as the bureaucrats, and workers and managers of the enterprises. Sudden privatization may arrest this opposition and private owners can proceed faster and more efficiently in the revival of the economies. Yet, sudden privatization is not without inequities, causing certain groups to enrich themselves at the expense of others, and even the State. These inequities undermine public support for economic reform.

16/ This question was recently discussed in detail in David Manassian, "A survey of business in Easter Europe", The Economist (21 September 1991).

80. In brief, there is no simple and ready-made formula for privatizing the ex-planned economies. In fact, each country appears to have chosen a different modality. These will be taken up subsequently when the experiences of selected countries are discussed.

E. Final remarks

81. The intellectual basis for identifying Government intervention with limits on the free market is, in many cases, weak. But the subtleties of collective goods provision, externalities, transaction costs, problems of equity and income distribution, oligopoly and monopoly behaviour will be injected into what is essentially a political and ideological discussion carried out before an uncomprehending public. And when the discussion is taken up by lobbying groups, not to speak of labour federations or political parties, the debate seems like a battle for the heart more than the mind.

82. Whatever the debate, the reality should be examined. If we were to describe a country as having done nothing in the area of privatization, we would be in grave error not to take into account the conditions in which economic transactions are carried out, both in the private and the public sector. There is evidence in some countries that the restructuring of the public enterprises will result in their greater subjection to market forces. In the private sector there would appear to be less movement toward the market at the level of Government intervention and regulation, although the maturation of the economic system in general provides natural forces in favour of "more perfect" market conditions.

IV. TECHNIQUES OF PRIVATIZATION: CASE STUDIES

A. Introduction

83. To give an inventory of all the privatization efforts throughout the world in a report whose scope is limited is quite infeasible. 17/ This section examines the privatization efforts in only selected countries of different socio-political environment. The case studies it contains analyze the experiences with different modalities of privatization. They also reflect the different stages of economic development as well as the diversity in the political systems.

84. Among the developed countries, Great Britain has been the leader of privatization if not the originator. Its experience is certainly worth dwelling upon. Chile, Mexico, and Honduras in Latin America reflect two diverse political systems as well as levels of development. Their relative success, or failure, merits an appraisal. Malaysia among the so-called newly industrialized countries, and Hungary, Poland, and Czechoslovakia among the

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17/ For extensive inventory see World Bank, op. cit..

ex-centrally planned economies constitute fascinating examples of privatization. The re-unification of Eastern Germany with West Germany gives rise to sui generis problems, which may not be altogether relevant for the developing or socialist countries. However, the modality of privatization in East Germany is worth the review from a theoretical point of view. One country in Africa, Togo, has made serious attempts towards privatization and their review is warranted.

85. The analysis of this section is not based on field work, but rather on already published sources which are indicated clearly wherever appropriate. Nor does it represent an exhaustive assessment of each transaction that has taken place. Rather, it conveys a global view of the privatization experiences in these countries, underlines the salient features, and draws conclusions for policy implications.

B. Great Britain 18/

86. Britain's privatization program began in 1979 when its nationalized industries accounted for 10.5 per cent of the GDP, 8.1 per cent of employment, and 15.2 per cent of gross domestic capital formation. Their profitability had been significantly below their private sector counterparts even when substantial subsidies they had been granted are not accounted for. The low rates of return and large financial deficits which have characterized them were largely the result of policies that led to overinvestment and internal inefficiencies. Public interest was the primary objective of their existence and managers and ministers alike were made its promoters and custodians. This internalization of public interest did not lead to an efficient performance. Lack of clarity in corporate objectives, overlapping responsibilities, and excessive political intervention in operational decisions resulted in detrimental effects on pricing, investment, and internal efficiency. There was a great deal of dissatisfaction with their performance which pressed for the advancement of privatization policies.

87. The privatization programme accelerated sharply in 1983. By 1987 the annual proceeds from asset sales were approaching L. 5 billion. Before 1984, the privatized firms were in reasonably competitive industries. Thereafter regulated private enterprise came to be regarded as superior to nationalization even in natural monopolies, and privatization policies acquired unlimited scope in their application to State ownership of industry.

18/ This section is based on the following works: David Clementi, "Privatization in industrialized countries: the experience of the United Kingdom", Privatization: Policies, Methods and Procedures, Asian Development Bank (Manila, Philippines, 1985); Cento Veljanovski, Selling the State: Privatization in Britain, Weidenfeld and Nicolson (London, 1987); and John Vickers and George Yarrow, Privatization: An Economic Analysis, The MIT Press, (Cambridge, Mass, 1988).

88. Overall, the principal objectives of the programme were:

(a) To stimulate competition and improve efficiency;

(b) To reduce the public sector borrowing requirement;

(c) To reduce Government involvement in enterprise decision making;

(d) To ease problems of public sector pay determination;

(e) To widen share ownership;

(f) To encourage employee share ownership; and

(g) To gain political advantage.

89. Major pieces of legislation were enacted to remove barriers to competition. The introduction of competitive tendering in contracting out for the provision of public services (trash collection, catering, cleaning, construction, maintenance work etc.) broke down the quasi-monopoly enjoyed by public employees in their internal supply. The transfer of the enterprise to the private sector reduced the public sector borrowing requirement and the sale of assets meant that the Government could obtain finance without having to issue debt. Privatization freed the management from political interference. It also provided an excellent vehicle to enhance "property-owning democracy" by offering shares to the general public at a discount with additional bonuses for the small shareholder. The sale of public sector housing also was a significant element of promoting private property ownership.

90. The sale of public enterprises has been the prime method of privatization, although contracting out has also been used, especially in the provision of public services by local Governments. Shares of companies to be privatized were offered for sale at a pre-determined price set by the Government and were put up for bids above a minimum price also determined by the Government. The combination of an offer for sale and a tender offer was also used. In some cases the sale was done in two or more stages to arrive at a more accurate market price for the shares. To spread the ownership of shares and enhance "property-owning democracy" sales to the public was made in installments and incentives were provided to encourage the shareholders to hold on to the shares over a long period of time. These consisted of mechanisms like free bonus shares or free tax free vouchers to customer shareholders to set against phone and gas bills.

91. The economic and political success of British privatization programme has been extolled widely. The major acclaim is the expansion in share ownership. Underpricing, especially in offer sales, combined with price incentives, gave rise to substantial capital gains, minimized the risk of capital losses, while the incentives encouraged long-term ownership of assets. Despite the quick sale for profit by some of the purchasers of the shares, the number of shareholders increased significantly. It was also a political success since

it averted the hostility of the individual investor/voters. Also, it raised considerable revenue for the Government. Moreover, State involvement in industrial decisions was reduced.

92. However, the programme has been, and is being, criticized for being weak in other respects which have reduced its efficiency. The criticism is not so much the failure of the programme, but that it could have achieved more with efficiency had some of its measures not been flawed. One criticism is that underpricing of shares has not been without cost, for the Government has not been able to collect as much revenue as it would have done had pricing been done correctly; revenue was forgone to the amount of the difference between the offer price and the subsequent market price. There is also the added cost in that to raise this difference in taxes would have cost more L for L when one accounts for the welfare losses generated by the distortion in resource allocation extra taxation causes. The argument is thus made that the sale of a given amount of shares at higher prices would have all the resource allocation efficiency advantages of lump sum taxation plus the virtue of being fairer. 19/

93. This argument first ignores the inequitable implications of a lump sum tax. Secondly, although the initial effect of the sale of shares on wealth distribution may have been inequitable, the free trade of the shares on the stock exchange would have changed the distribution in any case. It should be added, however, that subsequent privatization procedures are aiming at eliminating the flaw mentioned above. For example, the upcoming sale of half of the Government's remaining 48 per cent stake in British Telecom is to be made at a price close to the current market price which will be determined shortly after the institutional buyers submit their bids. The discount to individual investors is to be minimal. 20/

94. The second more serious criticism to the privatization programme in Britain is that it has not devised adequate measures of competition and regulation for the industries concerned. Rather, for reasons of political expediency, the programme was carried out hastily to widen share ownership and raise short-term revenues to the Government. Obstacles to competition have not been removed, and barriers to entry have not been forcefully dealt with. This criticism applies to the second phase of the programmes when enterprises with monopoly power were privatized. Without sufficiently effective competition and/or regulation, substitution of a private firm for a public leads precisely to a situation where gains in economic efficiency cannot be expected. The failure to introduce such policy measures before privatizing such industries will undermine the success of any privatization programme. 21/

19/ Vickers and Yarrow, op. cit., p. 180.

20/ See "Grumbling and Rumbling", The Economist, p. 102 (16 November 1991).

21/ Detailed plans for the upcoming sale of British Rail are expected to contain measures to restrain monopoly abuses. See "How to sell the railways", The Economist (30 November 1991).

C. Chile 22/

95. Privatization in Chile is not new; it has preceded the privatizations in Great Britain who is regarded as the pioneer in this field. The growth of the public sector in Chile began with the economic difficulties provoked by the Great Depression. These led to the establishment of CORFO (Corporación de Fomento) in 1939 whose involvement expanded into a myriad of entities for the sake of national industrialization and import substitution. From 1938 to 1973 State enterprises were set up in technology industries; joint ventures were entered into; financing private sector industrial projects became a Government prerogative; land was transferred from land-owners to co-operatives; Government acquired ownership in the largest copper mines which finally led to their nationalization; key local industries (primarily, but not exclusively, the banking institutions) were nationalized; companies and their assets were simply confiscated under one pretext or another. By 1973 Chile had roughly 500 SOEs. They contributed 85 per cent of the production value in mining, 40 per cent of industry, 100 per cent of utilities, 70 per cent of transport, 70 per cent of communications, and 85 per cent of financial services. Their operational deficits added significantly to a fiscal deficit of 24.7 per cent of GDP in that year. 23/

96. The consequence of this vast public participation in the economy has been the initiation of an extensive scope of privatization in 1973 following the demise of the socialist/marxist oriented Government. The economic policy switched to a market oriented one with emphasis on financial and trade liberalization. The understanding was that the retrenchment in the public sector and the increase in its efficiency would cure the economic problems facing the country.

97. The privatization process that began in Chile in 1973 had the objectives of denationalization, reducing the mounting deficits, and thereby arresting the runaway inflation that dominated the economic scene at the time. Subsequently, the objectives were broadened to include "popular capitalism", i.e. assuring broader participation in the ownership of national assets. The process can be broken down into five distinct phases.

98. In the first phase (1974-75), those companies that were confiscated by the Government were transferred back to their previous owners, and those that were set up by the Government were auctioned off. Most of the transactions, therefore, did not involve financial transfers.

22/ This section is based on "Techniques of privatization of State-owned enterprises", op. cit., The World Bank, and "Privatization in Latin America", Latin Finance, Supplement (March 1991).

23/ See Latin Finance, op. cit., p. 47.

99. The second phase (1975-83) was guided once again by the concern to limit fiscal deficits. Public enterprises were continued to be sold through public auctions. This phase of privatization was characterized by financing private sector acquisitions of the divested enterprises through the Government. Direct negotiations were entered into with the most qualified bidder after the auction, and a direct loan was made to the purchaser after the appropriate down payment was made. The transactions involved large domestic and foreign corporations and employee co-operatives; no individual investors were involved in this stage of privatization. Simultaneously, part was vested in peasants originally assigned to such land through communal co-operatives, and part was sold through public auctions.

100. The primary objective of the third phase (1985-86) was to reprivatize the companies that had been privatized during the previous phases, with a view to reducing the fiscal deficit, widen the capital markets, and encouraging a more competitive and efficient national industry. Chile went through a severe economic crisis during 1982-83. Its economy was particularly affected by the fall in its terms of trade, the rise in interest rates, and the abrupt cut off in the flow of external credit. The banking industry was particularly affected and the Government was compelled to bail out many institutions. The privatization process resumed once the emergency was over. This was the phase of "popular capitalism", when small equity shares were sold on credit to individuals, to employees, to civil servants, to pension funds, as well as to large investors.

101. In the fourth phase (1986-1990) the Chilean Government began the divestiture of the large industrial corporations and utilities, the objectives being essentially the same as in the third phase, i.e. widespread equity ownership and the possibility of placing public enterprises more appropriately in private hands.

102. The fifth phase (1990-) is one of standstill. There is a group of State enterprises (notably in mining-trading, railways, and the postal services) for which the necessary consensus for privatization has not been reached. There is also a great number of enterprises for which the Government has not come up with clear intentions for privatization, primarily because of the fear that once the enterprises are in the hands of the private sector the implementation of radical technological changes could lead to massive lay-offs or subsidies may be required to ensure minimum profitability. The argument is also made that the functions performed by these enterprises belong to the sphere of the public sector and are best entrusted to it. It appears that the standstill is due more to lack of political will and ideologically motivated concerns than to any other argument, considering that the privatization achieved so far has yielded benefits both to the Government and to the economy as a whole.

103. The basic method of privatization has been the sale or transfer of shares through a wide variety of mechanisms. One mechanism has been public auctions combined with negotiations. Most qualified bidders at public auctions have entered into direct negotiations where an agreement was reached on the actual sale price of the shares and on the terms of payment. A second mechanism was the sale of shares to employees, for which special legislation was enacted.

Thirdly, especially at the beginning, initial offerings were restricted to 30 per cent of the shares in view of a nascent stock exchange activity. Fourthly, most State enterprises were first transformed into corporations before their shares were sold, and only small percentages of shares were put on sale annually in order to create a market for them. Fifthly, shares were made available to pension funds which have become the most important element in private sector savings. Sixthly, new shares were issued for sale to the public to fund specific projects of State enterprises. Finally, payment of Government debt was made with a mix of shares in privatized companies.

104. Since CORFO was the entrepreneurial arm of the Government, the organization to see through the process of privatization was set up within it. The central Government set the goals of the divestiture programme. These were submitted to CORFO's Council which made the final decisions on privatization. The Privatization Committee, the administrative arm of CORFO, supervised the implementation of the proposals approved by the Council. Once an enterprise was identified for privatization, the Council and the Privatization Committee determined the percentage of its equity to be divested and what form the process should take. The Normalization Unit rationalized all Government-owned assets, restructured enterprises, screened prospective buyers, negotiated sales, and collected all payments by purchasers.

105. On the whole, Chile has been successful with privatization. Its experience has shown that if an adequate institutional framework is set up, special incentives are instituted for small investors and workers, legislation is enacted to guide the participation of large domestic and foreign investors, and pitfalls of previous attempts are avoided, a viable and efficient private sector can be created. It also cautions against privatization on an extensive scale where capital markets are weak, and suggests extending the procedure over a period to enable the development of such markets. Moreover, ownership concentration can be avoided if a careful and conscious policy of widespread ownership policy, involving incentives and financial assistance, is implemented, even at the cost of potential revenue to the Government. Perhaps the greatest lesson to be drawn from Chile's case is that privatization should follow stabilization and liberalization, if bankruptcy and reprivatization are to be avoided.

D. Mexico 24/

106. Mexico has pursued a large-scale privatization programme since 1983 after a long period of economic development policy built on State ownership of key industries embracing the view that the State alone can defend national resources and the well-being of its people against the exploitation of outsiders and entrepreneurs.

24/ This section is based on the following works: "Privatization in Latin America", Latin Finance, Supplement, March 1991; José Angel Gurría, "What Eastern Europe can Learn from Mexico", International Economy, May/June 1991; Guillermo Barnes, Lessons from Bank Privatization in Mexico, Washington, D.C.: World Bank 1992; Juan Ricardo Pérrez Escamilla Costas, La Privatización en México, 1982-1988, Instituto Tecnológico Autónoma de México, 1988; and Ben Ross Schneider, "Party for Sale: Privatization and State Strength in Brazil and Mexico", Journal of Interamerican Studies and World Affairs, Winter 1988-89.

107. The year 1970 saw the substantial increase in the State's role in the economy: hundreds of new State firms were created, spending rose, regulation became extensive, and land was expropriated. The oil discoveries in the late seventies appeared to promise a solution to the country's problems, but the prospect of sudden wealth further precipitated them. Growth surged, but so did debt and the parastatal sector which includes not only the business enterprises but also trusts, decentralized entities and specific committees and commissions. 25/ The mismanagement of the economy resulted in hyperinflation, loss of confidence in the country, and a critical deterioration in standards of living. The economic crisis of 1981-82 precipitated the nationalization of the banking sector in 1982. That year saw the simultaneous crises in oil, debt, inflation, growth, and Government relations with the private sector. As confidence plunged, private funds fled the country.

108. Privatization was not central to the economic plan of the administration in office, yet a modest programme was adopted in 1983 and expanded in 1985. The programme began slowly, but turned into a vast, top-priority project in 1987-1988. Only 23 firms were divested in 1983-84, but by mid-1988 765 were slated for privatization; in 1989 and 1990 a total of 353 entities were privatized or authorized for privatization; only 225 enterprises out of the 1,155 existing in 1982 were in public ownership by 1990; and by 1992 all the nationalized banks were sold to the private sector.

109. The term privatization, as it applies in Mexico, has a wider connotation than is usually understood. It is referred to as disincorporation (desincorporación) and includes not only the sale of companies, commissions, trusts, etc., but also their liquidation, extinction, merger and transfer to State and local Governments.

110. The objectives of the privatization programme were:

(a) To raise economic efficiency and productivity by responding better to market forces and raising the quality of the services;

(b) To reorient the State's priorities towards urgent social services rather than using scarce resources in competition with private investment;

(c) To prevent the bleeding of the public coffers by reducing subsidies and eliminating enterprises that are not going concerns;

(d) To maximize Government's revenues by selling the right firms at the right time to the right buyer. (The gain of administrative expertise from the sale of smaller concerns at the initial stage enabled the sale of larger concerns at a higher price at a later stage.)

25/ Between 1977 and 1980, 90 per cent of the public financial deficit consisted of the deficit of the parastatals. In 1989 subsidies to these entities represented almost 9 per cent of GNP, and parastatal debt reached 80 per cent of the public debt.

111. The basic method of sale has not been open public offerings in the stock market, since capital markets were not sufficiently developed to channel the sale of shares efficiently. Rather companies have been sold via closed bids where the Federal Government has the ultimate authority to decide. The guidelines of disincorporation are defined by the Privatization Commission that consists of representatives of several ministries. The Government sector that wishes to divest of an entity submits a proposal to the Secretary of Programming and Budgeting. The decision of the Secretary is submitted to the First Executive. Upon approval of the Presidential decree by the Intersectoral Commission of Financing and Spending, the Unit of Disincorporation of Parastatal Entities, which is attached to the Ministry of Finance, appoints a bank to perform the valuation of the entity and solicits the public to submit bids. The banks prepare the prospectus, the technical-financial valuation to determine the minimum reference price, bring administrators together with potential buyers, and submit the bids for Government's consideration. The Privatization Commission approves the sale upon recommendation by the Unit attached to the Ministry of Finance.

112. To oversee the process of the sale of the banks a Bank Privatization Committee was formed by Presidential decree. Its functions were to establish criteria and general policies for the process and formulate the specific strategy for the sale of each bank. The Committee consisted of Government officials from all areas related to financial activity. The bank privatization process consisted of qualifying and selecting the bidders, preparing the sale prospectus, and announcing the auction and its rules. Only Mexican citizens, the Federal Government, Mexican development banks, and the Bank Fund for Savings Protection were allowed to invest in "A" stocks. Other Mexican entities and financial institutions not controlled by foreign interests were allowed to invest in "B" shares. Foreign non-public institutions could invest in "C" shares up to 30 per cent of the bank's capital. The auction consisted of closed bids. The Bank Privatization Committee reviewed the bids and selected the winner based on the highest price offered, provided that this price was higher than the previously determined valuation. The final sale was decided by the Financing and Spending Commission of the Federal Government.

113. On the whole, Mexico has succeeded in privatizing numerous public sector entities. By the numbers, it is a world leader. The Government has ended up in vacating totally the industries of telecommunications, automobiles, pharmaceuticals, soft drinks, textiles, homes appliances, paper, china, aviation, cement and construction materials. Privatization has been partial in steel, sugar, and metallurgical products. The most significant sale has been that of Teléfonos de México (TELMEX). Labour has had a very flexible attitude in this sale in that all workers voted in favour of privatization in return for job preservation. However, labour has not always succeeded in this endeavour. In two cases at least, the Government has successfully used privatization to resolve intractable labour disputes by declaring loss making companies bankrupt and subject to liquidation; this automatically canceled the existing labour contracts. The Mexican experience also shows, as in the case of Chile, that a viable and efficient private sector can lead the way to development if privatization follows stabilization and liberalization.

E. Honduras 26/

114. Like most countries in Latin America, the reigning economic policy in Honduras in the sixties and the seventies was one of the State assuming the responsibility of development through its own enterprises. This was combined with a policy of import substitution which protected the domestic production by public and private companies through exorbitant tariffs and subsidies at the cost of the consumer who paid high prices for low quality domestic goods. The Central American Common Market merely intensified these conditions. CONADI (Corporación Nacional de Desarrollo Industrial) came to embrace a variety of industrial and commercial enterprises that included a gamut of activities from hotels to steel mills, from laboratories to shipyards, from furniture and dairy products to sugar mills. Only a few of these enterprises were profitable, while the vast majority were loss makers. CONADI, together with other State sponsored institutions in finance, trade, and agriculture, became insolvent. Substantial disbursements had to be made merely to keep it afloat. Action had to be taken.

115. The objectives of privatization were, consequently, to:

(a) Save fiscal support funds by minimizing the drain on fiscal resources the State-owned enterprises were giving rise to;

(b) Reduce, if not stop, an ever increasing fiscal deficit; and

(c) Reduce foreign currency obligations (about 40 per cent of the debt was attributable to CONADI).

116. The legislation that enabled the privatization process was enacted in 1985. This set the stage to develop a comprehensive privatization programme which subsequently led to technical assistance by USAID/Honduras to plan its implementation, since there was a dire need for qualified staff at all levels of the process. Many seminars and conferences were held to explain the benefits expected from privatization in an effort to overcome the opposition of special interest groups.

117. The basic method of privatization is the sale of the enterprises. This is to be done through a closed bid auction open to the public; should there be no bidders, then direct negotiation is resorted to.

118. The organizational framework of the process consists of a Privatization Commission, a Valuation Commission, and a Technical Working Group. The Privatization Commission is formed by two representatives each from the private sector, public sector, and labour. Its function is to oversee the

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26/ This section draws from the World Bank op. cit., Latin Finance, op. cit., and F.M. Andic, "The case for privatization: some methodological issues", Privatization and Deregulation in Global Perspective, D.J. Gayle and J.N. Goodrich, eds., Quorum Books (New York, 1990).

process. The Valuation Commission is a fiscal commission comprised of representatives of the Ministry of Finance, the Central Bank, the private sector, and the Accountant General's Office. The valuation reports of each State-owned enterprise are first reviewed by the respective board and subsequently appraised by the Valuation Commission to determine the selling price. The Technical Working Group has the task of assuring that the enterprise is free of any liabilities and cleared of any legal and financial obstacles. It appraises and evaluates the assets, recommends a divestiture strategy, and the appropriate sale price. Its report forms the Transfer Plan which is submitted to the management of the enterprise to be privatized for its approval. It then is reviewed and approved by the Valuation Commission. The final authorization to divest, to set the strategy and the sale price rests with the Board of Directors of the Enterprise. The decision is then made public.

119. Although the magnitudes involved may be small by international standards, the results of the process have been significant for Honduras. Foreign debt was reduced, new investments were generated, and new permanent jobs were created, and this considering that the country lacks an environment for privatization and a capital market through which to execute the transactions. Twelve enterprises were privatized from 1985 till the end 1990. Since the process began with the privatization of relatively easier cases, it is quite likely that the subsequent results will be slower in following, because the remaining cases are more complex and involve difficult legal and financial issues.

F. Malaysia 27/

120. Malaysia's efforts to privatize derive directly from the dismal performance of its SOEs which proliferated after the adoption of the New Economic Policy in the early seventies. The disappointing results and huge losses led to the reassessment of the role of the SOEs in the economy in the early eighties. Some were shut down. New capital was to be injected into the remainder to meet their equity needs, cut down their debt/equity ratio, and reduce State ownership.

121. The overall objectives of privatization were stated to be:

(a) To relieve the financial and administrative burden of the Government and reduce the size of the public sector;

(b) To promote competition, improve efficiency, and increase the productivity of the SOEs;

(c) To stimulate private entrepreneurship and investment and thereby accelerate the growth rate of the economy;

(d) To comply with the objectives of the NEP in increasing the entrepreneurship of ethnic Malays (Bumiputera).

27/ This section is based on The World Bank, op. cit..

122. Basically, four methods have been utilized: sale of shares and issue of new equity; contracting out; leasing; and sale of assets. A combination of outright sale, leasing, and contracting out has also been used. However, Malaysia has incorporated variations into these methods to accommodate issues arising from the ethnic composition of its population and from its concern with the employment consequences of privatization. These are spelled out in the Government's "Guidelines of Privatization". The worker protection clauses prevent their displacement and call for their absorption into private firms under terms no less favorable than those they enjoyed while working in the public enterprise. The ownership restructuring clauses distribute the shares among Bumiputera (30 per cent), other Malaysians (40 per cent), and foreign interests (30 per cent).

123. When shares were offered to the public, these were initially limited to Malaysian citizens with special quotas for government-approved Bumiputera institutions and for employees, purchase limits per shareholders, and special shares for the Government. In one case this gave the Government the right to a voice in general meetings and to appoint a certain number of the company directors, as well as chairmen and managing directors. Subsequently, recourse was allowed to offerings to international investment institutions; or, foreign investors were allowed to acquire shares in the secondary market after the companies were listed on the Kuala Lumpur stock exchange. In a third case, a State-owned natural monopoly was substituted by a private one with the newly formed private company initially acquiring 51 per cent ownership and the State possessing 49 per cent; immovable assets and land and building were leased from the State; and a management contract was agreed upon. Subsequently, shares were offered to the public with a special quota for employees.

124. The organization in charge of privatization is the Privatization Committee which has the responsibility to plan, monitor, co-ordinate, and evaluate the programme. There is also a Privatization Secretariat under the Director of the Privatization Task Force. The Secretariat sets up technical committees that conduct privatization studies and prepare and analyze reports. These are appraised by the Privatization Committee. The final approval rests with the Cabinet.

125. The result has been, especially at the initial stage, a slow process towards privatization despite the Government's political commitment to that end. This slow process has stemmed from various causes. One factor was the existing weaknesses in the organizational arrangements, which, although seemingly structured and systematic, have yet to function effectively. Secondly, despite the Government's commitment, there has been no total divestiture; the State has retained in all cases a substantial share in the companies, and, particularly in one (airline), it has maintained the deciding vote in major decisions. Thus, the divested enterprise, in this particular case, has been unable to restructure itself. It may have become less dependent on the Government for its financial needs, but it has not been able to cast off the political interference in its operations. Thirdly, personnel policy principles that guarantee the impossibility of restructuring the labour force of the enterprise have closed the door on any steps in that area to assure, if not increase, the efficiency of the operations. This is a major

constraint on the privatization programme. An added dimension is the preoccupation with ethnic balance in the business sector. Divestiture as an instrument of ownership restructuring is a very noble objective. Yet the means through which Bumiputera participation in economic activity is to be achieved was conceived as purchases of company stock through public sector foundations. The unintended result has been an increase in State participation in the economy rather than a cutback, and a decline in the share ownership of foreign capital, which the Government is attempting to restore. In addition, despite the objective of promoting competition, as specified in the Guidelines, Government interference in decision making of the divested enterprise has actually implied no significant change in operations and no increase in competition. Finally, it makes little sense to substitute a private monopoly for a public monopoly, unless the legal framework is changed and a regulatory framework is provided for the new company's operations. This has not been taken into account in earlier attempts, but has been set up for at least a later one which involved the privatization of telecommunications.

G. Czechoslovakia 28/

126. It is futile to enter into the objectives of privatization in a pre-centrally planned economy when it is undergoing an almost 360 degree transformation into a market oriented one. The economy will have to change from one where almost everything was owned by the State at one dominated by private ownership. Privatization as such is the fundamental element of this reform. It is ideology par excellence. What is interesting, therefore, is to examine how the transformation process is visualized and being implemented when the institutions conducive to a smooth passage to a western style democracy with private ownership and a market oriented economy have been absent for decades and are now being built from scratch. Czechoslovakia has responded to this challenge by introducing wide ranging economic reform proposals which contain anti-inflationary economic stabilization policies, liberalization of a wide range of domestic and import prices and of current account transactions, encouragement of private foreign direct investment, making the SOEs financially responsible and their managers accountable for the results, and protecting those that stand to lose from the entire adjustment process. 29/

28/ This section is based on Milan Jurceka "Public finance in the process of the transformation of the Czechoslovak economy", prepared for the 47th Congress of the International Institute of Public Finance, 1991; David Manasian, "Don't give up now: a survey of business in Eastern Europe", The Economist (21 September 1991); Dusan Tréska (Project Director of the Voucher Privatization, Fed. Min. of Finance, Prague), "Why and how to privatize in post-communist countries: the case of Czechoslovakia", no date; UNIDO Czechoslovakia: Industrial Transformation and Regeneration, Vienna, 1992; and Martin Kupka, "Transformation of Ownership in Czechoslovakia", Soviet Studies, Vol. 44, No 2, 1992.

29/ These are embodied in the "Economic Reform Scenario" adopted in October 1990.

127. Prodded by this need to confront the economic objectives of price stability and growth while accomplishing a democratic organization for its society, Czechoslovakia has adopted a combination of methods in its approach to the task of privatization. On the other hand it resorts to the direct sale of public enterprises to interested buyers, including foreigners, through public auctions; on the other hand by novel means it tries to assure that at least part of the ownership will remain, at least initially, with the people. This part of the programme aims to make stockholders out of citizens and inject into them a sense of involvement in the country's affairs. It carries no pecuniary benefit to the Government.

128. Many small enterprises (hotels, restaurants, shops, workshops, and small manufacturing units of local importance) have already been sold directly at auction to private investors in 1991. It is now the turn of big companies, whose numbers, by one estimate, exceed 4,000. The guidelines to their privatization are laid down in the Transformation Law of 26 February 1991, which entered into effect on 1 July 1991. The law defines three methods:

(a) Standard sale: the direct sale of the enterprise or its assets to domestic or foreign investors;

(b) Sale by investment vouchers;

(c) Joint ventures.

129. A privatization project has to be prepared for each enterprise. This is entrusted to the enterprise itself upon its designation by the ministry to which it is attached. The relevant information on the financial status of the enterprise and of its value is compiled into a prospectus which is made available to investors. Upon authorization by the Ministry of Privatization to implement the procedure, the enterprise is transferred from the ministry to which it was attached to the National Property Fund who then undertakes the sale.

130. About half of the roughly 2,000 enterprises to be privatized in the first of the two "waves" in early 1992 will be sold by investment vouchers. This requires first the incorporation of the enterprise so that the assets can be held in shares. Not eligible for privatization via vouchers are enterprises, specifically excluded in special lists, that are stated to be of public interest. These are the utilities and providers of vital public services, such as the majority of hospitals. Moreover, only part of the enterprise may be sold via vouchers, if property restitution comes into play or if the State decides to sell part of it for cash. Usually restitution has priority.

131. The vouchers are contained in a coupon book that contains an account of 1,000 points. The book can be purchased for 1,000 crowns (non-refundable), or roughly US$ 30, to cover the cost of the operation. All individuals will begin with the same number of vouchers. The points are for use in the purchase of the shares of the companies of investors' choosing when information on voucher privatization and the specific plans are made public. The vouchers are not traded, but the shares will be as soon as they are received. (A stock market is expected to function by mid 1992.)

132. The individuals can apply for any number of shares in any enterprise to be privatized. The price of each share and the number of shares each prospective buyer will acquire is expressed in points. If in the first round the sale via vouchers is undersubscribed, the price remains as is. If the sale is oversubscribed, the orders are canceled while the investor registration of points remains effective for the subsequent rounds. The price is readjusted in several subsequent rounds until the correct price is found for the points initially registered and all shares are dispensed. In other words, the "value" of the enterprise is determined in points by the private investors' demand for the shares of the enterprises.

133. Individuals can acquire shares also indirectly through Government approved investment privatization funds which are corporations whose assets consist of shares purchased with investment vouchers. The individual would deposit his points with the Fund and his share would be the proportion his points constitute in the total points invested in the Fund.

134. One advantage of the scheme is that it is relatively simple to administer and fast. Given that traditional sales methods can take an extremely long time, privatization may never get off the ground. The expectation is that managers and workers will bid for the shares of their own firm and that their management will give it at least a chance to function efficiently and contribute to the recovery of the economy, something that leaving the firms in State hands has not accomplished. A second advantage is that it is a fair method of asset disposal and share ownership promotion. Each member of the society will be owning as much of the company after privatization as he/she did before under public ownership. The only difference is that there is the freedom to vary one's share of the company. Also, there is no need to worry about asset valuation, pricing, underwriting. Price initially is expressed as investment points; and the market will determine the price of the share when trading begins. The disadvantage is that the scheme does not raise revenue; nor does it introduce new capital or expertise into the economy.

135. It will be interesting to observe the outcome of the venture. Certainly, the performance of the Czechoslovak economy after the scheme is carried through will be a test case to study and derive lessons from. Preliminary indicators for 1992 suggest that the decline in GDP will be halted towards the end of the year and there will be a modest upturn in its growth thereafter. The country has enjoyed, at least partly due to privatization, a not negligible inflow of foreign investment (US$1.7 billion by September 1992). The problems, however, are far from being over. The split of the country into two separate republics is bound to have adverse repercussions which may be more serious in Slovakia.

H. Poland 30/

136. Privatization efforts were initiated in Poland in 1989. The first version of the privatization law presented to the Parliament in Autumn 1989 had a general approach that resembled the British model. It envisaged the transformation of all SOEs into joint stock companies with all shares owned first by the Treasury followed by the public sale of shares with a pre-determined number being reserved for the workers.

137. This initial approach was revised subsequently due partly to worker pressure and partly to the lack of domestic capital and valuation problems. In July 1990 the Polish Parliament enacted a new privatization law that provided a general and very flexible framework allowing for different methods of privatization and different forms of ownership. These were: the free distribution through vouchers, the sale of shares, individual and communal property, and employee ownership. the process was to be overseen by the specially set up Ministry of Ownership Transformation (MOT). In addition, a stock exchange and a securities commission were to be established to facilitate the transition from the command to the market economy and establish the necessary foundations for a well-functioning private sector.

138. Early in 1991 the Government made public its programme (Program Prywatyzacji) containing two basic tenets: Privatization of half of the present State-owned sector within three years, and achieving the same ownership structure as in Western Europe within five years. This resolute stand stems, at least partly, from the fact that until the end of 1990 the procedure was based on voluntary application. As a result, only a small fraction of the Polish economy was privatized and neither was the MOT fully functioning nor had the State-owned enterprises (SOEs) taken firm decisions about entering a particular privatization track.

139. The privatization process in Poland can be grouped under two headings: privatization of the SOEs, and privatization of small enterprises. The first turned out to be a most complicated process. There were some 8,000 SOEs, 500 of which were very large enterprises each often employing 10,000 workers or more. The original approach was to offer shares to the general public on the

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30/ This section is based on the following works: Jeffrey D. Sachs, Accelerating Privatization in Eastern Europe: The Case of Poland, Helsinki, World Institute for Development Economic Research, Sept. 1991; I. Grosfeld and P. Hare, Privatization in Hungary, Poland and Czechoslovakia, London: London School of Economics, 1991; Jerzy Gajdka, Privatization in Poland, College Park, MD: CIBER, Univ. of Maryland, 1992; and Marek Kozak, "Country Paper: Poland", Paper presented in the Seminar on Industrial Restructuring within the Context of Macroeconomic Stabilization and Property Rights Reform in Eastern European Countries and the Russian Federation, Vienna, 20-30 October, 1992.

open market. This, however, was fraught with the danger that the communist "nomenclature", whose living standard was relatively higher, could acquire the majority of the SOEs in the free market. Also, there was an acute shortage of private capital in the country. Moreover, even if the "nomenclature" could have been barred from acquiring the majority of the shares, the process could last several decades. The process was also quickly marred by valuation problems which proved to be insuperable. Hence, the method of allocating free vouchers exchangeable for the shares of the enterprises found many supporters.

140. The result was a compromise. Currently the privatization of the SOEs occurs by offering third parties shares in a company that evolves from the transformation of a SOE (owned by the State Treasury). This is called capital privatization and consists of two stages. First, the SOE is transformed into a company still owned by the State (the process is called commercialization); second, the shares are offered to third parties. In turn, the shares owned by the State Treasury are sold to private buyers in either an auction, or through public offerings, or through invited negotiations.

141. Vouchers are to be distributed free of charge in equal amounts to all Polish citizens resident in the country. They can be used to acquire shares issued as a result of commercialization. They can also be used to acquire title to participation in "mutual investment funds" which have at their disposal shares resulting from commercialization. The vouchers can also be used to acquire enterprises or integrated parts of the assets of SOEs.

142. Small enterprises, such as shops, restaurants, apartments etc., were first transferred to local authorities that became responsible for their privatization. The transfer of property rights to private hands was rapidly initiated and yielded remarkable results. Small-scale enterprises mushroomed. While in 1988 there were some 650,000 unincorporated enterprises in Poland, their number is estimated to have jumped to 1,400,000 at the end of 1991.

143. Privatization opened Poland to foreign investment that can now participate in privatization in a number of ways. Foreigners can purchase shares from the State Treasury by means of joint ventures with Polish partners, or can establish a wholly owned company. No permission is needed from the Government in establishing a joint venture (unless activities are in a restricted area), and profits earned from investments in Poland can be repatriated without restrictions. At the end of 1991, some 2,000 private companies were operative in Poland, 75 per cent of which were joint ventures.

144. Poland's approach to privatization, sometimes called the "big bang" approach, is yet to be fully appreciated. It is certainly moving ahead much faster than in Hungary or Czechoslovakia. The Government still maintains its goal of privatizing 50 per cent of the State-owned sector by the end of 1993. The mass privatization project is far from over as yet, and the major portion of GDP is still produced by the public sector. However, some preliminary data

are worth considering. The private sector's share in industrial output almost tripled from 8.9 per cent in 1989 to 22.5 per cent in 1991. The share of construction rose from 29 per cent to 43.9 per cent and retail trade from 4.8 to 70 per cent during the same period. 31/

145. It would be naive to conclude, however, that privatization, as successful as it appears, will be without problems. The economy is still at the transition stage, and a variety of solutions are still needed within the Polish socio-economic framework. 32/

I. Eastern Germany 33/

146. The demise of the German Democratic Republic in 1990 and its unification with the Federal Republic of Germany extended overnight all Federal market and political institutions to this ex-centrally planned economy. All Federal legislation became effective immediately, and reform of the monetary system unified the two currencies. The privatization of the entire economy began.

147. The process is carried out by Treuhand, the State agency that was set up during the last administration preceding the unification. It is the legal owner of most of the previously State-owned properties. Its function is to privatize and reorganize these properties by means of sales in the market. The agency keeps a large catalogue, also available on computer disc, of firms that are being offered. Public utilities are excluded; they have been handed over to the municipalities. Most of the forests have also been returned to local communities, though the agency still holds privatizable land.

148. The sales of the companies to be privatized are not made via formal bidding procedures; rather they rely on the offers made by potential purchasers. The highest bidder does not always walk away with the prize; rather the Treuhand seeks the best overall package for the firm concerned, including investment pledges and job guarantees. The enterprises are sold as a whole after they are divided into competitively sized sellable units; they are not restructured into corporations whose shares become tradeable in the stock market. The number of firms involved is simply too large for their reorganization prior to their privatization. The restructuring process is left to the private purchaser.

31/ See J. Gajdka, op. cit., p. 16.

32/ For the elucidation of such solutions see Marek Kozak, op. cit..

33/ This section draws basically from Hans Werner Sinn, "Privatization in East Germany", paper prepared for the 47th Congress of the International Institute of Public Finance (1991); OECD, OECD Economic Surveys, Germany, Paris (1991); and "Privatizing East Germany", The Economist (14 September 1991).

149. Apart from selling a large number of small businesses (shops, movie houses, restaurants, etc.) mostly to easter Germans, the process has been rather slow for very many reasons. For one, about 30 per cent of the assets has to be returned to their previous owners. 34/ This is an enormous and time consuming task, given the difficulty of establishing unambiguously to whom the properties belong, since in many cases land registration is absent, and properties were reorganized frequently in previous years and may have had different owners at different times. The possibility that potential owners could stop all legal transactions has increased the risk to potential investors in addition to reducing their incentive to undertake any effort. It has also made the banks unwilling to accept the properties as collateral for credit. 35/

150. Secondly, the policy to sell entire companies, as mentioned above, limits the number of potential purchasers and slows down the privatization process. This number is further restricted by the fact that the assets could not be used as collateral because of the difficulties in confirming the legal property rights, and because of the lack of equity in the hands of eastern Germans that would have qualified them for loans.

151. Thirdly, the size of the privatization itself carries dramatic macroeconomic implications which deter the implementation of the process. The receipts from the sale of existing assets compete with the new private investment and ordinary government budget deficit for domestic private savings and capital imports and lead to an increase in the interest rate and a decline in the capital value of the assets to be privatized. This gives the Treuhand a strong incentive to slow down the process.

152. Finally, it should be emphasized that the privatization process is not being implemented in a vacuum, but simultaneously with the provisions of the German unification policy. One component of the latter was the currency conversion at par which has led to a dramatic increase in wages. The introduction of the West German collective bargaining system has also led to a high technology, high wage policy which has been used to compensate for the differences in the two regions of the unified country. Both factors have contributed to a dramatic increase in wage costs to levels far above the opportunity cost of labour and a severe reduction in the market value of the assets to be privatized which may have discouraged their sale by the Treuhand. It is quite likely, however, that had they been sold, the new owners would have restructured the production process and turned them into profitable enterprises.

34/ See D. Cornelsen, "Privatization: The example of East Germany", unpublished manuscript, Deutsches Institut für Wirtschaftsforschung (Berlin, 1991).

35/ The "Obstacle Removal Law" of March 1991 goes some ways into improving the situation in that it favours the investor over the previous owner and protects him from future compensation claims by the latter. See Sinn, *op. cit.*, p. 6.

153. Thus, if privatization has not led to expected results within the foreseen horizon, has caused production costs and the unemployment rate to soar, and did not yield the expected revenue from the sales, the blame to a large extent lies with the elements of the unification policy, and their impact on the economy. Obviously in Eastern Germany's case additional measures are needed for wholesale privatization to succeed within the particulars of the country. 36/

J. Hungary 37/

154. Hungary already has experimented with market type policies and management since 1968, thus its situation is not without peculiarities. Currently, measures have been taken to restore financial equilibrium and enhance economic competitiveness. Reforms of financial institutions were introduced relatively early. A two-tier banking system was set up in 1987 which subsequently developed into a full fledged banking system. Corporate bonds were issued in 1983 and several new investment funds were set up by mid eighties to provide capital to newly created small and medium size enterprises. The 1989 Company Act opened the way for the issue and trade of shares which almost immediately established an equity market. With the enactment in 1990 of the Securities Law the Budapest Stock Exchange reopened formally. Prices, imports and foreign exchange have begun to be liberalized. Currently, there is a broad consensus among the parties that economic recovery will not materialize unless privatization takes place.

155. The final objective of privatization is to create a market economy and strengthen the institutional framework of political democracy. There is a broad consensus that economic growth will not materialize unless a highly efficient and flexible enterprise sector is created. This will be conducive to open up export markets, ease the debt problem, speed up structural adjustment, and reduce the role of the Government in the economy. Yet a comprehensive reprivatization is not being considered. State property will not be freely distributed nor will the 1947 land tenure system be restored. It is argued that such distributions cannot muster together the new technology, know-how and management necessary for the efficient operation of the enterprises. Instead there is to be a limited amount of State divestiture by converting Government securities into private equity and the economy is to be opened up to new ventures. Thus, there is no specific privatization strategy, nor is a time frame specified.

36/ For a recent analysis in this respect see George Akerlof, Andrew Rose, Janet Yellen and Helga Hessenius, "East Germany in from the Cold", Brookings Papers on Economic Activity (January 1991).

37/ This section draws from L. Bolmas "Privatization in Hungary", paper presented at the Conference on Privatization in Eastern Europe, 7-8 November 1990, Ljubljana; Konstantine Gatsios, Privatization in Hungary: Past, Present and Future, London, Center for Economic Policy Research, 1992 (Discussion Paper No 642); and Yudith Kiss, "Privatization in Hungary - Two Years Later", Soviet Studies, Vol. 44, No. 6, 1992.

156. The organization in charge of privatization is the State Property Agency (SPA) which has taken over the rights of the State exercised previously by the sectoral ministries. When the SPA assumes direct ownership control of a SOE, it initiates, governs and assists all phases of privatization. However, most of the privatization is spontaneous, initiated by the SOEs themselves. It is believed that the enterprises should rely on their own initiative to transform and develop. Moreover, SPA is a thinly staffed agency who is not equipped to handle the work of a vast number of cases. It does not have a leading role in corporate restructuring, rather provides guidance, control and some assistance. But it does have the mandate to reclassify these self-managed SOEs if they fail to take into account the interest of the State. It should be added that in all cases of spontaneous privatization the role of outsiders to make a bid for the enterprises is not denied.

157. The SPA is aided by advisers who act on behalf of SPA and orchestrate the whole process of privatization. Most companies are privatized by a combination of private placement and public offering, with their securities eventually listed in the stock exchange and with part of the shares reserved for foreign investors. The aim here is to gain access to new capital and expand activities; the generation of revenue for the State is not an immediate goal. Those companies that are not profitable but that can be revitalized by cutback in output, labour force and by a comprehensive restructuring will be infused new capital especially from foreign investors in the form of joint ventures.

158. The privatization in retail trade and services reverses the trend of the early sixties when small and medium size enterprises were bureaucratically centralized into huge inefficient holding companies. This involves the sale of physical assets in open competitive auctions among potential buyers. It is assisted by a privatization credit facility offered by the banks. This credit covers 75 per cent of the total value of the assets acquired and has a flexible interest rate equal to 75 per cent of central bank prime lending rate. Once the sale receipts are in the hands of the SPA the bank loans qualify for refinancing by the central bank. SPA has a semi-independent programme office that assists small scale privatization; this office collaborates with local governments in processing the numerous individual applications for assets and loans.

159. It is still rather early to assess the results of the privatization process. There us a consensus that by April 1992 about 10 per cent of the national assets had been privatized, with the main change in property structure being enterprise transformations and the creation of new companies. The effect of privatization on the economy as a whole has been rather varied. There is a definite positive impact on exports. Hungary has succeeded in shifting its exports from the former Soviet Union countries to the European Community. Both foreign and domestic private firms appear to have played an important role in this development. Hungary, like Czechoslovakia, also has benefitted from considerable foreign investment (US$ 1.1 billion by September 1992). Nevertheless, Government's approach to privatization continues to be ambivalent.

K. Togo 38/

160. Togo was one of the first African States to implement privatization. The objective was the management of the burdensome and inefficient public sector. The major expansion of SOEs starting in 1975 was not a satisfactory development for the Togolese economy, since most incurred excessive costs and operated with large losses that were a heavy drain on the national budget. They also led to increases in the domestic and foreign debt service. Privatization was embraced as a means to reduce the financial burden on the State.

161. Three main methods have been utilized. One was the sale of assets following the liquidation of enterprises. The second was the lease of industrial facilities to the private sector with the SOE retaining ownership. And the third was the generation of new private investment with SOEs opening their share capital to private investors and the Government maintaining minority shareholding. The prerequisite of this last modality was either the settlement by the State of the enterprises' debt or its conversion to equity. New shares were then issued to qualified investors. Foreign investment was welcome.

162. The organization in charge of privatization is the Ministry of State Enterprises who formulate guidelines, classify the SOEs according to whether they are to be retained, liquidated or privatized/restructured, and gather and disseminate information to be distributed to local and foreign banks, chambers of industry and commerce, foreign trade offices and embassies, verify the elements specified with respect to investor qualifications, and consider the proposals.

163. The results have been rather slow in realization and successful only to a mixed extend. During the first four years since the decision to privatize, only eleven SOEs have been privatized by one method or another. Although there has not been an evaluation of the economic efficiency of the privatization process, it appears that the enterprises sold will be operating efficiently and increasing production both for the domestic and the export market at a competitive edge. The lease arrangement has led both to loss of direct employment and in one case to monopoly with prices unchanged, the practice thus benefiting the company financially. The Government may not have taken the time to establish a policy and regulatory framework within which the privatization programme could be implemented and may have followed a pragmatic approach of implementing a rapid lease arrangement beneficial to the private company as a means of giving momentum to the privatization process.

38/ This section draws from World Bank, op. cit., Vol. II.

V. ECONOMIC IMPACT OF PRIVATIZATION

A. Introduction

164. As stated in earlier sections, privatization is basically a political decision. Once it is made, a series of legal and financial actions ensue naturally from this political decision. Nonetheless, the question must be raised, free from political and legal considerations and ideological stands, whether or not privatization is justifiable on purely cost/benefit grounds. Granted, efficiency is a purely economic argument; but the issue here is the development of a technique which would allow a cost/benefit analysis where the economic and social benefits and costs of privatization can be measured with some degree of reliability.

165. Evaluation procedures and cost/benefit analyses to appraise a project from the viewpoint of a set of objectives and to arrive at a single social internal rate of return or a net present value are fairly well-established in economic literature. 39/ These types of analyses, however, refer to a set of circumstances which are somewhat different from those surrounding the assessment of the impact of privatization.

166. Project evaluation at the initial stage would entail a process of ranking a set of possible projects from the highest to in terms of net benefits. An analysis for privatization, however, cannot possibly follow the same established methodological path, simply because the comparison will have to be made on the basis of the current level of operation of the existing entity versus the expected stream of economic magnitudes after the entity (or firm) is privatized. There is a scarcity of a standard methodology developed for this purpose. With some modifications, however, the traditional methodologies of computing the internal rates of return, net present values, and cost/benefit ratios can be successfully applied to the economic evaluation of a privatization project. 40/

39/ Literature on cost/benefit analysis is very extensive and well known among the professionals. Only two sources are mentioned here: UNIDO, "Guidelines for project evaluation" (New York, 1972) and A. Ray, "Cost-benefit analysis" World Bank (Washington, D.C., 1984).

40/ The cost/benefit methodology explained in the subsequent pages was first developed by the author of this report for USAID and was applied to a set of businesses to be privatized in Honduras. It was subsequently published with some minor revisions. See Fuat Andic, "The case for privatization: some methodological issues", Dennis J. Gayle and J.N. Goodrich eds, Privatization and Deregulation in Global Perspective, Quorum Books (New York, 1990). This section is based on and draws from this article.

167. In purely economic terms, privatization gives rise to several possible alterations in the functioning of the production unit. At the one modest extreme, it may consist of simply improving or replacing a machine or a set of machines that are still physically operational but economically obsolete. As a result, a bottleneck may be resolved, production increased, quality improved, production costs decreased, and working conditions ameliorated. A much more ambitious reform involves management changes and complete restructuring of an existing unit, with the expectation of higher profits through a sizeable increase in production capacity and lower production costs per unit of output.

168. Several overall benefits may be expected from the private sector's takeover of the operations of certain public enterprises. The privatization of previously subsidized inefficient public production units benefits the taxpayers, since subsidies are lowered, i.e. the net claim on the public budget of non-financial State-owned enterprises is reduced. The reduction in subsidies implies that public funds are "liberated" and can be used more productively elsewhere in the economy. This may generate additional employment, reduce the current budget deficit, and raise domestic savings as well as public investment. The conversion of unprofitable State enterprises into profitable private entities also expands the profit tax base and hence raises tax collections. Thus, the current revenues of the Government rise and the deficit declines with possible employment and income generation in the economy.

169. The increased wage bill and profits generate additional indirect effects. If the increased wage bill stems from additional employment, the directly generated jobs, through inter-industry linkages and multiplier effects, lead to more jobs elsewhere in the economy. Labour income rises further, consumption and savings increase, and direct tax revenue expands. Similarly, the generation of profits in the economy can be expected to indirectly raise consumption, savings, and public revenue.

B. Cost/benefit analysis: a microeconomic approach

170. The following criteria need to be considered in testing with some accuracy the benefits and costs of privatization at the micro level:

1. The criterion of profitability

171. In evaluating privatization, it must be determined whether net value added after privatization is larger, or at least equal to, net value added before privatization. Net value added is the value of output minus the value of current material inputs and services purchased from outside the enterprise minus investment outlays (i.e. depreciation in a normal year). The criterion is expressed as:

$$\frac{P(NVA)_p}{P(NVA)_g} \geq 1$$

where p = Present worth of the net value added expected to be generated by the unit after privatization.
g = Present worth of the net value added expected if the unit is not privatized.
NVA = net value (= wages + salaries (WS) + social surplus (SS))

If the result is greater than or equal to one, then the next criterion is to be considered.

172. Wages and salaries are inputs from the point of view of the enterprise, but are part of the national income from society's point of view. The social surplus consists of taxes to the treasury, net profits (dividends), interest on borrowed capital, rent, undistributed profits, reserve funds, social welfare funds of the enterprise, etc.

2. Criterion of efficiency

173. The question here is: Does the economic internal rate of return expected from allocating resources to privatization equal or exceed the rate of return which reflects the opportunity cost of capital to the economy? This criterion can be expressed as:

$$\text{Accept if } IRR_{ep} \geq IRR_c$$

where IRR_{ep} = Economic (social) internal rate of return to privatization; and
IRR_c = Critical rate of return reflecting the opportunity cost of capital to the country.

174. It is also necessary to determine whether privatization will be financially attractive to purchasers of the firms. To this end, an analysis has to be made whether the financial returns to prospective buyers are high enough from a private viewpoint.

175. In addition, post-privatization results need to be compared with pre-privatization results by asking the following question: Does the expected net value added generated via privatization exceed or at least equal the wages to be paid to workers? This criterion is expressed as:

$$E_p = P(NVA)_p > P(W)_p$$

where E_p = Efficiency criterion; and
$P(W)_p$ = Present value of expected wages after privatization.

176. Alternatively, from the social surplus point of view, the same criterion can be expressed as follows:

$$\frac{P(NVA)_p - P(W)_p}{P(NVA)_g - P(W)_g} \geq 1$$

It states that the post-privatization social surplus should exceed the pre-privatization social surplus.

177. A third alternative is to compare the pre- and post-privatization internal rates of return. The internal rate of return is that discount rate that reduces the present value of a net income stream to zero. The criterion is expressed as:

$$\frac{IRR_p}{IRR_g} \geq 1$$

where subscripts (g) and (p) refer to pre- and post-privatization, respectively. The criterion states that the internal rate of return should be larger following privatization than what it was prior to privatization. In addition, the IRR_p must exceed a minimum acceptable level which can be taken to equal the interest paid on foreign loans.

178. E_p and IRR_p cannot possibly be calculated unless a series of assumptions are made with respect to the units' future. Needless to mention, such calculations are as good as their underlying assumptions which need to be made as realistically as possible and verified against similar units that operate privately.

3. <u>The internal rate of return and shadow prices</u>

179. Although the theory considers that shadow prices of inputs and outputs reflect scarcities more appropriately and reveal social costs and benefits more accurately, their application in countries where statistical data are either non-existent or unreliable may cause insurmountable impracticalities. It is, therefore, best to keep their use to a minimum and base the evaluation largely on actual prices, with some adjustments whenever necessary. Ideally, however, the shadow prices of foreign exchange, labour, and interest rate must be used and commercial profitability (IRR) should be contrasted with national or social profitability (SRR). While the calculation of the former uses market prices, the latter's computation should be based on shadow prices. 41/

41/ This report refrains from discussing the calculation of shadow prices. They have been extensively computed in the past and the formulae have been developed. See e.g. UNIDO, *op. cit.*, pp. 201 ff.

C. Privatization: macroeconomic effects

180. The measurements discussed in Section V.B. are necessary but insufficient for an assessment of the primordially important impact (mostly indirect effects) of privatization on the economy as a whole. Privatization's impact on gross product and employment, on the Government budget, on savings and consumption, and finally on foreign exchange earnings must also be assessed and quantified as much as possible. No doubt, these calculations too will be as good as the assumptions underlying them. Hence a single numerical value should be less desirable than computing upper and lower limits under alternative assumptions. These would then provide the decision makers with the parameters within which they may opt to operate. Below are the operationally manageable methods of quantifying macroeconomic effects:

1. Effects on value added

(a) Direct value added

$$NVA_p = O_p - (MI + D)_p$$

$$NVA_g = O_g - (MI + D)_g$$

where NVA = net value added
O = output
MI = material inputs
D = depreciation

Then the direct change in aggregate value added is:

$$NVA_p - NVA_g = \Delta NVA_d$$

(b) Indirect value added

The indirect change in aggregate value added is

$$\Delta NVA_i = \Delta NVA_d . K$$

where k = the income multiplier of the sector within which the privatized firm operates; and (d) and (i) refer to the direct and indirect effects on NVA.

(c) Total value added

Hence, the total change in net value added is expressed by:

$$\Delta NVA = \Delta NVA_d + \Delta NVA_i$$

(d) Rate of growth

$$I = \frac{\Delta NVA}{\Delta NDP}$$

where NDP = Aggregate net domestic product for the base year.

2. Employment effects

(a) Direct employment

The total direct employment effect can be expressed as follows:

$$\Delta E_d = (E_p - E_g) + E_{cd}$$

where E_p = Privatized employment

E_g = Non-privatized employment

E_{cd} = Employment in the central Government resulting from liberated funds or increased revenue

(b) Indirect employment

The change in indirect employment in the private sector is given by the following equation:

$$\Delta E_{bi} = (E_p - E_g) \cdot M_b$$

where M_b = Employment multiplier of the sector in which the firm operates.

The change in indirect employment arising from direct job creation in the public sector is expressed as:

$$\Delta E_{ci} = E_{cd} \cdot M_c$$

where M_c = Employment multiplier of the public sector.

Total indirect employment is then given by:

$$\Delta E_i = \Delta E_{bi} + \Delta E_{ci}$$

(c) Total employment

The total employment effect is then expressed as follows:

$$\Delta E = \Delta E_d + \Delta E_i$$

3. Wages and salaries

(a) Direct wages and salaries

The change in wages and salaries resulting from privatization is expressed as:

$$\Delta WS_{bd} = WS_{bp} - WS_{bg}$$

and central Government wages and salaries resulting from liberated

$$\Delta WS_{cd} = \Delta E_{cd} \cdot W_c$$

Total direct wages and salaries are then:

$$\Delta WS_d = \Delta WS_{bd} + \Delta WS_{cd}$$

(b) Indirect wages and salaries

Additional wages and salaries in the economy are then expressed as:

$$\Delta WS_i = \Delta E_{bi} \cdot W_e + \Delta E_{ci} \cdot W_c$$

(c) Total wages and salaries

Total wages and salaries are then equal to:

$$\Delta WS = \Delta WS_d + \Delta WS_i$$

4. Impact on the budget

181. The gains to the Government are the difference between the payments for debt service plus subsidies to the enterprises plus the expected increase in tax collections plus reduction in loan expenditures (principal and interest). This can be expressed as:

$$G_p = (T_p + S_p + D_p) - (S_g + D_g)$$

where
G_p = Net Government gain with privatization
S_g = Subsidies paid before privatization
D_g = Debt service prior to privatization
T_p = Changes in taxes after privatization
S_p = Subsidies paid after privatization
D_p = Remaining debt service of the Government.

Information on subsidies and debt service can be obtained from public documents. The impact on tax collections can be estimated as:

$$\Delta NVA \cdot t$$

where
ΔNVA = Estimated increase in net value added resulting from privatization
t = Average tax burden in the economy estimated as the ratio of total taxes to value added

5. Impact on savings and consumption

182. This impact can be computed using estimates of marginal propensities to consume and save for the aggregate economy. Thus:

$$\Delta C = \Delta NVA.b$$
$$\Delta S = \Delta NVA\ (1-b)$$

where ΔC = Change in consumption
ΔS = Change on savings
ΔNVA = Change in net value added
b = Marginal propensity to consume
$(1-b)$ = Marginal propensity to save

These are global parameters and do not differentiate between the propensities among different types of income earners in the private sector; nor do they distinguish the savings performance of the Government.

6. Balance of payments effects

183. The effects on the balance of payments can be broken down as follows. The items indicated with a (+) sign represent favorable repercussion and those with a (-) sign are negative implications.

(+) reduction in imports
(+) output exported
(+) public foreign debt reduction
(-) private foreign debt service increase, if any
(-) increased imports because of growth
(-) increased imports, if any, because of greater use of imported inputs.

For operational expediency, however, the impact on the balance of payments can be calculated by means of estimates of aggregate coefficients of propensities to import and export.

184. The proposed methodology is merely a beginning. Considerable field work will have to be carried out in future, methodologies will have to be tested, and wrinkles to be ironed out. 42/

42/ The author has applied the methodology outlined above in one country where statistical information is rather scarce. Nonetheless, some reasonable results were obtained in three enterprises selected as a pilot project. The following magnitudes were estimated for the four criteria:

Firm	$P(NVA)_p/P(NVA)_q$	E_p	IRR	SRR
A	1.64	1.68	26.2	18.7
B	1.60	3.03	14.6	13.9
C	1.56	1.89	13.1	4.9

Employment, consumption, savings, and foreign exchange earnings also indicated positive expectations, For details see, Fuat M. Andic, op. cit., pp. 46-47.

VI. INTERNATIONAL CO-OPERATION AND PRIVATIZATION

A. Privatization and International Assistance

185. Privatization has been transforming the lives of millions of people both in the developed and the developing world. The specific features of privatization, its pace, and the way people share its benefits and costs are essentially determined by how a country manages its human and material resources within the recognized property rights and restructured economies.

186. While privatization in the developed countries has remained basically an internal affair managed by internal resources, in the developing world and in formerly command economies the management of the privatization process has required foreign expertise and assistance. This requirement stems from various reasons. There is hardly a necessity to enter into a detailed discussion of these reasons, but some major ones should be mentioned, such as the lack of experience in managing private assets, absence or feebleness of financial markets, and the need to stabilize the macroeconomic parameters for a successful privatization process.

187. Various international and bilateral assistance agencies have been rather active in the developing countries and formerly command economies. IMF, IBRD, EBRD, UNDP, UNIDO, AIL are acronyms that immediately come to mind. Not all are able to provide all the financial and technical assistance to all of the countries in the privatization area.

188. It is now quite obvious that the following conditions must hold if privatization is to succeed:

(a) Internal and external macroeconomic stabilization must be achieved in a relatively short period;

(b) Competitive markets must be established and price reforms must be carried out;

(c) A mechanism must be put in place to reorient the State away from direct ownership/control towards a system of regulation that promotes adjustments and creates an "enabling environment" for private sector growth;

(d) Newly privatized enterprises must be restructured so that they become efficient and competitive;

(e) Financial markets must be operative and be conducive to the development of the private sector;

(f) Finally, a new breed of managers and technicians must be trained for macro- and microeconomic management.

189. There could hardly be any disagreement with these requirements. The international community has been in fact providing financial and technical assistance to fulfill some of these requirements. It is humanly impossible to present, within the short pages of this report, an inventory of all the areas where international assistance is provided, or to catalogue all the international agencies and their spheres of activity that are directly or indirectly related to the privatization process. At the expense of committing gross omissions one can mention that both the World Bank 43/ and the IMF have been tackling the issues of macroeconomic stabilization and price reforms. AID has been active for some time in the financial sector reform of the developing countries, and it has intensified such activities especially in countries (such as Eastern Europe) where privatization and rapid economic restructuring are of primary concern. It has also been providing technical expertise in privatization policies (e.g., Honduras) and privatization practice (e.g., Poland, Hungary). UNDP has become increasingly active in giving technical assistance to privatization, structural reforms, and private sector development.

B. Privatization and UNIDO

190. This section gives weight to UNIDO's internal capabilities and its potential to assist the developing and former command economies. In this context it should be noted that privatization is not end in itself, but a process to restructure the economies. In that vein macroeconomic reforms and micro-level enterprise restructuring interact in assuring the efficiency and competitiveness of the post-privatization era. 44/ Hence, technical assistance to be provided by UNIDO must be viewed from a wider perspective than privatization per se.

191. Given its in-house expertise, UNIDO can render useful assistance to the countries where privatization is under way or is likely to take place at two broad levels: at the macro policy level and the micro enterprise level. In addition, an area that cuts across both types of assistance is that of human resource development and training. 45/

43/ The World Bank has been rather active in providing technical assistance and financial loans to some countries where privatization is taking place. Recently it has created a vice-presidency whose office will deal exclusively with privatization issues.

44/ Interdependence of macro and micro reforms and UNIDO's role is ably discussed in a paper prepared by George B. Assaf of UNIDO's Regional and Country Studies Branch and submitted to the Seminar on Industrial Restructuring within the Context of Macroeconomic Stabilization and Property Rights Reform in Eastern European Countries and the Russian Federation, Vienna, October 1992. The author's emphasis is, as the title of the Seminar suggests, on Eastern European and FSU countries.

45/ A similar argument was put forward by the author in his "Issue Paper: Industrial Restructuring, Privatization, and Property Rights" prepared for the previously mentioned Seminar.

At the macro level UNIDO is capable of providing the following services:

(a) Policy advice on industrial restructuring and strategies for the pre-privatization (legislation required for privatization strategies) and post-privatization stages;

(b) Policy advice on the integration of environmental aspects into industrial policy in a manner that achieves a suitable balance between environmental protection and industrial development;

(c) Assistance in establishing and/or restructuring institutions and mechanisms for industrial development in the framework of a free market economy. This includes governmental organizations, ministries, as well as industry associations;

(d) Assistance in setting up information systems, data bases, and decision support systems suitable for use in a free market economy;

(e) Training programmes - both in the country and abroad - on the above aspects;

(f) In-depth studies and industrial sector reviews (these have so far been prepared for Poland, Czechoslovakia and Hungary);

(g) Assistance to private sector industrial organizations in developing meaningful interactions between the private and public sectors for policy formulation.

192. The following kinds of technical assistance may be provided at the enterprise level:

(a) Assistance to individual enterprises in restructuring their managerial, accounting, production, and marketing systems (such assistance is already being rendered to nine enterprises in Poland);

(b) Assistance to enterprises for conversion of production from military to civilian uses (this is being undertaken for an enterprise in Poland);

(c) Assistance to enterprises in cleaner production methods, including prevention of industrial pollution, waste recycling, and energy conservation as part of their restructuring process;

(d) Organizing and conducting investment fora that would bring together national and international investors to promote foreign investment and joint ventures (such fora have been organized in Czechoslovakia, Poland, and Yugoslavia).

193. UNIDO's human resource development programme can cater to the extremely urgent and critical training requirements. Training workshops, fellowships, and study tours can be organized and conducted on industrial management, bookkeeping, accounting, marketing, and export development strategies.

194. The lists are generic and all-encompassing. Undoubtedly, given its limited resources, UNIDO cannot cover all areas of expertise with equal strength and efficiency. It is, therefore, legitimate to ask the questions: Where does UNIDO's strength lie? In which areas can UNIDO provide technical assistance that no other competing international or bilateral organization can?

C. UNIDO's specific areas of strength

195. This report suggests four specific areas of technical assistance where, in view of its past activities, UNIDO has competitive advantage. The suggestion certainly does not limit UNIDO to only these four areas and does not imply that it should ignore other specific fields of activity. It merely highlights the technical assistance areas where UNIDO can excel over other organizations.

- Assistance to establish the mechanism for strategic management and industrial development;

- Assistance to solve a host of problems that surge after privatization and/or transition to a market economy;

- Assistance to train at the managerial and technical level;

- Creating linkages between developed and developing countries for a better transfer of technology and market awareness; facilitating the access to information indispensable for efficiency; supply sources; potential demands; and regional co-operation.

196. These four areas constitute the supply side of technical assistance with which this chapter is concerned. 46/ Further detailing is in order to delineate the meaning and boundaries of these overlapping areas.

1. Strategic management of industrial development (SMID)

197. For years UNIDO (and other multi- or bilateral aid agencies) have assisted the developing countries to prepare normative industrial plans and

46/ It is worth noting that there is also a demand for technical assistance which originates in the countries themselves. During the previously mentioned Seminar on Industrial Restructuring participants of nine Eastern European and FSU countries identified the following technical assistance areas as having primary significance: managerial training (6 countries); regional co-operation and East-East information exchange (9 countries); training (4 countries); market identification (5 countries). Strengthening the private sector organizations and industrial restructuring policies were also mentioned. See Final Report, Seminar on Industrial Restructuring within the Context of Macroeconomic Stabilization and Property Rights Reform in Eastern European Countries and the Russian Federation, Vienna, 5 November 1992.

build institutions (mainly ministries of industry) which tended to be dirigist and interventionist. The success stories are too few and too far in between. The more the help to governments and State-owned enterprises, the more the public sector activities stifled the private sector and its development. In fact, the private sector became an appendage to the public sector and was unable to respond to the rapid changes in the international environment.

198. In the early eighties it was realized that this approach to economic growth and development was neither valid nor useful. The World Bank, mainly, but also AID, began to consider reorienting assistance in a way that would give the private sector the prime role of promoting economic dynamism.

199. UNIDO did begin to develop a new approach - SMID - to respond to this need. The tenets of SMID, really a common sense approach, can be summarized thus:

(a) The developing countries lack the capacity to manage their industrial development;

(b) This capacity is needed in both the public and private sector, and the right way to build it is through learning-by-doing rather than through <u>ad hoc</u> short-term training courses or study tours;

(c) The appropriate method and the right policies and strategies for industrial revitalization, development, and competitiveness cannot be a "master plan"; rather they can be attained through an effective dialogue between the public and the private sector in which the private sector can articulate its requirements to function efficiently, and the public sector can commit itself to provide the enabling environment and the necessary conditions to satisfy these requirements within the existing internal and external constraints;

(d) The proposals resulting from these dialogues are usually crystallized within "strategic committees" set up in accordance with the importance of the sub-sectors and are transmitted to decision makers who are, as a matter of policy, favourably disposed towards the new dynamic role of the private sector;

(e) The strategy and policy proposals are harmonized by the public sector via a co-ordination committee of the highest level and converted into concrete policy actions and strategies.

200. In a nutshell, the SMID approach provides assistance to putting in place a mechanism to achieve an ongoing process of consultation and dialogue between the private and the public sector. This process, in fact, is one of the major outputs in fulfilling the objectives set out. It is not a "ready made" planning exercise, but rather a flexible approach for industrial development whose degree of efficiency depends upon the existence of several preconditions and constraints in the recipient country.

201. SMID is a common sense approach. It is currently being experimented with in several African countries. Countries in other continents are also ripe for this approach. Eastern European countries and former members of the Soviet Union are also in dire need to reshape their industrial policies. SMID, being a flexible approach, can and should be able to form the basis of future technical assistance to them. After careful examination of the approach and its application in a number of African countries one can say that UNIDO should adopt it as a standard operational procedure.

2. Pre- and post-privatization

202. Privatization per se is one component in the chain of industrial restructuring. Some of the enterprises that are candidates for divestiture will have to be prepared for privatization. This preparation, called pre-privatization here, may require reorganization, revitalization, or rationalization prior to the firms' transfer to the private sector. Clearly, UNIDO has the capacity to assist the enterprises in this pre-privatization process. Moreover, some of the enterprises were originally designed for military production and will now have to be converted to the manufacture of civilian goods. Again UNIDO can and should have a primary role in assisting in this conversion stage.

203. While UNIDO can be of assistance in designing the privatization policies and in the actual implementation of the privatization process (which is more of an accounting and legal work), it can be more effective in the post-privatization stage. In other words, it can lend its unique expertise in the internal restructuring of the enterprises after their privatization to assure that they operate efficiently and in a competitive manner. At this level the enterprises will required assistance in production management, training of managerial and technical staff, marketing and export marketing techniques, acquisition of new technologies, and a host of other aspects pertinent to the micro level. UNIDO is uniquely suitable to provide assistance especially in these post-privatization periods.

3. Training

204. There will be a great need for a different type of training. Through the SMID approach a new type of capacity will have to be built, and both public and private managers of economic resources will have to learn and adopt altogether new rules of the game. This is an inalienable component of the approach and it could certainly be a "patented" activity of UNIDO. Assistance to train technicians, plant managers etc., has been a major activity of UNIDO. What is imperative now is to fit these activities into an overall programme to be linked to post-privatization assistance.

205. New training needs are surfacing in addition to the usual ones UNIDO has been addressing. These can be grouped as follows:

(a) Economic resource management. This type of training aims mainly at making public and private sector decision makers capable of handling the economic resources efficiently. It does not consist of short-term study trips or intensive and purely technical and narrowly focused short courses. It is learning-by-doing. It is embedded in the SMID approach for sure. But it must be realized that it is training, and provisions must be made accordingly;

(b) Marketing. International trade is bound to expand. Neither the privatized public enterprises of the developing countries nor the new enterprises in the ex-command economies have a firm grip on marketing their goods internationally. Yet, without exports many of them will perish. They must be trained to function in the international arena. UNCTAD/ITC, for example, has designed programmes to this end; but UNIDO might want to expand them to encompass the specific new needs;

(c) Maintenance training. This is a very specific issue. In many developing countries, plant and equipment maintenance is in a dismal state. Maintenance is of utmost importance especially in the former Soviet republics, since it will take a while before they can renew their capital stock. UNIDO can very quickly develop projects to assist them in this crucial area. A follow-up of the Consultation meeting that took place in 1987 on this subject is more urgent now than ever before.

4. Consultations

206. The fourth area concerns the System of Consultations Division. The internationalization of the world economy is irreversible. There will be further opening of the markets, faster transfers of technology, upsurge of the need to know the new markets, identification of appropriate technologies, in short a need for closer sector contacts aided by an international data bank. UNIDO has that bank at hand. Through its regular activities the Division can open several dimensions to private enterprises, link them to their markets and sources of supply, and by a perfect catalyst among the private sectors of different developing countries, especially those that are reforming their economies as well restructuring them. Moreover, today the world counts with many more countries than ever before. These countries will have to realize that they will have to collaborate and co-operate on a regional basis, not because the governments dictate so, but because private sectors need to do so.

D. Concluding remarks

207. These four almost exclusive areas can constitute a comprehensive basis of action for UNIDO. If the strategy is designed well and co-ordinated with, say, that of the World Bank and with UNDP activities targeted to develop the

emerging private sector, UNIDO would be embarking upon an effective technical assistance path. Moreover, UCDs may assume even more of an active role in identifying the demand for technical assistance in the countries where they are stationed. 47/

208. These suggestions are not comprehensive; nor do they extend to the totality of UNIDO's in-house capabilities. Moreover, UNIDO may not wish to tackle all the areas outlined above. However, the essence of the matter is that UNIDO can and should play an important role in the privatization efforts of both the developing and ex-socialist countries. In the final analysis reorganizing and revitalizing the industrial sector and training in numerous areas are among UNIDO's main activities.

VII. CONCLUSIONS AND RECOMMENDATIONS

209. Distilling the text of the preceding pages into a single sentence, privatization can be said to be the return to profitable private motivation of any activity that had declined through unprofitable State intervention, be it in the form of State ownership of enterprises, excessive regulation, or pretending to transfer the means of production to collective ownership.

210. It is of some importance that at the outset privatization in mixed economies be distinguished from privatization in ex-centrally planned or command economies. In the former the issue is the realization that the public interest cannot be best served by spending much more of GDP through politician-dictated monopolies or through excessive regulation rather than market-leading common sense; that is, it is one of reform. In the latter the issue is to create the market economies; that it is one of transformation. Privatization in Eastern Europe and in the Republics that once formed part of the now defunct Soviet Union is not a matter of option, but the only vehicle to create capitalism. There it is not a question of raising Government revenues, nor is it a matter of waiting for better times. It is a matter of realizing that without privatization better times will never come.

211. Although the weight of this paper is on privatization in mixed or capitalist economies and although only three ex-socialist country experiences - one being very sui generis - are discussed, certain general comments relevant to them must be made here. For one, there is hardly any experience in the countries which were members of the ex-Soviet Union that would give enough handle to draw conclusions pertinent to them. Yet, it is clear that if they opt for capitalism they must realize, and sooner the better, that there would be no capitalism without capitalists. Capitalists, however, need numerous institutions, such as financial institutions and well-defined property rights, and access to savings - domestic or foreign - in order to set the capitalistic wheels in motion. Privatization in ex-socialist countries will be a necessary but a very insufficient condition for the required transformation.

47/ The World Bank has been extending as of late assistance especially to the former Soviet Union countries in setting up a "foreign assistance management unit" attached to a particular ministry where the supply of assistance is expected to be matched rationally with its demand.

212. Several Eastern European countries have made noticeable advancement towards privatization with varying degrees of success. In Hungary, for example, privatization has basically meant selling those assets for which there would be domestic or foreign buyers. The initial success of the Hungarian experience should not mislead the proponents of privatization in ex-socialist countries that this is the easiest way to place all State enterprises into private hands. In all these countries there are enterprises that are not sellable. Czechoslovakia's approach of setting up mutual funds and making their shares available to the public (through sale or gift) may very well be a faster way to privatize. None of the ways tried or implemented in Eastern Europe is an easy and foolproof way. Transition to capitalism is bound to be painful. Privatization is an inextricable part of this painful process.

213. In countries with basically "capitalist" economies privatization is a vehicle for reform. As has been repeated in this report over and over again, it is a matter of pulling back the frontiers of Government and enlarging the private ownership and portfolio through divesting the Government ownership and replacing regulations which stifle the private initiative with those which assist the private sector to flourish.

214. As examples show, the experience has been varied. One quick conclusion is that the more developed the country, the easier the road to privatization, simply because the sustaining conditions are there. Financial markets, stock exchanges, banks, insurance industry, and well-defined property rights have already been put in place through a long historical process. They are the facilitator of the process. In contrast, the experience of developing countries has been uneven, simply because there such pre-conditions exist in varying degrees.

215. Privatization is not a panacea for all ills. It is a method. Like the application of all methods it does require a set of pre-conditions. These are briefly:

(a) Commitment to privatization by the decision-makers. Yielding to international pressures, whatever the reason might be, and using privatization as a gimmick to secure further loans or aid or international political favours, in other words, using privatization as a lip service for purposes other than what is really meant is more harmful to the society. In such a case it is better not to privatize;

(b) The decision to privatize does not mean immediate divestiture. It does require full understanding of separating ownership from control;

(c) Privatization also requires the highest level of support and monitoring. A junior ministry or an *ad hoc* office is not sufficiently equipped to deal with the complex issues of privatization. Rather, a cabinet-level authority in decision making is required;

(d) Privatization alternatives must be in accordance with the existing institutions. The absence of such institutions could easily render futile all the efforts to privatize. Divestiture of SOEs by means of sales of shares where stock exchanges do not exist is not the technique to implement privatization. The required institutions must be put in place and the necessary legislation enacted prior to or at least concomitantly with privatization;

(e) Privatization is a process which changes the power relations reigning in a society and upsets vested interests. In countries where political democracy is the norm, a misunderstood privatization decision can easily be lost in the labyrinth of political bickering. An education campaign is necessary to assure the agreement of the different segments of the society with the decision to privatize.

216. These pre-conditions do not stem from abstract deductions, but from lessons learnt from the painful experience of a number of countries. 48/ They must constitute a set of criteria for countries to adhere to when they opt to privatize.

217. The past experience in market economies leads to the following recommendations:

(a) Assuming that the commitment to privatize is firm and the different segments of the society are in agreement with the decision to privatize, the execution of the procedure must tailor the choice of instruments to the needs as well as to the prevailling socio-economic framework. Instruments vary, as was discussed in Section IV.C.. That an instrument suceeds in one country does not necessarily mean that it will do so in another. The chosen instruments must be evaluated and subjected to a critical review prior to their deployment;

(b) Privatization does not operate in a vacuum. It requires a set of macroeconomic and sectoral policies. Governments must assure that privatization occurs in an economic environment in which competitive forces are allowed to lead to efficient production and hence to growth;

(c) Concomitantly, Governments must prepare and enact the necessary legislation;

(d) Several sectoral policies are necessary, but not sufficient. They must be complemented with sub-sectoral policies. This means, for example, that in potentially competitive sub-sectors deregulation must allow freer entry of domestic and foreign firms (unless national security is an overriding concern), and trade must be

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48/ See, for example, Starting up a Privatization Process: The Tunisian Case, by P.H. Elicker and Jamal Saghir, UNIDO, ID/WG.498, 2 January 1990.

liberalized to permit imports of commodities. In subsectors where natural monopolies cannot be avoided (such as utilities) deregulation should take the form of transparent regulatory control to protect the public interest;

(e) Since the very purpose of privatization is to reform the economy by allowing the private sector to expand and the public sector to provide an "enabling environment", it is desirable that Governments use the proceeds obtained from the sale of assets for infrastructural expenditures to provide such an environment and for the reduction of public indebtedness, rather than financing current expenditures.

218. The issues surrounding ex-command economies are much more complex and difficult. Many members of the ex-USSR are likely to choose privatization as a method of transformation; yet they are the least ready for a quick transfer of assets from the public to the private sector. In order to make the transition as efficient and smooth as possible:

(a) They should establish the pre-conditions for privatization as fast as possible by setting up the financial, regulatory and legal frameworks;

(b) They will have to distinguish between private trading markets and private industrial production;

(c) They will have to examine with critical eyes the experiences of Eastern European countries;

(d) They will have to seek internationally available technical assistance to design and implement realistic policies and strategies for transforming their economies in which privatization is but one component among many.

219. In the previous chapter this report put forward some suggestions for UNIDO to consider in supplying technical assistance in privatization and industrial restructuring. These suggestions were based on in-house expertise of the Organization. Given its past technical assistance experience in many developing countries and its qualified staff, UNIDO can and should play an important role in assisting the developing as well as ex-command economies in their quest of privatization and industrial restructuring. In doing so it may also consider to fortify its collaboration and co-ordination with other multilateral and/or bilateral aid agencies, such as the World Bank and USAID. Both have been active for some time in providing technical assistance and loans for the structural adjustment of the economies and for the development of the private sector.

220. Several areas of supply of technical assistance were detailed in Chapter VI:

(a) Assistance to establish the mechanism for Strategic Management of Industrial Development, so that the fledgling private sector can have an increasingly important role in shaping policies for industrial development;

(b) Assistance to solve a host of problems that surge after privatization and/or transition to a market economy;

(c) Assistance in training at the managerial and technical level, especially executives of the privatized industries, and in transfer of technology;

(d) Creating linkages between developed and developing countries for access to technological information and market awareness; facilitating the access to information indispensable for efficiency; supply sources; potential demands and markets; and regional co-operation.

221. These suggestions are not comprehensive; nor do they extend to the totality of UNIDO's in-house capabilities. Moreover, UNIDO may not wish to tackle all the areas outlined above. However, the essence of the matter is that UNIDO can and should play an important role in the privatization efforts of both the developing and ex-socialist countries. In the final analysis reorganizing and revitalizing the industrial sector and training in numerous areas are among UNIDO's main activities.

VIII. RECENT LITERATURE ON PRIVATIZATION

222. The literature on privatization, divestiture, and regulation has been growing in leaps and bounds in the past decade. It is physically impossible to list here all the books, articles, pamphlets, reports, papers, published or unpublished works. Nor is it possible to trace this literature back in history. Conceivably one can go back two centuries to Adam Smith and "The Wealth of Nations" as the theoretical underpinning of privatization. More recently in this century Hayek's seminal work ("The Use of Knowledge in Society", American Economic Review, Vol. 35, 1945) may very well be taken as the theoretical pillar of privatization.

223. This chapter cannot travel that far back. It is in fact much less ambitious than its title suggests, for it includes merely recent works that appeared since the early eighties. A few exceptions, however, were made and some earlier works have been included because of their particular importance. These have been kept to a bare minimum. The guiding principle in selecting the recent works was their relevance to practitioners, without completely eliminating theoretical writings. The works cited below are not organized thematically, but alphabetically according to the authors' last names.

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