Economic Perspectives

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FUTURE DIRECTIONS
FOR USAID

PRIVATIZING MONOPOLIES

ALTERNATIVE
FINANCING MECHANISMS

PENSION PRIVATIZATION

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ECONOMIC PERSPECTIVES
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PRIVATIZATION

During the past 15 years, the privatization of government services and state-owned enterprises has gained remarkable currency as a means of enhancing global competitiveness, fostering the establishment of democratic institutions and advancing economic development. In 1996 alone, privatization programs raised an estimated $85 billion worldwide and increased citizens' participation as shareholders in domestic and global economies.

U.S. support for privatization has been two-fold: In addition to providing bilateral aid, the United States works closely with the development banks that have played a leading role in the recent wave of privatizations.

This issue of "Economic Perspectives" explores the process of privatization, its problems, and its benefits — with special emphasis on the developing and transitional economies that have produced some of the most creative and far-reaching programs to date.

ECONOMIC PERSPECTIVES

An Electronic Journal of the U.S. Information Agency *Volume 2, Number 1, January 1997*

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Editor, Economic Perspectives
Economic Security - I/TES
U.S. Information Agency
301 4th Street, S.W.
Washington, D.C. 20547

E-mail: ejecon@usia.gov

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❑ THE CHALLENGE OF PRIVATIZATION: MESHING SOCIAL POLICY AND DEVELOPMENT GOALS

An Interview With Jan Piercy, U.S. Executive Director, the World Bank

State-owned enterprises have failed to make the kinds of investments in education, health care, and other social sectors that are critical to a globally competitive economy, says Jan Piercy, the Treasury official who serves as U.S. executive director at the World Bank. "As this connection is being understood, there is a much broader acceptance of the need for privatization as a critical element in a country's growth and development and its ability to compete globally," she says.

She points out that, over the last half decade, some privatization projects have proceeded with little thought to the regulatory or tax policies that support a country's social infrastructure.

"There is a clear conviction that further steps must be taken in terms of policy and regulation of the private sector, paying more attention to access to opportunities for ownership," Piercy says. The World Bank, she adds, is playing a vital role in the privatization process through its advice, loans, and guarantees, with special emphasis on fostering small and medium-sized businesses, management skills, access to credit and capital, and information technologies.

This interview was conducted by USIA Economics Writer Jon Schaffer.

Question: State-owned enterprises, once dominant players in mining, basic industries, utilities, and infrastructure around the world, are increasingly being converted to private-sector interests. Would you provide a conceptual overview of this transformation?

Piercy: Within the last three years, there has been a striking shift within the decision-making bodies of the World Bank, the IMF, and other development institutions that has been led by the United States. There is now a majority view in support of privatization of state enterprises and a recognition that such enterprises are a drain and a drag on the economy as a whole, inhibiting essential investment in social-sector spending, particularly in the areas of education and health. As this connection is being understood, there is much broader acceptance of the need for privatization as a critical element in a country's growth and development and its ability to compete globally.

The debate in these institutions now centers on timing, sequencing, and equity — not whether private-sector ownership is preferable to state ownership.

Q: After more than a decade of experience, does the Bank have a road map for a country moving toward privatization?

Piercy: I think we are still very much in the learning stages. There is evidence of both successes and failures in a range of privatization approaches — from vouchers to outright sales to foreign and domestic bidders — and I think that a mix of means is usually necessary.

A lot depends on the availability of credit and capital and the creation of a new mind-set in the financial sector regarding small and medium-sized businesses. For people accustomed to a centralized economy, the notion that a small business can be essential to the health of the economy may be alien. The European Bank for Reconstruction and Development (EBRD) and the International Finance Corporation (IFC), the private sector arm of the World Bank, are now involved in a series of programs that provide access to lines of credit and technical assistance to banks in Russia to try to orient the financial sector toward those small and medium-sized businesses. These programs are being extended to some other former Soviet Union countries.

Q: So privatization schemes have to address the differing circumstances of each country?

Piercy: Certainly. In the former Soviet Union, countries are in the first stages of conversion from nationally held entities to the delivery of services by the private sector.

In Latin America, however, some of the questions surrounding privatization have to do with who has had the opportunity to purchase state-owned enterprises. We have seen the creation of some private-sector-held monopolies that are nonetheless monopolies. There is a clear conviction that further steps must be taken in terms of policy and regulation of the private sector, paying more attention to opportunities for ownership.

Q: How does it benefit a country if the privatized firm maintains a monopolistic position?

Piercy: It is better because you end the drain on the national budget of loss-making state-owned enterprises so that money can be rechanneled into more productive uses. It is better because an enterprise is now much more likely to operate on a competitive, cost-effective basis and, therefore, become a more productive element contributing to national investment and savings. And it is better because, often, the privatized firm is a combination of domestic and international ownership that brings in and showcases the best business practices. Dissemination of business ideas is beneficial not only for that particular company but for others in the industry.

At the same time, a monopolistic position is problematic because there is often a gap between the divestiture of certain state enterprises and the development of sophisticated regulatory and tax systems that serve to create balance within certain industries. Some of the earlier privatizations were certainly not done in a transparent or particularly accountable manner. I think those earlier experiences are being taken into account in the privatization that is under way now.

There is a real shift globally in the extent to which public business is conducted in a more open and transparent way, driven, in part, by advances in electronic communication that make it easier to monitor what a government does. So in that environment, it is going to be harder and harder for a “sweetheart deal” kind of privatization to take place on any major scale.

Q: Even with advances in communication and growing transparency, there are numerous examples in which rapid privatization has given rise to corruption and bribery. How has the World Bank addressed this issue?

Piercy: It is very clear that the economic costs of corruption in the privatization process are significant, especially if you take into account the disincentive effect on foreign investors. World Bank President [James] Wolfensohn in October 1996 announced that the Bank would be pursuing anti-corruption efforts with renewed vigor. This was followed by remarks by U.S. Treasury Secretary Robert Rubin, who, speaking as a former investment banker, said that countries that have the reputation of being corrupt are discouraging international investment.

I think talking about the unacceptability of it, being willing to act where we have concrete evidence of it — those all begin to create the necessary pressure to eliminate corrupt practices.

Q: You mentioned earlier that countries need to create new “opportunities for ownership” as part of the privatization process. Would you elaborate on that point?

Piercy: Increasing attention is being paid to issues of access to credit by the very poor — micro-finance programs. Latin America, for example, has achieved impressive growth but with persistent poverty and great disparities between those who are affluent and those who are poor. Banco Sol in Bolivia, for example, which is made up of very small and relatively poor borrowers, has now reached significant scale as a financial institution. The evidence suggests that the poor, in fact, are good credit risks and that unsubsidized interest rates are not a barrier to borrowing.

The connection between privatization and providing credit access to the very poor has not been sufficiently well understood. There is evidence that unless the poorest citizens have access to the means for economic mobility, privatization and private sector-led growth can distance economic sectors of society in ways that are very difficult presently to bridge.

Q: What are some of the other obstacles to privatization?

Piercy: One of the things we have witnessed, for example, in Russia and the other former Soviet countries is that it is better to have a number of things happen simultaneously to avoid the gap I mentioned earlier between divestiture and the creation of essential institutions. For example, if you privatize a firm without a tax system in place to finance education, health care, and other public services, you create a disparity between the benefits to the economy from the privatization and the costs to society.

Remember, education and health care often were previously provided through state-owned enterprises. The first thing you do to prepare an enterprise for privatization is to divest it of its noneconomic functions — the child-care centers, the education programs, the delivery of health care. You need a social safety net — an alternative means of protecting the vulnerable in the population.

Ideally, we should have the social safety net and managerial skills in place. But the world doesn't operate that way. I think you have to unleash privatization. It's uneven, it's inelegant, it's awkward, and there have been tremendous dislocations in economies where privatization has occurred — but I do believe that, over time, the demand for social services and managerial skills will create the supply.

Q: This dynamic still seems elusive in parts of the former Soviet Union, including Russia.

Piercy: I'd assert, given a long enough time frame, that needs will be met everywhere, accelerated by the rapid expansion of information technology that allows experience and expertise to be shared across the barriers of distance.

One of the things the Bank is studying is how it can harness the capacity of information technology for development because we believe it is going to allow people to take advantage of insights from elsewhere rather than having to go through the same painful sequences that others have already dealt with. They can tap talent that may not be available to relocate, coach, mentor, guide, and support institutional development and the acquisition of necessary skill. Even in Russia, where there is no question that privatization is proceeding with great difficulty, there are lots of examples of enterprises that have achieved a stable footing, are providing employment, are operating on a profitable basis, and are being emulated.

Q: What response do you have to those economists who argue that, in Eastern Europe and the former Soviet Union, the large-scale privatizations of the early 1990s created more problems than solutions — problems that persist today?

Piercy: You have to understand it in terms of the momentum of the time. There was a sense of urgency in that what was under way was no less than the transformation of societies as well as economies.
I know best about Poland because, prior to joining the Clinton administration, I was a bank executive with the Shorebank Corporation of Chicago. Shorebank was asked to become involved in the privatization of state-owned banks in Poland.

In the early days, getting people to prepare a cash-flow statement on their small businesses in preparation for receiving a loan was virtually impossible because they had operated for decades outside the money economy. Given the kind of mind-set change that had to occur, we came to the conclusion that there wasn't any way other than to jump in and, over time, create the changes in attitude and behavior that were necessary to make the economy work. No question, it was very tough. But I don't really think there were alternatives because if you tried to privatize the enterprises but left the banks under state ownership, you would not have been able to provide the access to capital and credit to small entrepreneurs that was necessary to jump-start the formation of businesses.

Q: Can state-owned enterprises and privatized companies co-exist within a country?

Piercy: There is a lively debate over whether certain services critical to the economy, such as power, should be retained in public ownership. I think there definitely is room for a partnership between state-owned enterprises or partial state ownership and the private sector. This is particularly true in a transition period where you don't have the kind of regulatory structure that would provide confidence to the public at large that there will be some ways of assuring competitive pricing when it is entirely in the private-sector domain. Over time, however, state ownership should move in the direction of total private ownership.

Q: Privatization seems to have bypassed much of Africa. Is there a role for privatization in Africa?

Piercy: There is. In fact, this past summer the IFC launched an initiative to target a number of countries, the majority of them in Africa. This initiative is going to put IFC people in countries to prospect more aggressively for deals, to identify local entrepreneurs, to identify market niches, and to see if it can generate some partnerships and additional investment, and in sectors other than tourism and natural resources — to which much of its investment in Africa has been limited.

I think that, over time, if we see continued stability in Ethiopia, in Mozambique, and in South Africa, we will get some anchors on the continent that can become the base for building private-sector investment. But naturally, the circumstances that we face today in Zaire and Rwanda — the continued ethnic strife and instability — directly jeopardize foreign investment.

Q: How does the World Bank interact with other players in the privatization process?

Piercy: I think that is absolutely the key question. World Bank President Jim Wolfensohn says that we have to convert ourselves into the knowledge bank. By that he means that the real heart of what the Bank has to offer is not its loans but its expertise, and, specifically, its nonideological knowledge of approaches that have been used around the world.

In the area of health care, for example, a number of developing countries are coming to the Bank for help in designing delivery systems that may differ from those in industrialized countries, where the burden of health care costs is a serious threat to national budgets. The Bank can provide expertise in helping these countries to develop a system that is consistent both with budget restraints and broader access to care. It's also important to note that some countries are more open to advice from the Bank than from a bilateral donor because the Bank is not perceived as carrying an ideological bias.

Second, and very important, the Bank can offer loan guarantees that provide a sort of "comfort level" for private-sector companies in countries where the political climate is regarded as somewhat unstable or the regulatory and legal environment is undergoing change. Seeing the Bank, particularly the IFC, in these countries can provide a greater sense of security for companies to enter those markets.

Another approach — somewhat newer, and that the Bank has used in El Salvador — is to identify and work with the diaspora (overseas communities) of these countries to create links between the diaspora and investment. People are receptive to investing in their homelands for both economic gain and for noneconomic reasons. In El Salvador, it has triggered traditional investments but also has led to a number of contributions for education and other social sector initiatives.

Q: One barrier to privatization has been a long-held distrust in many developing countries of foreign direct investment. What role does foreign direct investment have in the privatization process?

Piercy: Let me respond with a story told by the president of Motorola about his company's negotiations to enter China. He was told by the authorities there that China was receptive only to joint ventures or to minority foreign ownership. In response, he said that if Motorola came in, it would do so at its own risk, but that it would model its operations on the same techniques that made it profitable internationally. He said the company would be hiring Chinese to work for it — employees who would be learning everything about what the company does and how it does it. He told the Chinese that within three years Motorola would create its own competitors in China because people who worked for the company would leave it, would establish their own businesses, and would be in competition with Motorola.

The best way to promote domestic ownership is to get foreign direct investment to bring in best practices, cutting-edge technologies, and foreign companies that are going to do their utmost to make a profit. Leave companies free to do business and you have the best possible laboratory to learn from and to set up your own business. And indeed, that is exactly what happened with Motorola in China.

Second, if you have problems such as corruption or other drawbacks or constraints, it can sometimes be easiest to go to foreign investment, which can be less subject to those pressures. For example, in some societies there are great social pressures to hire relatives, friends, or others with whom you are connected. But in the case of foreign direct investment, that pressure doesn't apply, and the operation of that company can create new norms and new acceptable business practices. ❑

❑ USAID: SETTING DIRECTIONS FOR THE NEXT DECADE OF PRIVATIZATION

By Penny Farley, General Business Specialist, U.S. Agency for International Development

Foreign assistance projects are most likely to succeed in environments that encourage individual initiative and private-sector choice. To that end, the U.S. Agency for International Development (USAID) has become increasingly involved in privatization-related assistance through bilateral grants, as well as close coordination with the World Bank and the International Monetary Fund.

"Declining resources and a shrinking field presence demand that USAID become increasingly collaborative," Administrator Brian Atwood said in congressional testimony last year. "We must continue to find ways to stretch the development dollar through improved donor coordination, tap into private-sector capital flows, and encourage networking among both governments and nongovernmental organizations to advance the development cause."

According to Atwood, the privatization of business and industry and the creation of capital markets are "key ingredients" for development and attracting foreign investment. Privatization, he says, can be "a profoundly democratic process" and can play a crucial role in building "broad support and understanding of the market reform process."

In the following article, Penny Farley, a general business specialist at USAID, identifies the agency's key goals for privatization assistance.

The U.S. Agency for International Development is defining future directions for privatization assistance based on the experience of the last 15 years — from a modest start in Latin America to the recent crescendo dominated by assistance to formerly Communist states.

In the countries of Central and Eastern Europe and the former Soviet Union, the privatization of state-run enterprises and the dismantling of state monopolies are critical to these nations' transition to free markets.

USAID-funded experts helped Russian reformers develop a new civil code, which is the key to letting businesses and individuals — Russian and foreign — privatize under predictable, transparent, and fair conditions. Codes based on the Russian example are being implemented in Kazakstan, the Kyrgyz Republic, Armenia, and Georgia. In the northern tier countries of Central Europe, the agency's success can be seen in the market democracies of the Czech Republic, Latvia, Slovenia, and Estonia. In each of these countries, it should be possible to phase out U.S. assistance over the next few years and change the agency's focus to southern tier countries like Romania, Bulgaria, and Albania.

Poorer countries and governments ideologically resistant to opening their markets — largely in sub-Saharan Africa, the Middle East, and South Asia — will need continuing technical and policy support, as well as new, creative interventions.

USAID believes that future challenges in privatization will focus on five key areas.

AGRICULTURE AND AGRIBUSINESS

Private ownership of land, an essential ingredient in restoring vitality to the agricultural sector, is proving to be one of the most resistant to reform.

Worldwide, direct sales of land and agricultural production units have been rare since relatively few developing societies regard land as a transferable resource. In Albania and Romania, however, governments are now legalizing holdings seized by peasants. The same process can be seen in Mozambique, Ethiopia, and Nigeria. In Asia, Latin America, and Africa, a number of large agricultural plantations have either been sold or are in the "privatization pipeline," and major programs are under way, with USAID support, to register land held by small-scale landholders — clearly defining property rights and facilitating the sale, lease, or joint development of the land.

Developing countries are also reducing or removing controls over agribusiness. Between 1980 and 1996, an estimated 75 percent of developing and transitional economies widened the choices available to farmers by eliminating barriers to private competition. In Africa and Latin America, the focus is on dismantling state control over procurement, marketing, and food and export crops.

For USAID, the stakes remain highest in Africa, where output has not kept up with population growth, and in the transitional economies of Eastern Europe and Asia, where agricultural recovery remains slow relative to other sectors. USAID has an important role in setting standards for agricultural restructuring and in improving food security. USAID is focusing on land-tenure reform, building the policy and legal structures required for land sales and ensuring the provision of commercial credit to potential landholders, large and small. USAID will also continue to carry out research at the policy level to demonstrate the benefits of removing controls on private initiatives. Further, the agency will assist with restructuring government's role into one of fair oversight and regulation of the market.

INFRASTRUCTURE

Economic expansion and population growth have intensified the need for new and improved infrastructure in developing countries. Urban pressures and the emergence of new "megacities" are straining urban water, transport, and power systems, while in rural areas the demand for better access to services is growing.

The World Bank estimates that developing countries currently spend about $200 billion annually on investments in infrastructure. This figure will multiply as economies grow. The challenge for these countries and the international development community is to design secure, long-term financing mechanisms.

USAID has worked to help local governments introduce private-sector participation through "Build-Operate-Transfer" (BOT) agreements. BOT refers to private-sector financing, construction, and operation of projects during a specified contract period, after which the assets revert to the government.

For example, Côte d'Ivoire and Guinea are welcoming private participation in water delivery systems, and many countries in southern Africa are jointly engaged in restructuring their telecommunications services through public-private partnerships. Mozambique is proceeding with plans to open its highway system to private participation. Senior government representatives of 17 African countries met in late 1995 to explore the restructuring of their ports through private partnerships.

USAID will channel some of its infrastructure assistance through institutions like the Southern Africa Transport and Telecommunications Commission, so as to develop regional as well as local institutions and to create independent regulatory agencies. This assistance will help to define the rights and obligations of stakeholders and establish legal and regulatory frameworks. USAID can help design programs that raise workers' incentives to participate in privatization initiatives, and, since not all infrastructure programs will attract international interest, it can work with local governments to find innovative financing for smaller domestic private infrastructure.

MANUFACTURING AND INDUSTRY

A critical factor in the long-term revitalization of manufacturing in developing and transitional economies is the restructuring of large government-owned industrial conglomerates into smaller privately owned enterprises.

According to World Bank estimates, almost 1,400 privatization transactions took place in the industrial sectors of transitional countries between 1984 and 1994, excluding mass privatization programs. From 1991 to 1993, average privatization transaction values relative to total industrial gross domestic product increased dramatically — more than 40-fold in Africa, 400-fold in Latin America, and 1,000-fold in Asia. Altogether, the sale of state-owned manufacturing enterprises during this period totaled more than $30 billion.

USAID's role in manufacturing and industry centers on seeking ways to reduce the time, costs, and risks of privatization in poorer countries, which are often most reluctant to proceed. Mass privatization and internal privatization — management and employee buy-outs — should be tried more aggressively in Africa. USAID believes that there may be a way to adapt some of the creative interventions under way in Asian countries to sub-Saharan Africa.

Ultimately, USAID programs can be most effective by supplying what developing and transitional economies need most — entrepreneurial skills — through continuation of such volunteer business internship programs as the International Executive Service Corps and the Financial Management Development Assistance Program, and through formal training in privatization and basic business skills.

SOCIAL AND MUNICIPAL SERVICES

Health Care: USAID has been instrumental in privatizing many health care services in developing countries, with good results. For example, teams of general practitioners in private practice in Namibia are providing surgical care in rural areas under contract to the country's Ministry of Health. In Mozambique, public providers are allowed to hold private clinics after hours.

The major challenge in privatizing health care is increasing the reliance on voluntary insurance, which requires regulatory and administrative mechanisms to ensure adequate coverage and equitable, efficient care. USAID also will continue to develop effective regulatory frameworks for monitoring, licensing, and other aspects of privatizing health care.

Housing: USAID has pioneered private housing programs directed at the world's poorest populations though its Housing Investment Guarantee programs. The trend is shifting away from direct government subsidy and construction to government participation in housing finance. Sri Lanka's "Million Houses" program, for example, provides small loans to households for construction and rehabilitation, which enables financial institutions to participate on a commercial basis. Other concepts under consideration are voucher grants to complement housing loans on commercial terms and savings programs earmarked for housing construction.

Education: Private financing is starting to play a significant role in education at the primary and secondary levels. To date, the private provision of education services has been largely limited to postsecondary and vocational training. Many developing and transitional economies are beginning to decentralize their education systems by letting local communities take charge of program design and supervision.

A comparative study of public and private secondary education in Colombia, the Dominican Republic, the Philippines, Thailand, and Tanzania found that private school students outperformed public school students in mathematics and languages and that private schools incurred lower costs per student.

Municipal Services: Contracting mechanisms and concession arrangements have produced worldwide progress in privatizing municipal services. In this area, USAID has helped countries develop debt securities, such as municipal bonds, to provide long-term, market-based financing and break the practice of government subsidies.

There is growing interest on the part of Western institutional investors in emerging markets spurred by the globalization of capital markets and the use of loan guarantees and investment funds. Latin America and Asia remain the most attractive targets for external investment capital, but African capital markets are assuming a place of their own. Twelve Western financial institutions now have formal Africa funds.

EXTRACTIVE INDUSTRIES

Private-sector participation in key extractive industries (mining and hydrocarbon) increased from the late 1980s to the mid-1990s, with relatively narrow contractual arrangements and production-sharing agreements broadening into outright private ownership. Bolivia sold off smaller mines in the early 1990s. By the end of 1995, Russia had denationalized its massive state extractive industrial holdings and had transformed some 380 enterprises into joint stock companies. Zambia has announced its intent to privatize its copper mines.

This is not a major area for direct USAID intervention because of the involvement of multilateral donors and the growing availability of private capital. Still, the extractive-industry sector remains a concern because of its importance as a foreign exchange earner and a major employer in many developing and transitional economies. USAID will thus continue to encourage the adoption of new technological standards, codes of practice, and appropriate regulatory frameworks. Where governments are fearful of massive labor displacement, USAID can assist in developing social safety nets and other policies and programs that might make it politically more palatable for governments to proceed with privatization. ❑

COMMENTARY

❑ METHODS OF PRIVATIZATION

By E.S. Savas, Baruch College, City University of New York

Government activities or state-owned enterprises (SOEs) can be privatized by three broad strategies: divestment, delegation, or displacement. E.S. Savas, a leading U.S. advocate of privatization and director of the Privatization Research Organization at Baruch College of the City University of New York, outlines the specific methods encompassed by each strategy.

DIVESTMENT

Divestment means shedding an enterprise or asset. This requires a direct, positive act by government and is generally a one-time affair. An enterprise or asset is either sold or given away as an ongoing business, or an enterprise may be liquidated (i.e., closed down and the remaining assets sold).

Divestment by Sale: The sale of an SOE can be partial or in stages, where the government sells only a portion of its holdings at any one time. (Some argue that unless government cedes majority ownership or control, such a sale is merely a form of raising capital, not privatization.) Whatever the specific form of sale, valuating the asset is generally a thorny problem.

Divestment by sale can be carried out in five ways:
• Selling the enterprise (or asset) to a single buyer in a negotiated sale;
• Selling it to the public by issuing and selling shares;
• Selling it to its managers;
• Selling it to its employees;
• Selling it to its users or its customers.

Divestment by Free Transfer: Divestment does not require sale of an enterprise — it can be given away to employees, to users or customers, or to the public at large.

A novel instance of giving away a state-owned enterprise to the public took place in Canada. A prolonged and bitter political debate focused on the proposed sale of an enterprise owned by a provincial government. In order to block the sale, opponents questioned the proposed sale price. The dilemma faced by the proponents was that if the price was too low, they would be accused of giving away the people's patrimony; if it was too high, the sale would not be consummated. In a stroke of political genius, the provincial premier reasoned that since, in the final analysis, the corporation belongs to the people and the people had already paid for it once, why should they be forced to pay for it again? It could be given away to them! Despite some complexity, this bold step was carried out successfully by issuing shares.

Giving away shares to the public has been a main feature of the privatization of SOEs in most post-socialist countries.

Divestment by Liquidation: Finally, divestment can be carried out by liquidating a poorly performing enterprise, that is, selling its assets if no buyer can be found for it and if the prospects are bleak for turning it around and achieving profitability.

PRIVATIZATION OF GOVERNMENT ENTERPRISES, ASSETS, AND ACTIVITIES

BY DIVESTMENT	**BY DELEGATION**
SALE	**CONTRACT**
— private placement	**FRANCHISE**
— public sale	— public domain
— management buy-out	(concession)
— to employees	— public assets (lease)
— to users or customers	**GRANT**
	VOUCHER
FREE TRANSFER	**MANDATE**
— to employees	
— to users or customers	**BY DISPLACEMENT**
— to the public	**DEFAULT**
	WITHDRAWAL
LIQUIDATION	**DEREGULATION**

DELEGATION

The second broad privatization strategy is delegation. Unlike divestment, which is generally a one-time act, delegation requires a continuing, active role for government. When privatizing by delegation, government delegates to the private sector part of or all of the activity of producing goods or services but retains responsibility for overseeing the result. Delegation is carried out by contract, franchise, grant, voucher, or mandate.

Delegation by Contract: Government can privatize an activity by contracting with a private organization to perform the work. Local governments, for example, often contract for services such as solid-waste collection, street repair, street cleaning, snow removal, and tree maintenance.

Delegation by Franchise: Under a franchise, government awards to a private organization the right (often the exclusive right) to sell a service or a product to the public. The private firm usually pays the government a fee.

Two forms of franchising exist. One involves the use of the public domain — airwaves, air space, streets, underground space, and the like. For example, broadcasters, airlines, bus and taxi companies, and utilities (electricity, gas, water, telephone) use the public domain in the course of carrying out their commercial activities. This arrangement is often called a concession.

The second form is a lease, in which tangible government-owned property is used by a private renter to engage in a commercial enterprise.

Delegation by Grant: Delegation is also achieved by awarding grants. Instead of the government itself carrying out an activity, it arranges for a private entity to do the work and provides a subsidy. (This device is often employed to gain political popularity, and therefore grants are frequently made to purely private enterprises under flimsy pretexts, even when little other public benefit is achieved.)

Grants are distinguished from contracts in that grants usually involve only the most general requirements (run a bus service, build houses that rent at below-market prices, do research, promote the arts), whereas contracts usually specify activities for a particular service in some detail (sweep the west side of certain streets between 7 a.m. and 9 a.m. on Tuesdays and Fridays).

Delegation by Voucher: Governments can also delegate by issuing vouchers to eligible recipients of formerly state-run services. Vouchers can be used for food, housing, education, health care, child care, and transportation. Recipients use their vouchers to purchase these services in the marketplace. Thus, instead of subsidizing producers as grants do, vouchers subsidize eligible consumers.

Delegation by Mandate: The final form of privatization by delegation is a government mandate requiring private agencies to provide a service at their expense. Unemployment insurance is a long-standing example of such a mandate; private employers provide this for their employees.

Mandates — like grants, vouchers, franchises, and contracts — can be considered forms of privatization only when they lead to a lesser, not a greater, role for government. Thus, if a government-run social security system were replaced by mandatory individual retirement accounts, this would be privatization by mandate, a form of delegation. On the other hand, if market-based health care were replaced by mandatory employer-provided health care, this would be the opposite of privatization, as it would involve a greater rather than a lesser role for government.

DISPLACEMENT

Privatization can also proceed by displacement. In contrast to the first two methods, which require active efforts by government, displacement is a somewhat more passive process that leads to a government's being displaced more or less gradually by the private sector as markets develop to satisfy needs. Displacement occurs by default, by withdrawal, and by deregulation.

Displacement by Default: When the public finds that government service is inadequate, and the private sector recognizes the demand and steps in to satisfy it, this can be termed displacement by default. Gradually, the public begins to look to the private sector for the service.

One example of this phenomenon is the growth of private transportation where government-provided surface systems are deemed inadequate by the public. "Gypsy" cabs, commuter vans, minibus systems, and other unofficial or technically illegal transport services have emerged in numerous cities throughout the world.

Displacement by Withdrawal: Whereas default is unintended, government can engage in deliberate load-shedding, or withdrawal.

An official from Thailand refers to this as "the bonsai approach" to privatization. His government, he says, deprives state-owned enterprises of expansion moneys and operating funds, thereby retarding their growth. By depriving the SOEs of water and nutrients, and pruning back any visible signs of growth, the private-sector competitors are tacitly encouraged to grow and take over the garden. Ultimately, in his colorful metaphor, the stunted bonsai plants, neglected and diseased, are eliminated.

Displacement by Deregulation: State-owned enterprises and government activities often exist because they are granted monopoly status, and competition by the private sector is prohibited. Deregulation is a method of privatization if it enables the private sector to challenge a government monopoly and even displace it altogether.

In countries where state-owned agricultural marketing boards are monopsonies — the only authorized buyers of agricultural products, to which all farmers must sell — deregulation allows private markets to develop and displace those SOEs.

While still operating under socialist regimes, the then-Soviet Union, China, and other socialist countries tried to revive their moribund economies by repealing laws that prohibited private ownership, encouraging entrepreneurs and joint ventures with foreign firms, and allowing market mechanisms to prevail. "Marketization" is another term for this process; it connotes exposure to market discipline, and it relies on deregulation to achieve economic efficiency.

The end result is the emergence of demand-driven, market-based arrangements — by for-profit firms, not-for-profit voluntary organizations, and competing public agencies — to satisfy unmet needs. ❑

The preceding excerpts are from "A Taxonomy of Privatization Strategies," by E.S. Savas. Reprinted by permission from *Policy Studies Review*.

❑ THE IFC AND PRIVATIZATION: TAILORING EXPERTISE TO FIT THE PROJECT

An Interview with David Donaldson, Senior Investment Officer, International Finance Corporation

Over the past decade, the International Finance Corporation (IFC) has advised governments from Kenya to Ukraine on innovative ways to privatize state-owned enterprises — whether through creative concession agreements or effective public relations.

The IFC, the private sector investment arm of the World Bank group, has also supported the process by investing in firms that have bought privatized enterprises.

Following is a USIA interview with David Donaldson in which he discusses IFC's overall approach to privatization, as well as specific projects in Argentina, Russia, Gabon, and other countries.

Donaldson is an IFC senior investment officer and a principal author of "Privatization: Principles and Practice." The executive summary of the IFC paper is on the Internet at:
www.ifc.org//PUBLICAT/BOOKS/NEWBOOKS/PRIVAT.HTM

Question: In its efforts to facilitate privatization, how does the IFC decide which role — adviser or investor — is most appropriate?

Donaldson: In a country such as Chile, where privatization has become less political, there is less need for an institution like IFC to be an adviser. Chile can rely more on independent investment banks or private consultants.

The IFC's comparative advantage as part of the World Bank group is more appreciated in Haiti or Gabon or Uganda. Typically, a higher risk country that is exploring privatization for the first time needs advice more than it needs investment. It will eventually need investment, but it often has no experience and no criteria by which to decide about privatization.

Many such countries are in Africa, but the IFC is also giving advice to Latin American governments — Brazil, Ecuador, and Venezuela — which have moved more slowly than the "first wave" countries with respect to privatization.

Q: What kind of advice can the IFC offer these countries?

Donaldson: When we advise on the sale of large-scale enterprises, it's usually broken down into two phases. We first consider the strategic options available to governments. For example, do you privatize this by asset sale? Do you privatize it by open competition? Do you break it up? Do you introduce competition into the sector, particularly in the infrastructure sectors? How do you structure the sector so that it yields best value to customers and best value to governments? When a government has looked at our recommendations, and if it decides to move ahead, then the second phase involves actually selling a company or companies.

Q: What about the IFC's role as an investor?

Donaldson: We invest in support of firms that are buying privatized enterprises from governments. We almost never invest in order to purchase assets, but rather to support the rehabilitation or expansion program that's usually a part of privatization. So if there is a competitive bid taking place, we will not line up behind a particular bidder. We instead tell bidders — in some cases, several potential bidders — to go ahead and bid, with the understanding that if they are successful, we will look at the possibility of supporting their investment program. We don't make any firm promises to avoid making the playing field uneven.

Q: Where do you take equity?

Donaldson: Normally, we don't buy the equity that is being privatized. We might, however, take part of a capital subscription or a capital increase.

In one or two cases — exceptional cases, which may become less exceptional as time goes on — we actually took some shares from the government as part of a privatization that was pursued over at least two phases.

The Hungarian telecommunications company was one case. The government was not ready to jump into a majority privatization, so the project was designed to move them step-by-step toward that goal.

We bought shares in the company from the government and said we would keep the shares as long as the government went ahead with the remainder of the privatization. Otherwise, the government would be required to buy back our shares. Since then, the company has gone through more phases and is now majority private-owned.

Q: The IFC has also done extensive privatization work in the former Soviet Union, has it not?

Donaldson: In Russia, Ukraine, and Belarus, we have advised on models for privatization that could be replicated swiftly, given the scale of the changes that were taking place. Small-scale privatization by auction is an example — literally involving somebody standing up and selling a cheese shop. Over a period of a couple of years, there were 20 to 50 transactions every Tuesday afternoon in a variety of cities throughout Russia.

We established a model for the first such transaction, and it was subsequently rolled out through the rest of the country. Brochures and guidebooks were written, teams of local consultants were recruited. It was really quite an exciting program, and it had a lot of funding, encouragement, and effort behind it.

The location of the initial project was also important. We chose Nizhny Novgorod province in Russia, which has a very go-ahead government. Nobody in Russia had any notion of the idea of private property, or how an auction might be conducted, and, really, what to do with a shop once they got hold of it. So there was a great deal of popular distrust.

Q: How did the IFC address this distrust?

Donaldson: In addition to financial organization, a lot of work went into public relations — marketing. For example, the public relations for a voucher scheme for privatizing large-scale enterprises involved stringing a number of Soviet-style banners across streets. In the past, the lettering usually said something like "Work harder for the socialist cause," but the slogan on this banner was "Think of yourself for a change." It was apparently quite successful in attracting people to invest in these ventures.

Q: The IFC was also involved in land privatization in former Soviet states, was it not?

Donaldson: Yes — the big, collectivized state farms that were typically a mixture of agriculture and industry, or agro-processing. These were whole villages with 5,000, 10,000, 15,000 people living in them. They were like little states in their own right and terribly inefficient. It's estimated that a quarter of the output of Russian agriculture was produced by the 3 percent of land that individuals were allowed to keep as private gardens.

Q: How did the IFC program work?

Donaldson: It essentially created entitlements and then a market by which those entitlements could be traded. Every adult was entitled to a certain amount of land — from the general manager down to the pensioner. Everybody also had an entitlement to a share of the machinery.

People then had the option of trading their entitlements as individuals, or they could form groups and pool a certain set of entitlements. One group could say to another, "We'll give you our land, and you give us your tractors." And then there was an auction process at the end for all those entitlements that had not been pooled and traded.

So a collective was broken up by a long, drawn-out auction and trading process. The result, at the end of the process, could be a very, very small, individual farm; it could be a big farm with 150 members; it could be a milk-bottling plant; it could be an individual offering tractor services.

Given the need for speed and replicability, it was not possible to address the needs of each particular collective. The idea was to set up a model that could be repeated literally thousands and thousands of times — and it was. Over a period of two years, the combination of small-scale, large-scale and land privatizations in Russia created 30 to 40 million shareholders.

The important thing was to seize the window of opportunity to effect that transfer into private hands. Often in privatization, timing is everything.

But the process didn't inject cash to repair the tractors or to buy fertilizer — because the money simply wasn't there. And that, of course, is a great weakness of Russian privatization.

Q: Are the lessons learned from Russia applicable elsewhere?

Donaldson: There are certainly things we have learned, but I think the circumstances there were probably unique. There are, though, general principles, and the need for transparency and fairness is one of them.

Q: What can the IFC do to ensure transparency and fairness?

Donaldson: There is an interesting transaction under way in Gabon involving a concession agreement to run the water and electricity sector for 20 years. It's a massively complicated, 300-page agreement, and everybody has a different view about how each clause should be written.

Three investors are pursuing the transaction, and the IFC has organized the process as follows: We hold a series of discussions with the government and with the three bidders individually on draft versions of the concession document. We listen to the bidders' comments and discuss with the government whether to incorporate them.

We tell each bidder about any changes we have made, so that everybody knows what's going on all the time. And finally, we will close the discussion and say, "There it is. There's a concession agreement. It incorporates your comments to the extent that the government felt comfortable with them. Now, bid on the price."

The price is not how much a bidder pays to get the company, but the tariff rate they're prepared to charge users when they take over. At the end of the process, we will open three envelopes — they will be very slim envelopes — and one will say minus 5 percent from the current rate and one will say minus 10 percent, for example, and the lowest one — in this case, the 10 percent decrease — will win. On the day of the announcement, with the cameras rolling, it boils down to a single figure, and nobody can argue with it.
Buenos Aires realized a 27-percent reduction in water tariffs by the process of competitive bidding.

Q: Do concession arrangements — where a government awards a private organization a temporary right to sell a service or product to the public — make it easier for governments to privatize important assets?

Donaldson: Yes, because the government remains the landlord, essentially, and gets it all back at the end. Is it true privatization? I would say yes. In Argentina, the company that won the waterworks concession committed to $4 billion worth of new investment over the course of a 30-year concession period. By the time the company has spent that $4 billion, its contribution to investment in the sector is going to have been considerably greater than the government's. The assets will then revert to the government and, in that sense, they remain public property.

Q: And at that point, the government literally gets back a functioning service?

Donaldson: Exactly. But one hopes the government realizes that this has worked well over the last 30 years and will put it out to competitive tender once more.

In the case of Argentina, the municipal authority in Buenos Aires had actually been subsidizing the water company. That subsidy stopped the day the private operator took over, the private operator turned the company back into profitability, and the government started collecting taxes on it.

Q: Are you finding that concessions are a useful device for privatization?

Donaldson: If you are in a sector like water or power that has certain monopoly characteristics that make it difficult to arrange for competition *within* the market, concessions enable you to organize competition for the right to be the service provider. You give away a 20-year concession, on a repeating basis.

Twenty years is a long time, but there is one moment of competition every 20 years and it's a big moment, because that's when you get that 27-percent reduction in tariffs. And since you haven't sold the assets, you know that, in 20 years' time, you're going to be able to organize another competitive bid.

Q: But political problems can crop up eventually?

Donaldson: We don't know the answer to that yet, but we do know that the first few years are great. In Buenos

Aires, for example, the waterworks privatization produced hundreds of thousands of new connections in the first three years, environmental improvements, lower tariffs, no state subsidy, and profits for the private operator. Everybody is happy, and it's a win-win-win-win game.

But what happens 5 or 10 years down the line? Well, the private operator has done his job, has turned the company around, and is starting to make really nice profits. He is comfortable and has a monopoly because that was the only way the operation could be privatized. There is no competitive pressure. And when people see that the water bosses got another pay increase and see all these profits earned by a foreign company, the danger is that they may begin to wonder if they're being exploited.

There are two answers to that. The first one is that the smart operator will make sure his profits are not excessive because he knows that, beyond a certain level, they become very visible and endanger the whole concession. Second, we are learning to write into concession agreements provisions for a review every five years.

Q: Those provisions help protect both the government and the concessionaire?

Donaldson: Exactly. Furthermore, we write into the concession agreement clauses about repudiation or termination, stipulating the concessionaire's rights if the government turns around and says, "Sorry, we changed our minds" or, alternatively, if the government claims that the concessionaire has failed to live up to its half of the bargain. There is a process defined by appeal to international legal institutions, whose ruling will be taken as binding.

But to conclude, I should emphasize that privatization is so, so new — only a handful of countries have done water and electricity privatizations, for example. We're learning all the time, and IFC's job is to design innovative solutions to problems as we become more aware of them. ❑

❑ FINANCING MECHANISMS FOR PRIVATIZATION

By Michael L. Unger, Kogod College of Business Administration, The American University

Although underdeveloped capital markets can severely constrain privatization programs, countries in Africa and elsewhere are discovering that alternative financing techniques can help move the process along, says Michael Unger, a professor of international finance at The American University in Washington, D.C.

From 1984 to 1996, Unger was chief financial economist at the U.S. Agency for International Development's Bureau for Private Enterprise and a senior adviser at USAID's Bureau for Africa.

The privatization of state-owned enterprises (SOEs) is primarily a financial transaction, making capital markets an integral part of the process. Given the shortage of capital and liquidity in many countries, particularly countries in Africa, governments have learned to use alternative financing techniques that both facilitate privatization and, in the process, deepen their countries' capital markets.

Virtually all of the techniques discussed below contribute to the development of capital markets by offering investors additional long- and short-term instruments and generating revenue for the government. They represent an increasing body of experience with financing mechanisms that overcome severe capital constraints and encourage local ownership.

PUBLIC FLOTATIONS

Public flotations, or initial public offerings (IPOs), are appropriate for larger — usually more profitable and well-managed — companies that can attract large numbers of investors, thereby encouraging broad shareholding and wider distribution of wealth. Public share offerings are most commonly used in developed countries but are becoming increasingly common in developing countries where there are functioning capital markets and mechanisms for distributing and trading shares.

Broadly targeted IPOs are generally characterized by openness, transparency, and accessibility to the small investor. Public share offerings have the disadvantage, however, of being technically quite complex and time-consuming and requiring significant technical input from lawyers, investment bankers, and accounting firms. IPOs offer several advantages:

• By targeting a large segment of the investors, they help meet the goal of an equitable transfer of capital from government to the private sector.

• In developing countries in particular, IPOs often add a considerable supply of securities, stimulate capital market activities, and help create a new class of capital owners. The flurry of privatization activities in Chile was the principal reason for the rapid expansion of the Santiago stock exchange, the capitalization of which multiplied nearly fivefold between 1989 and 1993.

• The openness of IPOs helps to diffuse suspicion that a government is transferring state-owned assets to powerful interests or wealthy individuals at below-market prices.

• IPOs can be a significant source of revenue for governments.

• Successful IPOs and the subsequent gains in share prices serve to create constituencies that will support existing and future privatization projects. Such was the case of British Telecom's privatization, which was so popular that the country's Labor party, which had threatened to take back the shares if it returned to power, subsequently retracted its threats. Privatization in Great Britain proceeded apace.

Several African countries have used IPOs selectively as part of their privatization programs. In Kenya, five SOEs had been privatized using IPOs as of 1993. Two firms, the Housing Finance Corporation of Kenya and Uchumi Supermarkets, were privatized within three months by the sale of $15 million in shares.

Countries with less-developed capital markets have used IPOs in combination with a private sale to finance privatization transactions. In such cases, IPOs help to broaden share ownership among the general public while drawing on the managerial and technical expertise, as well as the capital, of strategic investors to finance post-privatization restructuring. Zambia, for example, has used a 70-30 formula (divesting 70 percent through private sale and 30 percent via the stock market) to privatize several large SOEs.

PRIVATE PLACEMENT AND SALES

When significant management or technical expertise is sought for a company, private share sales, through competitive bidding or direct negotiations, might be the most appropriate privatization method. As one of the most commonly used methods of privatization, the private sale can assume several different forms, including direct acquisition by a single buyer and a private placement involving a specific group of purchasers.

Governments use a variety of techniques to execute the private sale of an SOE. Two of the most common involve an invitation to bid through public tendering or through direct negotiations. Direct negotiations are generally preferred when conducting a private sale to a corporate entity that already holds shares of the SOE. Public tendering provides the seller with a larger pool of potential buyers and a wider range of offers. However, the public tendering process may be more costly and time consuming than direct negotiations. The advantages of a private sale are:

• In the absence of developed equity markets, a private sale can provide a viable alternative. Waiting to create a capital market could delay privatization for years.

• The private sale allows the government to examine the potential purchaser closely. The government may, for instance, want an owner who has certain management skills, technology, access to certain markets, or an employee benefit system.

• The private sale is flexible; a government can begin the privatization process through a private sale but conclude with another method.

• A private sale can be partial or whole and can occur at once or in stages. It can take many different forms and involve many potential purchasers or just a few.

• In a private placement, the government may have more control over the demand for shares, share prices, and sales proceeds, compared with a public offering.

• A private sale limits the amount of information that potential buyers can obtain about the competition. This provides the government with more control over the process and a better negotiating position.

• Private share sales are simpler and less costly than other methods, especially public offerings, in terms of disclosure, legal requirements, and transaction costs.

When considering a private sale, a government must weigh these advantages against the problems associated with this method. Private sales may give rise to criticism about the lack of transparency in the selection of buyers and to concerns about fairness and equity.

FINANCIAL INSTITUTIONS AND INSTITUTIONAL INVESTORS

Financial institutions and institutional investors such as pension funds and overseas mutual funds are an important source of capital. Institutions set up specifically to facilitate privatization may take the form of closed-end funds (e.g., investment trusts), open-ended funds (such as unit trusts), or a warehouse-type of institution such as a privatization trust fund.

Financial intermediaries and institutional investors have played an increasing role in privatization, particularly in mass privatization in Eastern Europe and the former Soviet republics. Pension funds have been instrumental in financing privatizations in several Latin American countries, most notably Chile. In Africa, Zimbabwe and Swaziland have recently established unit trusts, and Uganda is currently considering the establishment of a unit trust to facilitate its privatization process.

Under this method, the public is involved to the extent that it participates in the investment funds or pension funds that are invested in privatized SOEs. Fund managers thus play a predominant role in the privatization process, including the monitoring of enterprise performance and the trading of shares on behalf of fund owners and participants.

MANAGEMENT AND EMPLOYEE BUYOUTS

Management and employee buyouts (MBOs and EBOs,) as well as employee stock ownership plans (ESOPs), are useful means of transferring ownership to SOE management and employees. An ESOP is an ownership plan in which a firm's employees acquire stock, usually with the assistance of a corporate trust fund, but do not accumulate a majority of the voting shares. In the case of an MBO, as well, the transfer of ownership is to a relatively small and homogeneous group of existing managers, which may encourage efficient operations because managers now share in potential profits. An EBO attempts to garner the same corporate governance advantages of an inside buyout while promoting broader ownership of a company's assets. In cases where individual workers lack the private resources to acquire stock in their company, an ESOP can subsidize share purchases via a company-established trust fund.

The most challenging aspect of an MBO and an EBO is financing the transfer of ownership. In some instances, managers or employees might finance a buy-out through private sources such as savings, pension funds, or other liquid assets, but few managers or employees possess the financial reserves to purchase any but the smallest companies entirely from their own resources. Consequently, many MBOs and EBOs emerge as highly leveraged transactions that must be financed through some sort of government assistance, such as loans or deferred payment schemes. Examples of financing options include subsidized investment loans, installment payments, pre-privatization financial restructuring, or use of vouchers or leasing arrangements on assets with the option to buy.

Despite their popularity, MBOs and EBOs present several complications. A buyout by a small group of insiders may increase financial risk and engender suspicion that managers are exploiting their position to acquire the most profitable firms for themselves and exclude the citizenry. Due to these suspicions, pure MBOs have not been a common financing mechanism for privatization in most countries.

MASS PRIVATIZATION

Under mass privatization, voucher coupons allow privatization transactions to take place quickly and efficiently and contribute to widespread participation. Instruments that have the greatest impact on encouraging widespread local ownership of shares are initial public offerings, bond issues, pension funds, employee stock ownership programs, and special government financing schemes offering concessional financing or deferred payments to small, local investors.

Mass privatization is common in Eastern Europe and the former Soviet Union, but has not been utilized to date in Africa. The main appeal of mass privatization is the speed, widespread ownership, and volume of companies that can be transferred to the private sector in a short period of time. The primary drawbacks of this approach are the limited amount of revenue generated from the sale of companies and the inability of this process to target strategic investors who may be best qualified technically and financially to run a company.

UNCONVENTIONAL FORMS OF FINANCING PRIVATIZATION

Unconventional financing techniques are utilized in countries where existing financial markets are weak, investors have limited liquidity, and long-term financing is not widely available. Although the burden of finding financing ultimately rests with the buyer, privatizing governments are often well aware that the availability of financing can be critical in determining whether the privatization succeeds. Following are some primary unconventional financing methods:

• Venture capital funds provide start-up capital for new or existing high-risk businesses having high profit potential. Venture capital managers provide significant oversight and input to the target companies. Such funds have been established in Ghana, Tanzania, and South Africa.

• Bonds, which can be issued by national, state, or local governments or by private corporations, are a source of long-term financing for privatization transactions. Because most governments have long sold treasury bills and bonds, bond markets in developing countries are usually more developed than the stock market. Buyers of the bonds include the general public and domestic institutional investors. Medium-term bond instruments can mobilize private domestic capital to finance privatization even in countries where the capital markets are rudimentary and underdeveloped. However, issuing bonds involves fairly high fixed transaction costs and is thus more appropriate in cases where large sums of money must be raised.

• Debt-equity swaps are privatization financing mechanisms in which the debt holder is interested in buying an enterprise. In a swap, the debt holder trades the debt, worth a fraction of its face value, for equity in a newly privatized company. Since debt is usually held by a commercial bank, not surprisingly a substantial proportion of the swaps under privatization have involved the original commercial bank lenders.

• Informal sector finance (ISF) refers to all unregulated and unrecorded financial activities including lending, borrowing, leasing, and remitting, especially in countries where the informal sector is active. Anecdotal evidence in East Africa suggests that the informal sector has helped to finance some of the privatization transactions in the Asian communities. In countries where large debt overhang would significantly deter investors from buying privatized SOEs, debt-equity swaps can serve the dual objective of privatization and debt reduction, thereby enhancing a country's investment climate.

• Government financing schemes have been used in countries where the SOEs are not attractive enough and equity markets are not deep enough to attract equity or other private investment funds. One form involves a government's accepting deferred payments either at commercial or at subsidized interest rates. Also, a government may offer preferred shares at a discount price to some class of buyers in the country. ❑

❑ THE PRIVATIZATION OF MONOPOLIES

By Jim Waddell, Vice President, International Privatization Group, Price Waterhouse, LLC

The privatization of monopolies — with their power to set prices unrestrained by competition — is fraught with special problems and highlights the need for reliable regulatory frameworks, says this experienced practitioner.

When governments transfer state-owned enterprises to the private sector, they generally have a number of objectives: improving efficiency, reducing the fiscal commitments of the state, providing better service to customers, obtaining sales proceeds, and laying the foundation for a competitive market-based economy.

There may, however, be conflicts among the objectives. For example, the sales proceeds to the government may be enhanced by selling a large enterprise as a single entity, whereas restructuring the enterprise into smaller units will improve the competitiveness of the sector and the economy but reduce the proceeds of the sale.

DEALING WITH MONOPOLIES

The dilemmas faced in the privatization of monopolies are even more complex. Since the abuse of monopoly power leads to higher prices for consumers and the underutilization of a good or service, governments often intervene through regulation of monopoly markets or, more commonly in many parts of the world, by providing the service directly through a self-regulated state-owned enterprise. The privatization of such enterprises is frequently criticized as turning a public monopoly into a private-sector monopoly, where it is open to additional potential abuses.

In some cases, monopolies can be restructured into smaller units so that their market power can be eroded. Governments can also create a more competitive market by enforcing antitrust laws and revoking any legal powers that served to create and support the monopoly.

For a special class of monopolies, however, restructuring will not have such salutary effects. These are the so-called "natural monopolies" that exist when economies of scale are so significant that the optimal size of a business is larger than the market itself. In effect, with "natural monopolies" there is enough room in the market for only one firm; competition is not feasible or efficient. Traditional examples of natural monopolies are the "network industries" such as electric and telecommunications utilities and transportation systems. Privatization of natural monopolies requires governments to take special care to ensure that the monopoly power of the firm is restricted and cannot be abused by the private sector.

PROFIT REGULATION

Various forms of regulation have evolved to reduce the market power of private monopolies. Profit regulation is the traditional approach to regulating utilities in the United States. Under this approach, the utility calculates — and the regulator reviews — the expected operating cost for a normal year. The cost of operations includes both the cost of plant and equipment and the operating expenses required to fund the utility during the test period. A regulated utility's prices are then computed to permit it to earn an adequate return on its invested capital. The objective of this form of regulation is to limit the rates charged by the firm to a normal level — one not reflecting its monopoly power.

In practice, there are two major difficulties with this style of regulation: It is very complicated to administer, and it creates an incentive for a utility to overinvest in capital. The administrative difficulties are obvious because of the large number of subjective decisions that must be made to determine the appropriate amount of capital and operating expenses to be incurred. Many extensive reviews have been held by regulatory commissions, at substantial cost, to determine whether investments undertaken by a utility were prudent and whether they should be part of the rate base on which the utility is allowed to earn a return. But because the reviews are held long after the capital is invested, they have rightly been characterized as second-guessing the utility's management — with the benefit of hindsight.

With profit regulation, reviews of this type are necessary because this regulatory form creates an incentive for a utility to install as much capital as possible, perhaps to the point of being excessive. Because a utility's profits are based only on the amount of capital it has invested, management can increase profits only by investing more capital. Its tendency to distort input choices, as well as its administrative difficulties, has made this method of regulation increasingly unpopular.

PRICE CAP REGULATION

An alternative form of regulation, known as "price cap" regulation, emerged during the privatization of Britain's utility industries. Under this regulatory form, the focus is on the future adjustment of prices relative to changes in consumer prices. During the British privatizations, the pricing formulas developed as part of the plan allowed for utility rates to increase at the rate of price inflation less a percentage amount that would reflect a utility's potential efficiency gains.

This approach provides a less restrictive form of regulation, and provides an incentive for a utility company to minimize its costs; it produces profits to the extent that its costs are less than the prices it is allowed to charge. Price caps also allow a company to adjust prices quickly when market or competitive conditions require, because an extensive review of costs and earnings is not required. Instead, price cap provisions enable a utility to adjust prices as it wishes, provided the average price for a specified basket of services does not exceed some maximum value.

This flexibility and the relatively greater ease of administration have made price caps a preferred form of regulation for both utilities and governments. Politically, price caps are readily acceptable because they normally provide that prices increase more slowly than the rate of inflation in the economy.

Regardless of the form of regulation selected, it is important that the government establish some form of regulatory structure prior to privatization. Gaining political support for the privatization will require that consumers be protected from monopoly abuses. Investors also are aware that there are going to be political pressures to regulate a monopoly and need to understand the form of regulation they will face prior to making their investment.

OTHER CONSIDERATIONS

Additional issues facing governments and investors concern the form of the regulatory body, its funding and legal authority, and the process by which regulators are appointed.

The telecommunications sector offers one example of a successful formula for monopoly privatization, particularly for emerging markets. The formula consists of the following elements:

- Sale of a substantial portion of the equity, usually 40 to 43 percent, to an international operating company.

- Assignment of a sufficient number of board seats to the investor to guarantee control of the business.

- Agreement on a management contract whereby the investor will be compensated for managing the utility.

- Agreement on a series of quality standards that the investor must achieve, normally including a substantial increase in the number of customers connected to the network and a reduction in system congestion.

- Establishment of a period of exclusivity for the investor, usually from three to nine years, during which no other operator may compete. The exclusivity is designed to allow the investor to recover the costs of system improvements that are undertaken to comply with agreed quality standards.

- Development of a price cap formula that will allow the investor to adjust the prices for telecommunications services at somewhat less than the rate of inflation, depending on the investor's perceived ability to improve efficiency. Normally, this efficiency factor is between 1 and 7 percent.

- Agreement that the remaining shares held by the government will be divested through one or more public offerings to the domestic and international capital markets. Further, the investor is normally prevented from selling shares in the business for a fixed period of time.

This type of structure has proven popular for privatizing telecommunications monopolies because it benefits all the parties. Consumers receive higher quality service at prices that will decline in real terms. The government is not required to invest in upgrading or extending the telecommunications network, and it receives considerable sales proceeds and continuing tax payments.

Development goals are advanced as well: A basic infrastructure service is extended, and the availability of relatively stable shares helps develop the capital market. The investor benefits through the return on the management contract and by ownership in a growing enterprise that he or she controls, with a predictable process for price adjustment. Employees benefit from various job protections that are written into the agreement and from the increasing need for workers during the network expansion. ❑

❏ PRIVATIZATION OF PUBLIC PENSION FINANCING

An Interview With Robert J. Palacios, Pension Economist, the World Bank

Demographic trends in much of the world mean that fewer workers are paying taxes to support growing numbers of pensioners who are living longer. This, experts say, is causing a global crisis in the public financing of old-age pensions and has prompted many governments either to begin privatizing pension plans or at least to study this alternative.

World Bank researchers from 1992 to 1994 conducted an extensive study of pension provision around the world. They examined a century's worth of experience with publicly financed Pay-As-You-Go (PAYGO) programs. PAYGO, the most widespread method of pension financing, uses taxes on workers' wages to pay for the benefits of retired workers.

The researchers, says World Bank pension economist Robert J. Palacios, found that PAYGO pension plans, regardless of the country, have a life-cycle that eventually leads to a deterioration of their capacity to continue.

Palacios was interviewed by USIA Economics Writer Warner Rose.

Question: Would you describe the "life cycle" of the Pay-As-You-Go pension system?

Palacios: The life cycle has three stages. The first stage covers the time when the scheme is being set up. This usually occurs when the average person in the country is relatively young. There are going to be few pensioners in the new system for some time, and the worker-to-pensioner ratio is very favorable. Financing the scheme will require fairly low payroll taxes.

In the second stage, the system begins to mature; more people become eligible for pensions, and the government's promises to pensioners are often increased. Funds set aside to finance the system, if there were any, are often depleted. Tax rates now tend to rise and the system encounters its first financial problems.

In the third stage, we have a mature pension system with a relatively older demographic structure. The worker-to-pensioner ratio becomes less favorable. In some countries at the latter part of this stage, there are fewer than two workers per pensioner. Schemes often run deficits. Payroll taxes often rise, making labor much more expensive. High taxes also encourage evasion where that is possible. Sometimes benefit promises begin to be broken. We see this pattern over and over. All countries sooner or later arrive at this third stage.

Q: This is a problem throughout the world?

Palacios: Yes. Most countries have some kind of public pension system, at least covering civil servants and usually covering private-sector salaried workers. Most use PAYGO earnings-related pension schemes. About half of the world's labor force is covered under such plans. In the industrialized countries the coverage is pretty close to universal. Most of the industrialized nations' pension systems have reached the third stage, with a few notable exceptions. The same has occurred in developing countries with older populations that have had pension programs for some time.

Q: Will developing countries face the third-stage problem much more quickly than the industrialized nations did?

Palacios: Yes. In middle-income countries like Venezuela and Mexico, the aging process is very rapid. It's taking them only from one-third to one-half as much time to experience the demographic aging that occurred in the industrialized countries. This is due to the success of the dissemination of medical technology, birth control, and other things.

This means that the time these countries have to adjust their policies away from complete dependence on PAYGO schemes for the coming wave of retirees is shorter than it was in the industrialized countries.

In China, with one-fifth of the world's population, the situation is quite dramatic because the demographic shift is speeded up by the one-child policy and by substantial gains in longevity.

Q: Could you describe the economic distortions that PAYGO produces in labor markets?

Palacios: The distortions are those caused by high marginal taxes on labor, which are well known. It's not just the pension portion but health and unemployment and other earmarked taxes that, when added up, in some countries are greater than a worker's take-home wage.

These costs distort the way businesses demand labor. A lot of the high unemployment we see in Europe today can be explained by rigid labor market conditions and high payroll tax rates.

Now because the pension system and some of the other social insurance categories are financed on this PAYGO basis, the only funds available to finance those growing expenditures come from current workers. And therefore, if you have only a limited number of current workers, you have to raise their payroll taxes.

Q: Could you explain the concept of the implicit pension debt, which in many countries exceeds the explicit public debt?

Palacios: Implicit pension debt refers to the unfunded promises that governments made to workers and pensioners. There are different methodologies for measuring it. Industrialized countries tend to have implicit pension debts that are larger than their official public debts. The problem is that the implied obligations of the pension program usually do not appear in the government accounts. Nevertheless, there is a growing recognition that these pension promises are as real as official government debt. In some countries, such as Poland and Brazil, the courts have even asserted that the promises are protected by the constitution.

Q: How do countries solve this problem?

Palacios: Certain steps such as raising the retirement age must be taken. But the long-term solution requires at least partially replacing the PAYGO system with a privatized pension program in which workers make contributions that are invested in well-regulated funds that trade in stocks and bonds.

Q: Could you explain the multiple pillar system of pension privatization?

Palacios: The multi-pillar arrangement separates the two major functions of public pension systems: income redistribution and savings for retirement.

A government-guaranteed program that ensures a basic pension to all retirees — regardless of how much each individual worker paid into the system — is the first pillar of such a system. This is essentially a government redistribution program designed to reduce poverty among the old. It is tax financed, and the type of tax depends on the conditions in each country.

The second pillar involves savings for retirement. The worker is mandated — forced — to save, so that he or she will have a certain level of money set aside for retirement. These forced savings are often justified on the grounds that many workers fail to save enough for their retirement.

This second pillar is where the World Bank believes that privatization should begin. The government mandates the savings, maintains some regulatory oversight, and in some cases provides guarantees, but the funds themselves are placed in a privately managed system.

The third pillar is simply an extension of the second in that it encourages workers to make additional, voluntary, savings for their retirement. Although such saving is not mandatory, the government could provide incentives in the tax code or through other means.

Much more liberal investments could be allowed in the third pillar, and the government would not necessarily provide any guarantees.

We advocate defined contribution plans for the second pillar, meaning that the worker is committed to making certain contributions, but what he or she withdraws at retirement depends on how well his or her investments have done. An advantage of defined contribution plans is that they are usually portable; holding and building the plan is not dependent on remaining in the same job.

Q: Where is this new three-pillar system working in the world?

Palacios: Chile has had a very successful privatized system for the last 15 years. The average annual rate of return so far has been around 12 percent to 13 percent, and the system has not experienced any major failures. Workers in Chile can expect to have much better pensions than they would have had under the old system, which had basically collapsed.

In that sense it is a very successful system. I don't think it's easy to say that Chile has the most successful system because conditions in different countries can vary dramatically. For example, in Chile many workers do not contribute regularly. And the system has been in place for only 15 years, which by pension system standards is not very long.

Some of the other multi-pillar countries have had even shorter experiences. Since the mid-1980s, Switzerland has required all employees to belong to a private scheme. Australia did the same in 1993. The United Kingdom has allowed workers to choose not to participate in the earnings-related public scheme since the late 1980s. Even more recently, in the early 1990s, Argentina, Colombia, and Peru converted to multi-pillar schemes, and they will soon be followed by Mexico and probably Venezuela. So far the results in these countries have been quite positive, and more and more countries are considering the multi-pillar system.

Q: Do you find that the existence of second and third pillars encourages the establishment of private mutual funds? Do they encourage companies to issue stock?

Palacios: In Chile, the establishment of the privatized pension system clearly helped develop that country's capital markets. It encouraged Chilean companies to issue stock and helped create demand from institutional investors for shares of companies that were privatized. Before this reform, there was no medium- or long-term bond market in Chile. Today there is, and it's largely because there is a pension fund sector that holds assets that now are equivalent to 40 percent of GDP (gross domestic product). Chilean pension plans hold corporate bonds, government long-term bonds, and stock.

In countries where the capital markets are fairly well developed, the creation of multi-pillar systems has had a positive impact on things like liquidity in the markets and stock market capitalization. In the Netherlands and in Switzerland, for example, the institutional investors' pension funds in particular hold a huge amount of assets in these countries. And the stock market capitalization is over 100 percent of GDP, based largely on pension fund investments.

Many countries considering this type of reform must first create conditions conducive to the healthy development of a private pension sector.

Q: What are the basic conditions for the multi-pillar system?

Palacios: The basic conditions include a rudimentary private banking system and capital markets, and the ability of the government to supervise them. We are not talking about well-developed financial markets, just the minimum needed to efficiently and safely absorb the retirement savings of workers. Argentina and Hungary, for example, have relatively low stock market capitalization — 5 to 10 percent of GDP — but this, along with other regulated investment opportunities, provides enough of a foundation on which to build the second pillar. The two things — the country's capital markets and the private pension funds — grow and reinforce each other over time. Of course, some countries should not move ahead with pension privatization until more basic reforms, such as a private banking system, are in place. Instead, they should make sure that the implicit pension debt in the PAYGO scheme is kept under control. This will make the introduction of the private pillar easier when the time is right.

Q: In the second and third pillars, what kinds of guarantees are needed to give workers confidence that the money will be there when they retire?

Palacios: The guarantees will vary from country to country. There could be a guarantee, for example, of the minimum pension that would come out of such an arrangement, as is the case in Chile. There the government makes up the difference between a certain minimum pension level and the annuity that can be bought with the retirement savings accumulated in an individual account.

In a sense, the best guarantee is strong supervision that enforces the rules of the game. These rules have to balance the need for flexibility with financial safety and must adapt to changing conditions over time. At the least, the government will usually guarantee the system against fraud or theft. The guarantee and the supervisory structure will also depend on the way the second pillar is set up. It could be based on occupational pensions as in Australia, or on individual plans with companies that specialize in providing pension services, as in Argentina. ❑

❑ A FIRST FOR AFRICA: THE PRIVATIZATION OF KENYA AIRWAYS

By Mike Tiller, IFC Corporate Finance Services Department

A step-by-step account of how Kenya turned a struggling state-owned airline over to private hands — and profitability. Mike Tiller is a principal investment officer of the International Finance Corporation (IFC), which is the private-sector affiliate of the World Bank Group.

The sale of a major state-owned asset to private interests is usually a highly charged political event. The recently concluded two-year process by which 77 percent of the shares in Kenya Airways were sold to a broad array of private investors — with the International Finance Corporation (IFC) serving as principal adviser — was no exception. From the outset, the press and public of Kenya speculated as to how and when the process would fail and which interests would profit from that failure. Yet it proved to be a success. Key factors in this first-ever airline privatization in Africa were that:

• A special committee made up of key government and airline officials, dedicated solely to the privatization of Kenya Airways, was formed to ensure that each step in the process was conducted in the best interest of the Kenyan public;

• The IFC advisory team and the Kenya Airways Privatization Committee adhered to the principle of strict transparency at every juncture; and

• A structure was created that enabled the IFC team to produce business analyses of important matters (after consultation with interested parties in government, in the airline's unions, and among prospective investors), and to have those analyses presented to the highest levels of authority in the country by a trusted Kenyan spokesman. Controversial — and even unwelcome — advice got a respectful hearing, and in the end was accepted.

A remarkably diverse collection of "stakeholders" welcomed the eventual outcome. The Kenyan Treasury received over $70 million from the sales and saw government's remaining 23-percent minority stake increase in value. Over 113,000 Kenyans were able to buy a total of 22 percent of the shares in the national airline, more than 78,000 of these for the minimum stake of about $200. Kenyan financial institutions bought a further 12 percent, while international financial investors subscribed for 14 percent. Employees of the airline participated in a special program by which they will acquire 3 percent. A strong alliance partner, KLM Royal Dutch Airlines, purchased a 26-percent share of the equity, and Kenya Airways seems poised to continue the profitable operations it achieved over the past two years. Service standards and reliability have improved dramatically. Perhaps most important, the government was relieved of the financial strain of keeping a money-losing operation from going under at a time when it was also struggling to fund a program of economic reform and development.

CHAIRMAN'S ROLE

The role performed by the airline's chairman, Philip Ndegwa, was particularly crucial. He was both a successful private businessman, as the chairman of First Chartered Securities Limited, and familiar with Kenya's political scene as a former governor of the Central Bank of Kenya and economic adviser to the president. When Ndegwa was appointed chairman of Kenya Airways in 1991, the airline was in desperate condition. It had massive accumulated losses, along with crippling debt arrears arising from its failure to service its loans. Kenyan authorities made the political judgment that the time had come to do whatever was necessary to reform the airline. An entirely new slate of directors was appointed to the board, and Ndegwa assumed the chairmanship with an express mandate to ensure that the airline cease being a drain on the Treasury. Ndegwa concluded that Kenya Airways could not be made viable without ending its ownership by the state. He believed that the airline could only become a commercial success when its route and fare structures, fleet-acquisition decisions, hiring and promotion practices, and financial management systems were based on normal business grounds free from political considerations and interference.

To these ends, the airline's board brought in a high-caliber management team recruited through British Airways' wholly owned firm Speedwing Consulting. This team, headed by the effective managing director Brian Davies, was given considerable leeway to restructure operations and management. Routes, fares, and the fleet were rationalized. Management was overhauled, with substantial downsizing. The entire staff was put through training designed to engender a corporate culture oriented toward customer service and commercial viability, as opposed to the former preoccupation with self-administration.

IFC STEPS IN

The next step, taken in April 1994, was to engage IFC's Corporate Finance Services Department as principal adviser to help bring about private ownership of Kenya Airways. Ndegwa and Davies considered that IFC had the right combination of technical expertise, political sensitivity, and credibility required by the difficult environment surrounding this privatization.

These actions were not popular with staff who owed their appointments to patronage. Nor were they popular with public officials accustomed to using Kenya Airways for their own convenience. But the board had a strong mandate. It had confidence in Davies' management team and its privatization advisers, and — in the person of the chairman — had ready access to the highest levels of power. These characteristics made possible decisive action when difficult business decisions had to be taken, even in the face of powerful opposition. Within this favorable context, it was IFC's task to define the key business issues affecting the privatization, to subject them to rigorous analysis, to formulate detailed recommendations, and to frame them in practical ways susceptible to successful implementation under real Kenyan conditions.

Foremost among these issues was the company's crippling burden from debt arrears. Even though the new board and management had been servicing current debt as it fell due from the beginning of 1993, the debt arrears and penalties arising from 17 years of accumulated losses had become insupportable. Since government had guaranteed all foreign loans and was itself a major creditor as a result of "bridging" loans provided regularly to fund operating losses, government held the ultimate responsibility for these obligations in any case. A recommendation for government to assume the debt arrears accumulated prior to 1993 and to convert most of its own debt to equity in Kenya Airways was submitted, accepted, and executed. This had the effect of cleaning up the airline's balance sheet and showing a truer picture of its operating performance on its profit and loss account. It also sent a powerful signal that government was acting in earnest toward the privatization of Kenya Airways. No other single event did more to persuade domestic and international private investors to take this business seriously.

One of IFC's first tasks upon accepting the advisory assignment was to determine who could take decisive action on behalf of the government. Here, fortune played a part. Kenya Airways Limited had been created in a crisis atmosphere in 1976 out of the ruins of the liquidated East African Airways Corporation following the collapse of the East African Community.

The new airline was registered — largely for reasons of speed and administrative convenience — as a limited liability company wholly owned by the government. This legal status made Kenya Airways exempt from cumbersome procedures binding state corporations. Instead, Kenya Airways' board of directors and its principal adviser were free to devise a relatively streamlined process in consultation with key government officials.

IFC recommended that an even smaller body be created to conduct the myriad tasks of the privatization, so that its members could devote the time necessary to master the details of plans and negotiations and, thus, to be able to brief government decision-makers thoroughly whenever necessary. As a result of these recommendations, a Kenya Airways' Privatization Committee was formed as a subcommittee of the board, headed by the chairman. Its other members were the board members representing the ministries of Finance and Transport and the Attorney-General's Chambers, along with the airline's managing director and finance director. The company secretary and the head of the IFC advisory team were nonvoting members.

IFC presented to the full board a strategic review of the airline's operations and financial condition, along with an options report evaluating the relative merits of the various courses available toward its final privatization. The board used these documents to develop a consensus strategy for future action, taking into account government preferences and priorities. On this basis, IFC then produced a detailed action plan designed to reconcile government's objectives and practical constraints with the commercial realities of the international air transport industry.

ACTION PLAN IMPLEMENTED

The Kenya Airways Privatization Committee became responsible for the implementation of that action plan, relying on the IFC advisory team and the airline´s management to carry out the staff work necessary to reach its decisions and to execute its directives. Each step in the privatization process was taken by — or under the direct supervision of — the Privatization Committee. Especially important elements included:

• Debt restructuring: Seventeen years of losses had rendered Kenya Airways technically bankrupt; a proposal for government to assume obligations for past debt was submitted; after government's formal approval, new agreements had to be negotiated with 18 different international creditors.

• Strategic partner: IFC's recommendation that future business growth for Kenya Airways depended on securing an alliance with a major international airline through participation in the equity was particularly sensitive, since it meant the introduction of a non-Kenyan shareholder in the national flag carrier.

• Information memorandum: This IFC document, describing the company, elaborating the privatization process, and soliciting investment proposals from prospective airline partners, had to be scrupulously faithful to the facts, to Kenyan legal practice, and to government's intentions and commitments.

• Partner selection criteria: The bases by which investment proposals would be analyzed, measured, and ranked had to be agreed in advance with the board.

• Evaluation of proposals: The creation of a short list of acceptable strategic partners required assessment of uncertain and even unquantifiable factors.

• Negotiations with prospective partners: In the end, two airlines were invited to Nairobi for sequential negotiations of shareholding and business partnership agreements; it was the intention to stimulate a competition between the two in order to achieve the best deal possible for Kenya.

• Recommendation of preferred partner: The final recommendation of the best available partnership (KLM) went from IFC to the Privatization Committee, then to the full board, and from there to the Kenyan cabinet, where it was accepted.

• Design of public offerings: This included the details of the public offering to Kenyan investors on the Nairobi Stock Exchange, as well as the placement of additional shares with international investment funds.

• Appointment of implementation team: Lead managers for the domestic public offering, as well as for the international private placements (Citibank, in both cases) had to be selected through an open competition and appointed, along with reporting accountants, lead sponsoring stockbrokers, receiving bankers, advocates, share registrars, public relations specialists, advertising specialists, and others.

Each of these steps was handled in the same manner. The Privatization Committee established guidelines. The IFC advisory team and airline management coordinated the work of all the professionals in the implementation team to produce recommendations and drafts. Privatization Committee members consulted with their seniors in government. Final determinations were made in formal session and minuted. Landmark decisions were reported to the full board, and, if necessary, ratified. Board decisions were reported directly to the highest levels of government by the board chairman. The only exception to this procedure was IFC's valuation report. Because of the need for its complete confidentiality, this report was submitted by IFC only to the chairman. He and the head of the IFC advisory team ensured that its findings were taken into account when negotiating price with strategic investors and when the initial public offering share price was being set.

PARTNER SELECTED

The selection of Kenya Airways' strategic partner took most observers by surprise. There had been widespread speculation in the local and international press that the strategic investor would be British Airways because of its association through the Speedwing contract and because of the generally close relations between Kenya and the United Kingdom. It shows the fairness and transparency of the process that, in the end, an airline with no prior relationship with Kenya Airways — KLM — was judged to have made the superior investment and partnership proposals. The alliance agreements, signed on December 15, 1995, yielded immediate benefits for both partners in terms of code sharing, shared reservation systems, joint marketing, and joint purchasing of aircraft, fuel, spares, and insurance. An alliance committee has been formed, meeting alternately in Nairobi and Amsterdam, to ensure that all available mutual advantages are exploited. The guiding principle of that committee, chartered by a formal cooperation agreement, is that any initiative by either partner must either benefit the other or have no effect upon him. Initiatives not meeting that test will be subject to mutually agreed compensation or will simply not be carried out.

Throughout this process, the chairman's business acumen challenged the privatization team to produce the finest business solutions to each element of the airline's transformation and sale process. His credibility at the highest levels of government ensured that those solutions — no matter how unpalatable — got a fair hearing. In all important instances those recommendations were approved and executed. The tragic irony of the Kenya Airways story is that in January 1996, just after the signing of the partnership with KLM and before the launch of the public offering, Philip Ndegwa died.

After the chairman's death, the quality of communication between the privatization team and government declined. Misunderstandings became brushfires that required great effort to put out and put right. Even after public trading in Kenya Airways shares began on the Nairobi Stock Exchange on June 3, 1996 (where they rose in value by 20 percent during the first five days' trading), a long-simmering industrial dispute with the airline's pilots flared up to threaten the company's future profitability. The new private owners of Kenya Airways kept Davies' outstanding management team intact, having brought the Speedwing contract to an end. This team, along with the new owners and new board, was challenged to devise means of replacing the late chairman's skills at conciliation and finding constructive solutions in order to resolve the pilots' dispute.

One of Philip Ndegwa's legacies is a profitable, well-managed Kenya Airways with a strong international airline partner, solid international and domestic institutional investors, over 113,000 individual Kenyan shareholders, and healthy shareholding from the company's employees.

Another legacy is the Kenya Airways model of how frank, meticulous, well-supported, and trustworthy communication between implementing advisers and government can help make possible a successful passage through the dangerous once-in-a-company's-lifetime experience called privatization. ❑

FACTS AND FIGURES

❏ SELECTED TRENDS IN PRIVATIZATION, 1993-1996

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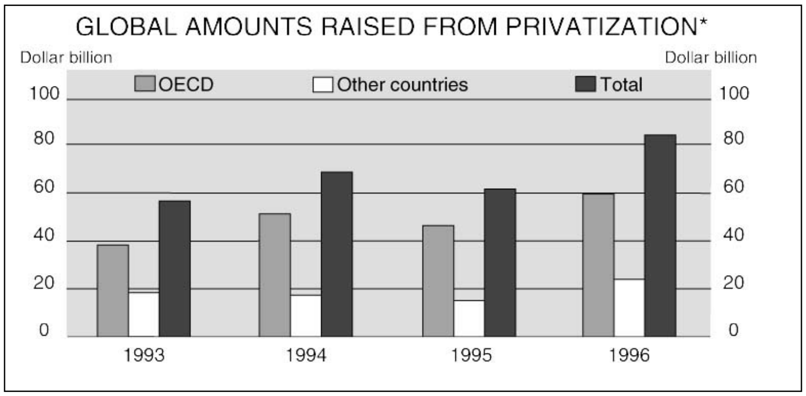
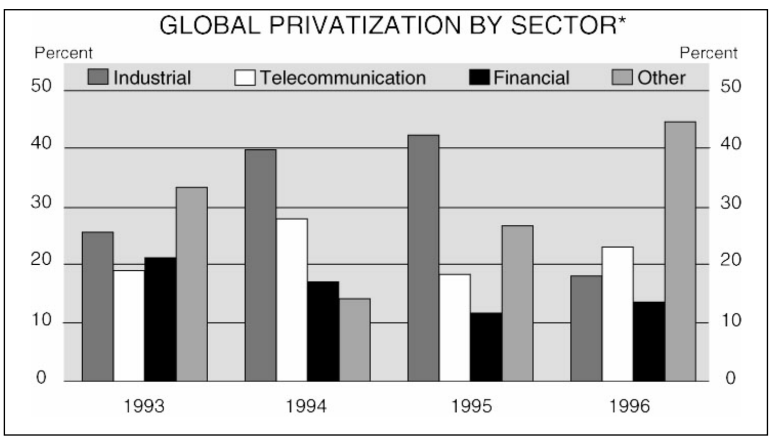
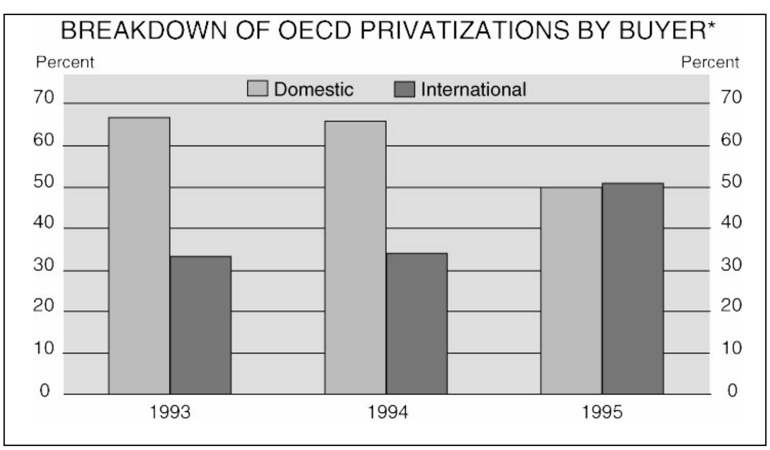


*Figures for 1996 are best estimates



*Source: National submissions and estimates by SBC Warburg and OECD Secretariat



*Not based on all OECD countries

KEY CONTACTS AND INTERNET SITES

KEY CONTACTS

U.S. Agency for International Development
320 21st Street, N.W.
Washington, D.C. 20523 U.S.A.
Telephone: (202) 647-4274

U.S. Department of State
Economic and Business Affairs
2201 C Street, N.W.
Washington, D.C. 20520 U.S.A.
Telephone: (202) 647-7951

U.S. Department of Commerce
International Trade Administration
14th and Constitution Avenue, N.W.
Washington, D.C. 20230 U.S.A.
Telephone: (202) 482-3809

U.S. International Trade Commission
500 E. Street, S.W.
Washington, D.C. 20436 U.S.A.
Telephone: (202) 205-1806

The World Bank
1818 H. Street, N.W.
Washington, D.C. 20433 U.S.A.
Telephone: (202) 477-1234

KEY INTERNET SITES

U.S. Agency for International Development
— Homepage: http://www.info.usaid.gov/

U.S. Department of Commerce
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ECONOMIC TRENDS

Entering 1997, the U.S. economy appears poised to continue its six-year-old moderately paced expansion, which has been characterized by low unemployment and the lowest inflation rate in decades.

The consensus forecast of Blue Chip Economic Indicators, a private economic analysis firm, is that the U.S. economy expanded by 2.5 percent on an annual basis in the fourth quarter of 1996. That estimate was based on a poll of more than 50 independent economic forecasters employed at major banks, insurance companies, manufacturers, brokerage houses, and universities. The Blue Chip growth estimate for all of 1996 is 2.3 percent, slightly higher than the 2.0 percent growth rate for 1995.

Both the U.S. Department of Commerce's Chief Economist Lee Price and analysts at Blue Chip believe that the fourth quarter forecast is low, particularly in light of economic statistics released in January. In an interview with USIA, Price said fourth-quarter growth will likely be at least 3 percent. Preliminary U.S. government estimates for fourth-quarter gross domestic product (GDP) growth will be released January 31.

Price said that all indicators point to continued economic expansion, reflecting a "reasonably balanced economy," with growth based on a range of activities, including investment, consumer spending, housing, and exports.

Inflation, as measured by the Consumer Price Index (CPI), rose by 3.3 percent in 1996, a 0.8-percent increase over 1995 and the biggest annual rise since 1991. However, the 1996 CPI increase is still lower than any yearly rise from 1972 to 1990 — except for 1986, when the collapse of oil prices slowed price increases to just 1.1 percent.

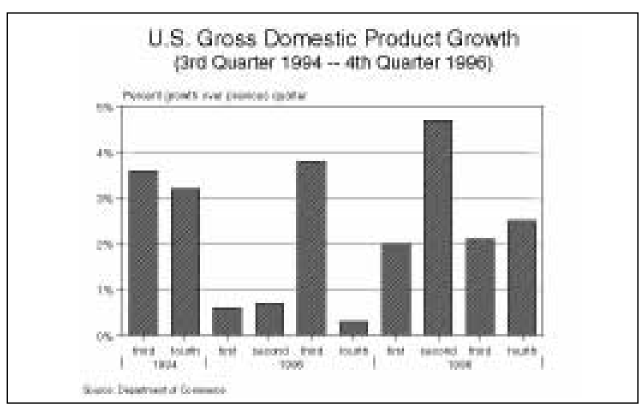
Higher prices for energy and, to a lesser extent, food were responsible for the CPI increase during 1996, a development some economists say portends greater pressure on prices ahead. "A surge in food and/or energy prices has preceded each of the last three inflation cycles since 1960," says Gail Fosler, chief economist at the Conference Board, a business-sponsored economic research group.

Price, however, said he did not see an inflationary threat, noting that stock and bond markets both rallied when the year-end CPI figures were released January 14. The "core" inflation rate, which excludes the price-volatile food and energy categories, has fallen, he said. The core inflation rate for 1996 was 2.6 percent.

The unemployment rate remained at low levels, declining from a 1996 high of 5.7 percent in January to 5.2 percent in August, then rising to 5.3 percent at the end of the year. The unemployment rate has been below 6.0 percent since September 1994. The size of the civilian labor force and new payroll employment continues to increase. A slowdown in benefits costs has helped keep labor costs in check, Price said.

Other indicators of the continued expansion include increased retail sales, up by 0.6 percent in December, a rise in business inventories, and increased industrial production, up 0.9 percent in November after declining in the previous two months. Capacity utilization was also up.

The measures for productivity in the non-farm business sector — which are released quarterly — declined in the third quarter of 1996 by 0.3 percent, after increasing in the first half of the year. Price said he believes there are "serious problems" in some new methods for measuring productivity that were used in 1996. ❑



CALENDAR OF ECONOMIC EVENTS

Jan. 30-Feb. 4	World Economic Forum annual meeting, Davos, Switzerland
Feb. 10-12	Organization for Economic Cooperation and Development (OECD) Bribery Working Group, Paris, France
Feb. 15	Deadline for concluding World Trade Organization (WTO) negotiations on telecommunications, Geneva, Switzerland
Feb. 26	International Conference on Child Labor, organized by the Dutch Social Affairs and Employment and Foreign Ministries and the International Labor Organization (ILO), Amsterdam, the Netherlands
Mar. 5-6	Summit of the Americas (SOA), 8th meeting of the Summit Implementing Review Group, Washington
Mar. 6-7	14-member Indian Ocean Rim (IOR) ministerial summit, at which the charter establishing the Indian Ocean Rim Association for Regional Cooperation (IOR-ARC) will be signed
Mar. 17-19	Annual meeting of the Inter-American Development Bank, Barcelona, Spain
Apr. 8-10	32nd World Congress of the International Chamber of Commerce, Shanghai, China. This year's theme is "Asia in the Global Economy"
Apr. 28-May 2	The Inter-Pacific Bar Association annual meeting in Kuala Lumpur, Malaysia. Plenary session devoted to a discussion of "WTO: Implications for the Pacific Region"
May 11-13	Asian Development Bank annual meeting, Fukuoka, Japan
May 17	World Telecommunications Day
May 17-19	Association of Southeast Asian Nations (ASEAN) regional forum senior officials meeting, Kuala Lumpur
May 28-29	African Development Bank annual meeting, Abidjan, Cote D'Ivoire
Jun. 20-22	Group of Seven (G-7) Economic Summit, Denver, Colorado
Jul. 27-29	ASEAN regional forum, Kuala Lumpur
Sep. 7-10	International Conference on the Panama Canal, Panama
Sep. 23-25	International Monetary Fund and World Bank Group joint annual meetings, Hong Kong

WHAT'S NEW IN ECONOMICS: ARTICLE ALERT

Boeker, Paul H. TAKING STOCK OF LATIN AMERICA'S FIRST DECADE OF PRIVATIZATION (Economic Reform Today, no. 4, 1995)

Over $75 billion worth of assets have been privatized by Latin American governments since the mid-1980s, and the satisfactory results are liable to lead to major privatizations in the next half decade, says the president of the Institute of the Americas. Argentina, Chile, and Mexico account for two-thirds of this value. They achieved their fiscal aims and raised productivity. Countries such as Brazil are now positioned to follow. The effort is spreading from utilities sales to the pension system, "the heart of how an economy generates savings and turns them efficiently into investment." Bolivia's capitalization plan may prove an "ingenious combination of privatization and pension funding."

Pinera, Jose. EMPOWERING WORKERS: THE PRIVATIZATION OF SOCIAL SECURITY IN CHILE (The Cato Journal, vol 15, no. 2-3, Fall/Winter 1995-96, pp. 155-166)

Around the world, state-financed pension systems face bankruptcy as proportionately fewer workers pay ever larger payroll taxes to support more retirees. Chile led the way in reform when, in 1980, it began privatizing its pension system. The author, who was in charge of the privatization, explains how Chile's privatized pension system works and how it has overcome the flaws of the "pay-as-you-go" pension programs.

Brada, Josef. PRIVATIZATION IS TRANSITION—OR IS IT? (Journal of Economic Perspectives, vol. 10, no. 2, Spring 1996, pp. 67-86)

Looking at Russian and Eastern European economies, this article finds two tracks in privatization — quick emergence of private small business proprietors, including some farmers, but continued domination by the state, often in cooperation with holdover company insiders. Even while some of the large companies have adjusted in market-like fashion to new competition and while some governments have taken only a passive role in their ownership, the author says, transition in these countries is incomplete and its future uncertain. Even less-than-complete privatization, however, can alter the way these economies work, he says.

Borish, Michael S.; Noel, Michael. PRIVATE SECTOR DEVELOPMENT IN THE VISEGRAD COUNTRIES (Finance and Development, no. 78, December 1996, pp. 45-48)

The Visegrad countries — Poland, the Czech and Slovak Republics, and Hungary — are enjoying solid economic growth driven by vibrant new private sectors, write Borish and Noel, financial analysts for the World Bank. While private sector growth in the Czech Republic and Hungary is primarily the result of selling off state-owned assets, and in Poland and the Slovak Republic the result of small and medium-sized start-ups, all countries show considerable private-sector gains, even though their degree of macroeconomic stability varies. To maintain this growth, these countries will have to push forward with reforms in property rights, contract enforcement, bankruptcy procedures, and bank supervision. The authors are optimistic that the Visegrad countries will be able to join the European Union one day.

Van Thuyt, Pham. LEGAL FRAMEWORK AND PRIVATE SECTOR DEVELOPMENT IN TRANSITIONAL ECONOMIES: THE CASE OF VIET-NAM (Law and Policy in International Business, vol. 27, no. 3, Spring 1996, pp. 541-600)

This article examines the balance Viet-Nam is striking between encouragement of the private sector and retention of its socialist ideology. A principal obstacle to private-sector development is that land ownership remains with the state. Similarly, the legal infrastructure slows down domestic and foreign investment, hampering major development under the 1989 Foreign Investment Law. The author appears to misread the purpose of the laws as intending a "transition to a market economy," whereas his discussion clearly shows that the government is not aiming to reverse the dominance by state-owned enterprises in industry, trade, and banking. ❑