THE BLEYZER FOUNDATION
Turning Transitions Into Prosperity

PRIVATIZATION IN EMERGING MARKETS

A. Criteria to decide on whether or not to privatize.
B. Privatization Principles
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- From the end of the Second World War to the 1980s, many Governments took ownership of production activities, replacing private sector ownership in many industrial and utility sectors.
- This trend was induced by beliefs that the free market system had deficiencies that could be corrected by Government ownership:
  - Private ownership led to income inequality with low wages.
  - Market failures (externalities, economies of scale, information gaps) led to less than optimal production in "strategic" sectors.
  - Government investments could promote economic growth.
- After the 1980s, however, there was general recognition that state enterprises just favored vested interests and were "inefficient".
- These inefficiencies may be due to their multiplicity of goals, weak incentives, monopolistic behaviors, and soft budget constraints.
- Therefore, a substantial wave of privatization of state enterprises has been take place since then.
- Emerging markets also heavily engaged in these programs.

A. Criteria to decide on whether or not to privatize.

- Two major factors affect the outcome of privatization:
- First, the nature of the market in which the enterprise will be divested (competitive vs non-competitive).
  - In a non-competitive market (such as utilities), a regulatory framework must be in place before proceeding with privatization.
  - Otherwise, we will create private monopolies without regulations.
- The second factor is the capacity of the country to regulate properly: That is, whether the country has the capacity to de-regulate in competitive markets or regulate properly in non-competitive markets; or whether this capacity is low.
  - In the case of a competitive market and high regulatory capacity, the company should be privatized.
  - In the case of non-competitive markets and low regulatory capacity, additional work may be needed in developing the government's regulatory capacity before proceeding with privatization.

B. Privatization Principles

Principle for success of a privatization program:

1. **Defining Privatization Objectives and Strategy.**

- Decide the objectives of the privatization: Is it for efficiency gains? For raising public funds? attracting new investments? developing capital markets? reducing the size of the government?
- Clear objectives are needed to sort out conflicts that will develop later on.
- Decide whether you go for **fast speed** (with some sacrifices in transparency) **or for full transparency**.
- In other words, decide whether to proceed quickly with privatization on a piece-meal, company by company basis, as Mexico did it; or whether to proceed more slowly with a Master Plan where a large number of companies are evaluated, appraised, discussed by Parliament, etc. (such as in Turkey).

- Decide whether to start first with the easier and smaller ones or with the crown jewels (as in Argentina, to signal commitment to reform).

2. **Providing a Strong Legal Framework.**

- A legal mandate is needed to permit the government to proceed expeditiously, sorting out conflicts that will develop later on.
- A legal mandate is also needed to take necessary measures, such as taking over excess debt, reduce excess personnel, liberalize prices, increase tariffs for public utilities, etc.
- Clear and transparent privatization procedures are needed to bring confidence to foreign investors and avoid misinterpretations.

3. **Ensuring a Competitive Environment or Appropriate Market Regulations.**

- An adequate competitive environment should be in place.
- If not, in natural monopolies, appropriate pricing and other regulations are needed to obtain efficiency gains and protect consumers.

4. **Carrying out Public Awareness Campaigns.**

- The are critical to explain the benefits and cost of privatization and securing political support.

5. **Managing the Process.**

- There should be an **autonomous central "custodian"** of the public enterprises to be privatized, such as the Treuhandanstalt in Germany, which can make business decisions independent of individual Government agencies.

- Otherwise there will be endless disputes among various government agencies.
- This agency should carry out the privatization process, with the support of financial institutions.
- Leaving firms to restructure and privatize themselves is bound to fail, because the companies find it difficult to construct open balance sheets, make a business plans under private hands, and appraised their value.
- This slowed down the processes in Czechoslovak and Hungary.
- Existing management may not have the expertise or the will to privatize.

6. **Limited Restructuring the Firms**.

- Restructuring should be limited to legal, labor or debt aspects.
- Large physical investments before privatization are not desirable as the new owners may not value these imvestments.

7. **Pricing and Valuation.**

- Letting the market decide the sale price through competitive bidding is the optimal method.
- Some external valuation of the firm is useful but not to set a floor price.

8. **Mass privatization**

- This involves giving free vouchers to all citizen in the country, which can be used to buy shares of public enterprises (through periodic auctions of the shares).
- This has been done principally for medium sized firms, with low profitability, which could not be sold for cash easily.
- Mass privatization may have a political goal--it may bring shareholders but may not help in providing ownership control, management support and financial resources to help put the companies back in their feet.
- This is the problem with the Czech voucher system.
- The Polish model, with citizens' shareholdings put in mutual funds run by experienced managers could be more dynamic, provided that the Warsaw stock exchange offers tradability.
- This is why capital markets must be developed alongside with mass privatization.

C. Privatization in Mexico

- Mexico carried out a major privatization program starting in 1986.
- The program reduced the number of state enterprises from about 1,200 to about 150 five years later.
- The selection of candidates for privatization was made by the sector ministry, based on market conditions and structure, financial and legal factors, level of employment, complexity of the case, etc.
- The smaller and easiest cases were selected first.
- Based on this selection recommendation, an Inter-ministerial Committee made proposals to the President.
- If approved, the Ministry of Planning and Budgeting would issue a formal resolution to proceed.

- The handling of the sale was assigned to a small Privatization Unit (about five people) in the Ministry of Finance, which reported directly to the Minister of Finance.
- This Unit just identified and selected the **financial adviser** (normally a domestic commercial bank) that would take charge of executing the entire sale transaction.
- Once the Adviser was selected, the Unit would just monitor process.
- The financial adviser played the key role in the entire privatization process.
- Ex-post, the process was criticized as favoring vested interest groups, with the private financial advisers operating in a non-transparent manner with few checks and balances.
- The role of the financial advisers was the following:

Role of the Financial Adviser

1. Makes the corporate, financial and technical analysis of the company.
2. Defines the method of sale (how the auction will be done).
3. Evaluates the net worth of the company and recommends a minimum selling price (which is not announced).
4. Produces the Offering Memorandum.
5. Contacts potential buyers, domestically and abroad.
6. Requests, receives and assesses the bids.
7. Reports the results of the bids to the Ministry of Finance. At least two bids must be received.
8. Once approved by the Ministry of Finance, formalizes the sale.
9. If the minimum price is not achieved, the Interministerial Committee reviews the case, setting new selling criteria.

D. Privatization in The Philippines

- Contrary to Mexico, in Philippines Government agencies played key roles in the privatization process.
- Under the privatization program developed and supported by the World bank, of the 300 PEs in existence in 1988, only about 37 remained in the public sector.
- The rest were privatized, liquidated or merged.
- About 55,000 public employees were transferred to the private sector.
- The process started in 1988 and was as follows:

First,

- The required legal instruments -- several Laws and Presidential decrees -- setting the policy and legal framework for the program were approved.

Second,

- An Interministerial Committee on Privatization was formed to oversee the program and was composed by the Ministers of Finance, Trade and Industry, Justice, and Budget and Management.
- An implementing organizations was also formed: the Assets Privatization Trust.

Third,

- Privatization guidelines and procedures were approved by the Committee on Privatization.
- Also the operating guidelines, budget organization and staffing of the Asset Privatization Trust were approved by the Committee.

- These guidelines set procedures for:
  - the Committee's monitoring of all privatizations,
  - required the preparation of detailed privatization plans for each PE,
  - required approval by the Committee of the privatization plans,
  - provided guidelines for the evaluation of assets, identification of investors, disposition methods, etc.
  - set a very transparent process, to bring public confidence in the process.

Fourth,

- Procedures for the formulation of privatization recommendations were approved, naming the Office of Budget and Management as the agency responsible for making the recommendations.

- Such recommendations were to be reviewed by the Interministerial Committee on Privatization.
- After its approval, the recommendations were sent to the President of the Republic for final approval.
- The Committee on Privatization also approved the terms of individual sales and reviewed the progress of the entire program.

Fifth,

- The Assets Privatization Trust was established as the main agency in charge of the actual selling of the PEs.
- The Board of Directors of the Trust was appointed by the President of the Country upon the recommendation of the Interministerial Committee on Privatization.

- The Board of the Trust was composed of five full-time members drawn from senior executive levels of private industry. In addition to these five persons, the trust has 42 employees.
- The Trust was in charge of negotiating and effecting the sale, and was supported by consultants in finance, accounting , auditing, law, plant operations, etc. to carry out the detailed work.
- The idea was that the Trust will have executive powers but with lean staff, hiring external expertise and technical assistance to support the privatization process.

Conclusions on privatization.

- In general, the Philippines process was quite successful in completing privatization with minimum problems.
- Similar schemes were developed in other countries, such as Peru.
- In other countries, such as Ukraine, the initial legal framework was never approved and privatization is still suffering from interferences and conflicts of interest.