Facilitating Foreign Participation in Privatization

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Abstract

Foreign direct investment can play an important role in making a privatization program successful. The inclusion of foreign investors increases the pool of potential bidders with strong financial resources and technical expertise, raising the chances for these enterprises to be transformed into efficient and profitable entities. But foreign investors will not just automatically participate in any privatization. In order to design an attractive privatization program, developing country governments have to take into consideration investor concerns. Political commitment, business orientation, and transparency are fundamental principles of any successful privatization program. Only if every element of the process—from the design of the general political, legal, and institutional framework down to every single step in the actual sales procedure—is based on these principles, can a government expect strong participation by foreign investors.
Preface

In recent years, the developing world witnessed a rapid increase in foreign direct investment inflows. A number of countries used the sale of state-owned enterprises as an effective instrument to attract foreign investors. However, not every country which pursued a policy of privatization found itself automatically subject to strong interest from investors from abroad. In fact, a number of countries seem to have difficulties in attracting foreign investors as active participants in their privatization programs. In order to develop a better understanding of this mixed performance of foreign direct investment in privatization programs, the Foreign Investment Advisory Service (FIAS), member of the World Bank Group, together with the Canadian consulting firm Groupe Secor, undertook a review of the major privatization programs in the developing world.

With a particular focus on the privatization programs in Argentina, Ghana, Hungary, Mexico, Mozambique, Peru, the Philippines, and Poland, where we conducted field research between September 1994 and March 1995, we tried to identify the major impediments and enabling factors in attracting foreign investors in privatizations. The countries surveyed were selected for their geographic, political and economic diversity as well as their strong experience in privatizations. Within their regions, each of these countries stands out as having one of the most active and intensive privatization programs.

Based on the review of these privatization programs combined with interviews at the headquarters of about thirty foreign investors, we have attempted to isolate the fundamental principles underlying successful privatization. Based on these experiences we tried to develop some best practices in structuring and managing privatization with foreign investment, from the establishment of the general policy framework up to the actual divestiture process.
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Executive Summary

In recent years, an increasing number of developing countries have embarked upon extensive privatization programs within the framework of macroeconomic reform and liberalization. However, the performance of these individual privatization programs differed substantially, especially with respect to foreign direct investment (FDI). The most successful privatizers managed to sell numerous state-owned enterprises (SOEs) with strong participation by foreign investors. At the same time, FDI inflows not related to privatization sales also increased rapidly, reflecting the increased confidence of the foreign investor community in these countries as attractive investment locations. Many other countries, however, have been struggling. The number of privatization transactions as well as the sales volume remain small, and interested bidders from abroad are generally absent. Overall FDI flows to these countries also remain stagnant, contrary to the general experience of rapidly increasing inflows to developing countries worldwide.

This correlation between the success of privatizations and a country’s attractiveness to foreign investors is not accidental. In fact, a strong participation by foreign investors is a reflection of the attractiveness of a privatization program, and is therefore in itself an indication of success. More importantly, strong foreign investor involvement plays an important role in supporting the effectiveness of a privatization program. The inclusion of foreign investors as active participants raises the level of competitiveness of the bidding process. Higher bid prices and stronger technical proposals increase the chances for the government to select the best suited bidder to turn a SOE into a profitable and efficient entity. In addition, the fact that foreign investors can freely participate in a privatization program advertises the country as an attractive investment location, and additional FDI flows in, further supporting the private sector development.

But foreign investors do not just jump on any privatization opportunity that presents itself. A review of some of the most successful privatization programs in the developing world shows that foreign investors are particularly loath to get involved in a highly politicized environment, marred by excessive bureaucracy and unpredictable decisionmaking. While investors tend to be sympathetic to the political difficulties surrounding the sale of SOEs, they want to see a firm commitment by the government to the reform process in general as well as individual privatization transactions. Participating in a privatization sale is resource-intensive and expensive for foreign investors. They will be hesitant to enter into a privatization if they get the sense that final sales decisions are based on criteria other than the technical and financial elements presented in bid proposals. The more they feel that they are wasting their time in an unnecessarily bureaucratic and convoluted process, confronted with too many government officials who lack the necessary skills, the more they will be tempted to walk away and not to bid.

If a country wants to derive the maximum benefits from its privatization policy, it has to make sure that the program is sufficiently investor...
friendly. As long as foreign investors feel comfortable with the skill level, commitment, and decisionmaking authority of their government counterparts, they will also feel comfortable in participating in the privatization process. On the other hand, any attempts to limit the involvement of foreign direct investment can cause substantial damage to a country’s privatization program in the eyes of the public as well as the foreign investor community.

An attractive privatization program should therefore be characterized by three fundamental principles: political commitment, business orientation, and transparency. These are not esoteric and theoretical concepts, but should rather be applied during the design of a privatization program as the guiding elements in every step of the process. For any privatization program to be reliable and attractive to a foreign investor, it has to be publicly declared as a key element in an overall reform process. The process should be embedded in a simple, but comprehensive legal framework which clearly specifies the scope as well as the decisionmaking authority for the divestiture program.

To implement a privatization program, an appropriate institutional framework has to be designed based on these principles. While no two institutional setups are alike, one fundamental rule is that the individual sales process has to be separated from general policy decisions. The privatization agency’s primary concern should be to efficiently conduct sales transactions, and it needs the necessary authority to do so, free from any political interference. To obtain the financially and technically most attractive offers, the agency will have to focus on having as many competitive bidders as possible participate in the tender.

To create an attractive privatization program, the agency will face the challenge of combining the political requirements of privatization with an investor-oriented sales process. Experience reviewed in this paper shows that privatization agencies are more effective the less they are involved in the political process of privatization. In fact, the more time and energy the agency’s staff can invest in serving potential investors, the more likely is the success of the overall privatization program.

Care should be taken to make this investor orientation a cornerstone in all the steps of the privatization process:

- The agency should have the right to select individual state enterprises for privatization primarily based on market criteria, free of any political disputes regarding their availability for privatization.
- In preparing a particular enterprise for privatization, the agency will have to make sure that all the pertinent information is available to and easily accessible for interested investors.
- Prior to the sale, some SOEs might require restructuring work to make them attractive to potential investors. However, in order to avoid lengthy delays, the agency should focus on those restructuring activities in which the government has a comparative advantage, such as shedding liabilities or labor force reductions. Investments in the rehabilitation or expansion of existing facilities should be left to the new private owner.
- Privatization agencies typically undertake a valuation of the assets to be privatized in order to determine an acceptable sales price. However, asset valuation is more an art than a science, being very much dependent on the underlying assumptions and methods applied. The only true assessment of a company’s market value results from a competitive bidding process. Agencies therefore tend to fare better when more resources are applied to the attraction of potential bidders, rather than on the determination of an artificial asset value.
- When announcing a SOE for sale, the agency has to make sure that the company is advertised for a sufficiently long period of time domestically and internationally, to allow potential bidders to prepare an adequate and sincere response. The agency should register these expressions of interest, and should engage in a strong promotion of the company to maximize the number of bidders.
- Transparency is key in the selection of the winning bidder in order to avoid criticism from investors as well as the public that decisions have been reached in a biased and unfair manner. In the pre-qualification as well as the final evaluation of bids received, the agency should ensure that all decision criteria are clearly specified and known to
all interested parties. The more the final decision is based on simple quantitative comparisons of the various bids, rather than qualitative judgments, the less likely it is that the agency will be subject to damaging criticism.

- The eventual transfer of the assets to the winning bidder should be handled as fast as possible. In many cases, privatization agencies engage in lengthy post-bid negotiations on key elements of the contract. But if investors are led to believe that the tender is mostly an administrative step with everything open for negotiation afterwards, they have no strong incentive to provide sincere and reliable offers during the bidding process.

To conduct such a privatization process effectively requires a highly trained and skilled staff, familiar with private sector motivation and objectives. Many developing countries lack a sufficiently large pool of private sector expertise precisely because of the previous dominance of the public sector. This can, and should, be overcome by making extensive use of external advisors and consultants with international experience.

Such advisors can be especially helpful in the promotional aspects of the privatization process. Most privatization agencies have not been particularly successful in developing a strong outreach program, capable of generating additional interest for particular SOEs in the international markets. Especially for medium-sized enterprises, investment promotion is often neglected, with the scarce resources available being used primarily for the largest, and therefore most visible, projects. A stronger promotional effort can support the overall success of a privatization program simply by attracting additional bidders.
Introduction

Over the past decade, an increasing number of countries have embarked on programs to privatize public enterprises, reversing the earlier strategy of public enterprises as the engine of economic development. Indeed, the pace of privatization has increased dramatically over the past five years. In the period 1988 to 1994, developing countries around the world sold about 3,300 state-owned enterprises (SOEs) with sales revenues rising from only US$2.6 billion in 1988 to a peak of US$29 billion in 1992. Foreign investors played an important role in this process, representing about 40 percent of the total sales revenue of US$112 billion accumulated during this period.¹

However, while the number of countries undertaking privatization programs is steadily increasing, not all of them are equally successful. On the one hand, Argentina, one of the most successful privatizers in the world, effectively managed to complete its divestiture program in a four-year period. Since 1990, it has sold about 120 major enterprises for US$17.4 billion, including foreign investment of US$8.2 billion and the retirement of almost US$18 billion in external debt.² Many other countries, on the other hand, burdened by political difficulties, struggle along with only a few sales per year and a lack of interested buyers, especially from abroad.

In order to develop a better understanding of this mixed performance of foreign direct investment (FDI) in privatization programs, the Foreign Investment Advisory Service (FIAS), member of the World Bank Group, together with the Canadian consulting firm Groupe Secor, undertook a review of the major privatization programs in the developing world. We selected a set of eight countries—Argentina, Ghana, Hungary, Mexico, Mozambique, Peru, the Philippines, and Poland—which are considered to have extensive and successful privatization programs in their respective geographic regions. Based on a detailed study of these programs as well as interviews with about thirty large foreign investors, who have been active in these programs, we tried to identify the major impediments and enabling factors in attracting foreign investors in privatizations.

This report attempts to isolate the fundamental principles underlying successful privatization, and to develop some best practices in structuring and managing privatization with foreign investment throughout the process. Rather than providing a detailed review of the individual privatization programs studied, we use these specific country experiences to underline the findings. While some countries might be cited more often than others as negative examples, it is important to keep in mind that all these countries have been quite successful in implementing privatization, especially when compared to many other developing countries.

Notes

2. World Bank Privatization Database.
The Role of Foreign Investment in Privatization

Why Privatize?

State-owned enterprises, initially thought to enhance the process of economic development, performed disappointingly in most developing countries. Financial losses resulting from inefficient management, antiquated technologies and bloated workforces often posed a major burden for already hard-pressed public budgets. For example, in 1989 SOE losses as a percentage of gross domestic product reached 9% in Argentina and Poland, while half of Tanzania’s 350 SOEs persistently ran losses that had to be covered from public funds. Eventually, economic realities became too pressing to be ignored, and an increasing number of developing countries began to privatize their SOEs.

Generally, governments hope that the change in ownership will decrease the financial demands made by SOEs on strained government budgets, and that it will improve the efficiency of the economy, resulting in an overall net positive effect on the country’s economic and social development. However, depending on the existing political environment, there is a vast array of additional specific objectives that governments might want to pursue in the process of privatization. All these objectives can be grouped into four broad categories:4

Financial Objectives

- maximize net proceeds of divestiture in order to fund other expenditures, reduce taxation, reduce the public sector deficit or repay domestic and foreign public debt outstanding;
- reduce and/or eliminate the financial drain of SOEs on the State through subsidies, unpaid taxes, arrears, etc.;
- limit potential future demands to provide capital for expansion and upgrading or the rescue of SOEs in financial difficulties.

Efficiency and Economic Development

- enhance the domestic private sector economy;
- attract foreign capital and expertise;
- improve the level and/or quality of goods and services produced;
- promote the economy’s efficiency and competitiveness;
- promote innovation through better access to new technologies;
- develop efficient capital markets.

Distributional Objectives

- foster broader, widespread capital ownership combined with the development of a national middle class;
- encourage economic development of a particular group in society;
• promote employee ownership to elicit public support for initially costly liberalization policies;
• restore full property rights to previous owners.

Political Objectives

• reduce the size and scope of the public sector;
• reorient public administration efforts away from public production towards engaging in enabling and regulatory activities;
• reduce opportunities for corruption and exploitation of public assets by government officials and SOE managers;
• reduce the influence of particular pressure groups such as parties, the bureaucracy, or labor unions;
• reduce the possibility for a successor government to reverse the privatization process.

All these objectives may, and often do, conflict. For example, any limitation on eligible investors through preferential treatment of employees or specific domestic investor groups will jeopardize the goals of revenue maximization and company efficiency. Dispersed ownership can also pose difficulties to enterprise efficiency. If ownership is spread too broadly in support of local capital markets and the involvement of domestic investors, efficiency of the company might suffer due to the lack of a strategic investor. But too many goals may not only conflict, they might even jeopardize the viability of a privatization program as a whole. Thus, attempts to accomplish multiple objectives can result in failure to achieve any.

Thus, the definition and determination of privatization objectives is an important step which should be carried out immediately at the beginning of the process. Many privatization programs have stalled or fallen apart simply due to the lack of a clear set of objectives or because of simultaneous pursuit of incompatible objectives. Setting objectives is not an abstract exercise. The government’s strategic task in the process of privatization is to balance conflicting objectives and prioritize them, which will often involve identifying, assessing and resolving policy tradeoffs.

No two countries are likely to be facing exactly the same configuration of problems and obstacles when formulating a privatization strategy. It will depend largely on country specific conditions. However, governments should never lose sight of the primary motivation for privatization: to transform SOEs into efficient and profit-making private enterprises.

Privatization will have its greatest impact on national welfare if the efficiency objective is paramount. A competitive and profitable enterprise is the most effective mechanism against unemployment, for future investments, and for the development of a private sector. The potential of a well-functioning private sector is also the most effective way to attract foreign investment. A strong effort to privatize, with efficiency gains at its core, sends a strong message to foreign investors that the host country is willing to open itself up to private entrepreneurship and to provide support to private economic activity and competition.

Why Sell To Foreigners?

Few issues related to privatization are as contentious as the sale of state enterprises to foreigners. In most countries with a long history of publicly-owned companies, the general opinion is that SOEs represent the fruits of decades of domestic savings and investment. Thus, the sentiment often is that these enterprises belong to the people and should not be given away to foreign interests, amounting to “selling the family jewels”. Any opposition to large-scale privatizations, typically motivated ideologically or by concerns about the potential loss of economic rents, can generate strong public support especially by appealing to these nationalistic sentiments.

In order to forestall such opposition, governments often send ambiguous signals to foreign investors. While generally acknowledging the benefits of their participation, governments, not infrequently, succumb to political pressure, giving preferential treatment to domestic buyers. Some countries even impose limits on foreign investment to a certain percentage share in domestic enterprises, or prohibit foreign participation in certain types of enterprises and activities.

This behavior clashes with the increasing liberalization of foreign investment regimes around the world when the involvement is in the form of new enterprises via greenfield investments or joint ventures with local partners, reflecting the
political nature of the privatization decision. A strategy dominated by short-term political goals rather than economic efficiency considerations can however be quite costly, not only for the privatization program itself, but also for the process of private sector development as well as the foreign investment climate in the country.

The exclusion of foreign investors is detrimental to the success of any privatization program. The most immediate effect is that the exclusion of any potential buyer simply reduces the number of offers received, while the competitive pressure among the bidders is limited. A recent econometric analysis of 346 privatization transactions in Mexico shows that increased bidder involvement results in substantially higher sales prices. In fact, according to this study an extra bidder in the final auction would have raised the price by 15 to 20 percent, while the exclusion of foreign bidders as a preferential treatment to local investors had a substantially negative effect on prices. The same argument holds for other bidding components such as future investment commitments. Thus, by opening the program to foreign investors, the government simply raises the probability of a successful privatization process. It ensures that it will receive the maximum price for the enterprise as well as attract the strongest investor.

In addition, the exclusion of foreigners can also be detrimental to the development of a country’s private sector. A major problem in many economies dominated by public enterprises and isolated from international competition is the general scarcity of domestic entrepreneurs and investors. Technical and managerial skills are often scarce, while private savings are too low to satisfy the economy’s investment needs. Many governments find it tempting to use a privatization program to directly create a private sector, giving preferential treatment to domestic bidders. Almost invariably, such attempts run into major difficulties, with the companies sold not improving in terms of efficiency and performance, and buyers not being able to generate the funds to undertake necessary investments or even to pay the bid price, often negotiated as installment payments over time. Especially in poor countries, the most qualified investors are often foreign. In Mozambique, for example, the government allows domestic investors to pay in installments. Most of the domestic investors have run up substantial arrears, and the government has substantial difficulties to collect on the initial promises. By the end of 1995, after seven years of relatively intense privatization activity, domestic investors have paid only about 17 percent of the total investment amount they committed to, compared to 83 percent by foreign investors.

However, privatization has implications far beyond the sale of individual state enterprises. In fact, privatization should be one of the main components of a broad liberalization program, designed to stimulate private economic activity and to tie the country into the global economic system. In many cases privatization represents an opening of the economy after years of protectionism and isolation. Foreign investors tend to be careful in evaluating such radical policy changes, and they will want to be reasonably certain that the government is serious about its reform agenda. Only when convinced that the government is truly interested in creating an attractive and open environment for private business, will they be willing to commit substantial resources in the form of investment projects.

Privatization can be used as an important tool in this process, reflecting the government’s commitment to open up the country’s economy by systematically reducing the influence of the public sector. And in fact, privatizations appear to have played a vital role in the rapid growth of foreign direct investment to developing countries since the late 1980s. A recent FIAS study shows that during the period of 1988–93, about 10 percent of total FDI inflows resulted from privatization sales directly. In addition, privatization appears to have an important signaling function. An econometric analysis for a cross-section of 36 countries indicates that each dollar in privatization revenue attracts another 88 cents of foreign direct investment independent of the privatization sales themselves.

This implies that privatizations can have a strong advertisement effect for a country, capable of generating additional foreign investments. However, this is not invariably the case for all countries that have some type of privatization program. Foreign investors will take the performance of the privatization program as an indicator for the sincerity with which governments pursue reforms. Figure 1 shows that the size and stability of the privatization program has a strong impact on foreign investment inflows.

In fact, for the period of 1988–93, the countries that conducted large privatization programs in terms of revenue as well as the countries whose
Figure 1: The Importance of Scope and Stability of Privatization

**SIZE MATTERS**
(Average Value for 1988–93)

![Bar Graph for SIZE MATTERS](image)

**STABILITY MATTERS**
(Average Value for 1988–93)

![Bar Graph for STABILITY MATTERS](image)

Note: "Largest Privatizers" is based on privatization revenue per capita, 1988–93, and includes: Argentina, Barbados, Chile, Czech Republic, Greece, Hungary, Jamaica, Malaysia, Mexico, Portugal, and Venezuela. "Very Stable Privatizers" is based on the continuity of the divestiture program, and includes: Argentina, Chile, Czech Republic, Hungary, Jamaica, Malaysia, Mexico, the Philippines, and Portugal.


program remained very stable and reliable during this time both received substantially larger privatization revenues as well as FDI inflows per capita compared to the developing world as a whole. The annual growth of FDI inflows also was larger in both cases. On the other hand, other privatizing countries that did not have large or stable privatization programs, clearly lagged behind in all three categories.

Categorizing the countries based on their ability to establish a successful privatization program, defined as the combination of size and stability, the effect on FDI inflows over time is impressive (see Figure 2). The most successful candidates managed to establish their credibility by selling a large volume of state assets with a stable involvement of foreign investors over time. Consequently, foreign investors accepted these countries as attractive investment locations and FDI grew rapidly from only US$6.5 billion in 1988 to almost US$22 billion in 1993. Even more revealing, when privatization revenues began to decline in 1993 because most of the large enterprises had been sold, FDI continued to rise. On the other hand, countries which were only moderately effective in their ability to establish a sizable and stable privatization program, FDI inflows reached only about US$9.7 billion, having started at almost the same level as the most successful privatizers. Finally, for countries which failed to convey the impression of a systematic reform program, with individual privatization decisions caught up in political indecisiveness reflected in small and volatile privatization programs, FDI inflows effectively stagnated.

Thus, privatizations can have a strong impact on the future development of the foreign investment climate. In fact, governments can use privatization programs as a highly effective advertisement tool to attract additional foreign investors. In order to be effective, however, governments will have to convincingly prove to the foreign investor community that they are committed to a serious reform program geared towards a liberalization of the business environment. The most convincing proof certainly is the effective withdrawal of the state from the economic sphere. Only when investors recognize that the country promises to be an attractive investment location, free of unnecessary government interference, will they be willing to risk their own funds to establish long-term operations.
Figure 2: Successful Privatization and FDI Inflows

Note: Successful Privatizers includes: Argentina, Chile, Czech Republic, Hungary, Jamaica, Malaysia, Mexico, the Philippines, and Portugal.
"Moderately Successful Privatizers" includes: Barbados, Benin, Brazil, Estonia, Ghana, Honduras, Indonesia, Laos, Morocco, Nicaragua, Nigeria, Pakistan, Peru, Poland, Sri Lanka, Thailand, Togo, and Tunisia. "Unsuccessful Privatizers" includes: Bangladesh, Bolivia, Bulgaria, Colombia, Côte d'Ivoire, Egypt, Greece, India, Kenya, Lithuania, Mozambique, Nepal, Romania, Turkey, Uganda, Ukraine, Uruguay, Venezuela, Viet Nam, and Zambia.

Notes


5. Florencio Lópes-de-Silanes, "Determinants of Privatization Prices", mimeo, Harvard University, January 1994, pp.28f.

3

Fundamental Principles of Successful Privatization

Three Overarching Principles

A privatization program is successful, when it results in an efficient transfer of public enterprises into private hands under the conditions that the sales generate the maximum price attainable in the market and that the future viability of these companies is improved. In all of the eight countries we studied, the degree of success of their privatization initiatives was strongly related to the extent of competition among bidders. Whenever governments managed to attract several investors for individual SOEs, they typically received a high sales price combined with a strong business plan and large investment commitments. Some countries—notably Argentina, Mexico, Peru, the Philippines, as well as Hungary in the early stages—generally managed to attract a number of potential investors. The other countries, however, did not manage to do so in many cases, resulting in unsatisfactory or even failed sales which often led to criticisms of the privatization program as a whole.

Strong competition does not only result from the attractiveness of the individual SOE sold, but is also very much dependent on the attractiveness of the privatization program itself. While the effective structure of any privatization program may depend on country specifics and political circumstances, the successful cases we studied had three fundamental principles in common: political commitment, business orientation and fairness.

In all countries, foreign investors tended to equate the effectiveness and efficiency of a privatization process with the government’s sincerity and commitment to reduce the role of the public sector, opening the economy to private entrepreneurship on a broad scale. A technically sound and business-oriented treatment, untainted by subjective political decision-making and bureaucratic incompetence, was mentioned by practically all investors as the outstanding feature in

Figure 3: Fundamental Principles of Successful Privatization

- Political Commitment
- Business Orientation
- Fairness

Successful privatization
Argentina’s and Peru’s privatizations, clearly indicating to them that the government understands the concerns of the private sector. Finally, investors need to be convinced that they will be treated in a fair and objective manner, free of any type of corruption and red tape. Wherever that was not the case, investors expressed their concerns to enter the privatization process.

Political Commitment

Political commitment is a sine qua non to the success of privatization. Foreign investors will only be interested in participating in a privatization program when they are convinced of the sincere commitment by the government to carry out the reform program. Especially in the case of Argentina, investors emphasized the determination of President Carlos Menem as the driving force behind the privatization effort.

However, political commitment does not simply consist of policy statements by the government, announcing and supporting a general privatization policy. More revealing for investors is the size of the program, reflecting the government’s willingness to actually part with their SOEs. If the program includes only a few select enterprises, investors will not perceive the program as a fundamental reform of the country’s economic structure. In addition, for the program to be truly convincing, it must include most of the large SOEs.

The sale of a large and well-known enterprise can have a strong demonstration effect as in the case of Argentina’s national telephone company Entel which effectively jump-started the entire country’s privatization program in 1990. This was followed by the sale of a vast number of enterprises, including the national petroleum company YPF for about US$3 billion. Similarly, Mexico sold not only its telephone operator Telmex, but also transferred the entire banking industry to the private sector, amounting to total sales revenues of approximately US$12 billion. These large-scale privatizations indicated that the governments were determined to push the reform process, not shy to tackle even the most difficult areas.

Business Orientation

However, willingness and commitment alone will not by itself make a program attractive to foreign investors. A privatization transaction that is unduly lengthy due to bureaucratic procedures and indecisiveness on behalf of the government translates into increased costs to the investor and renders the project less attractive. Serious bidders find themselves with resources tied up in the process which are not available for alternative investment opportunities. In addition, after announcing their sale, SOEs typically lose in value the longer they are caught in this interim stage, with workers and management being unmotivated due to the uncertainty related to the imminent change in ownership.

Potential investors monitor the performance of the privatization program carefully, and difficulties encountered in individual transactions will translate into an overall loss of reputation and investor confidence. Among the countries we studied, we encountered a noticeable difference in this respect. The vast majority of investors interviewed in Argentina, Mexico, and Peru expressed their strong satisfaction with the privatization process. They described their counterparts in the respective privatization agencies as highly competent and endowed with the necessary authority to make binding decisions. In fact, several investors admitted their own surprise to have been able to conclude such a transaction just as effectively as a standard private investment in their home country. Especially in Ghana, Mozambique, and Poland, on the other hand, foreign investors frequently complained about the general sense of hesitance and indecisiveness they encountered when entering the privatization process. In several cases, investors did not seem to have a clear picture of who effectively was their counterpart with decision-making authority. Many of these investors expressed their doubts about the effectiveness of the privatization program and did not recommend entering the country in this fashion.

Thus, an unattractive process will result in a smaller number of interested bidders and consequently reduces the probability for the government to find the desired investor who is willing to pay an acceptable price. In order to establish a successful privatization program, governments will have to be careful that the needs of the investors are being met. We found the competition strongest in those countries where investors had confidence in the process. In the other cases, sales frequently failed or were publicly criticized due to the lack of competitive bidding.
Fairness and Transparency

Given the political nature of the process, a privatization program will almost invariably be subject to the suspicion of insider deals and corruption. The danger of decisions being based on other criteria than the merits of individual bids is always present, especially in developing countries where government salaries are typically low. Political opponents as well as unsuccessful bidders will tend to be critical, challenging the program as a whole as well as individual decisions.

Foreign investors in Argentina, Peru, and the Philippines, in particular, commented with a remarkable frequency on the complete lack of irregularities in the decision-making process, regarding their own project as well as the program as a whole. In some of the other countries, however, a frequent complaint was that crucial decisions in the process were overturned in the last minute, apparently for purely political reasons, to avoid a politically inconvenient transfer of ownership. This seemed to be a particular problem in Ghana and Mozambique. While investors generally praised the governments for a strong commitment to privatization, they seemed concerned that decisions were very much dependent on authorities outside the established process. Even if individual investors had been unaffected by such interferences personally, they were well aware of such occurrences in other transactions and tended to be critical of the overall transparency of the process.

Such criticism represents a danger to the reputation of the privatization program. The bid preparation is costly for investors, requiring a lot of time and resources. The perception that the government's decisions are subjective and unpredictable will frighten off investors from abroad, especially those who are less familiar with the country and fear to be disadvantaged by not having strong political connections. Many of the ones remaining, on the other hand, will be tempted to enhance their chances of winning by gaining the inside track, thus fostering the same culture that is so dangerous to the reform process in the first place.

The Application of these Principles

Political commitment, business orientation and transparency are not independent from each other. In fact, they reinforce each other in every step of the way, and should be the guiding principles underlying all aspects of a privatization program, from the establishment of long-term policies, through the creation of the institutional and legal framework, to the actual divestiture process (see Figure 4).

The commitment to sincerely pursue privatization as a key element within a long-term reform agenda will only be convincing if it clearly indicates the government's willingness to withdraw from the economy. The government will have to provide a reliable and clear legislative environment, designed to enhance private

Figure 4: The Impact of Fundamental Principles of Key Aspects of Privatization
participation in the economy in exchange for public sector activity. Both the institutional setup as well as the process itself have to be credible and operational. Foreign investors will distrust public statements of general commitment if this does not translate into an overall privatization approach that will actually produce results acceptable to all involved.

In order to be credible, the privatization program must also be transparent. Transparency requires, among others, straightforward laws and well-defined institutional responsibilities, i.e., foreign investors have to know whom to address at various stages of the process and to be assured that the information they receive is trustworthy and the process non-discriminatory.

Finally, investors will participate in privatization only if they have a sense that they are not wasting their time. Incompetence and unprofessionalism in the design of the program and strategy as well as the actual process because of poor decisions or the delays they create will deter investors, and even lead them to withdraw from the process.

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**Box 1. The Perspective of Foreign Investors on Fundamental Principles**

The comments of foreign investors surveyed strongly confirm the importance of these principles as the basis of successful privatization. The most frequent criticisms based on their experiences in privatization programs were:

- excessive bureaucracy;
- too much political interference;
- too many people with the potential to influence the process;
- lack of a clear, consistent process;
- lack of business capabilities;
- lack of clear, objective, publicized decision criteria;
- insufficient commitment to sell;
- the need to ensure that transactions are based on commercial and not political considerations;
- unrealistic guarantees required particularly regarding maintaining the labor force.
Privatization Strategy

The Need for a Political Master Plan

Strong political commitment can best be demonstrated through a comprehensive privatization plan which forms an integral part of an overall economic reform agenda. Such a plan should spell out the government’s vision, objectives and methods of privatization. The absence of clearly stated objectives weakens not only the perception of the process but also its execution in that the government does not formally commit itself to a comprehensive restructuring of its economy. This raises concerns that the government might back out of difficult or controversial decisions and fosters doubts in the minds of investors regarding the reliability and viability of the privatization program.

At the same time, however, such a master plan has to be realistic. As Hungary realized over the last two years, foreign investors are keen observers of how intended privatization results compare to the actual outcome. After the election of a new government in 1994, the attitude towards privatization changed drastically, and privatization sales practically stalled after a period of rapid growth until 1993. At the same time, inflows of foreign direct investment fell from US$2.4 billion in 1993 to only US$1.2 billion in 1994. When asked about Hungary, the investors we interviewed tended to reminisce about the past, emphasizing that the once most attractive investment location in Central and Eastern Europe had lost much of its glamour.

In general, the privatization master plan has to convey the government’s commitment to withdraw from the economic sphere. For such a plan to be more than simply a political announcement, the government should clearly state the manner and extent to which companies are selected and sold. This will avoid unnecessary initial criticism regarding the scope and transparency of the privatization program.

Company Selection

A core element of the government’s overall strategy is the selection of the companies that will be subject to privatization. While eventually priorities will have to be established regarding the promotion and sale of individual companies or whole sectors, commitment to the process is most clearly signaled by adopting an overarching strategy of privatizing all companies. The sale of some particular enterprises might be postponed for specific strategic reasons, but the starting point should be the inclusion of all SOEs. The Peruvian government, for example, announced that effectively all its SOEs are available for privatization. Mexico developed a short and clearly defined negative list of companies or sectors not to be divested. All the remaining enterprises, however, were for sale, supporting the government’s sincerity to withdraw itself from economic activity. In Mozambique, on the other hand, each line ministry proposed individual enterprises to be sold each year. This makes it
impossible for the country to develop a long-term privatization strategy, leaving the reform process in the hands of a number of different actors who might not always be supportive of divestiture.

The first step has to be to identify all existing public enterprises. While this might sound obvious, in many countries individual ministries created or absorbed enterprises over time without the existence of a general register. Once the portfolio of companies slated for privatization has been established, an overall strategy regarding the selection of individual companies to be sold must be developed. Efficiency and speed should be the main considerations. It is important, however, not to announce the actual sale of individual companies too far in advance of the target date for their privatization. Too lengthy a delay between the time a company is announced to be privatized and the beginning of the process can have negative side effects. Most importantly, the performance of a company tends to deteriorate resulting from the uncertainties regarding its future, thus reducing its sales value. In the case of Mozambique, for example, sales of companies to be privatized dropped by an average 42 percent during the last three years prior to the sell-off.

In general, the selection will depend on the government's overall objective and capacity. Mexico, for example, decided to start its privatization process with smaller enterprises to learn the trade and to avoid making mistakes in larger transactions. Argentina, on the other hand, started its privatization process with particularly large enterprises such as the national airline and the telephone company. This achieved the goal of immediately convincing foreign investors of the government's sincerity regarding economic reform, and resulted in large inflows of FDI through privatizations as well as in the form of new, greenfield investments. In Peru, the Philippines, and Hungary (in its early phase up to 1993), the privatization agencies would each year select those companies that had been sufficiently prepared and for which they expected strong investor interest. At the same time, these countries remained careful to be realistic by not taking on more transactions than the staff could handle.

In each of these cases, the selection process was quite effective, helping to maintain the momentum of the reform process. In Ghana, Poland, and Mozambique, on the other hand, the selection process appears to be an impediment to the reform process. In the case of Poland, the selection of individual companies is dependent on the initiative of the potential investor who first have to signal their interest. At the same time, the worker council has to agree to the transformation of the company, providing external forces with a strong role in shaping the privatization policy. In Ghana, similar to Mozambique, the selection decision appeared to be driven by immediate political concerns, lacking an overall, long-term strategy of systematic divestiture.

**Government Stake**

The sale of a SOE does not automatically imply that it is being sold completely. For a variety of reasons, governments frequently decide to only offer a share of the company in the initial privatization. The government may want to retain a minority stake to benefit from the company's future gains in efficiency and profitability, resulting in dividend payments or an increased market value of its stake. The Mexican government generally opted for a complete sale of its enterprises, with the exception of particularly large enterprises such as the national telephone company TELMEX or several of the sizable commercial banks which were sold off during 1991 and 1992. Argentina, on the other hand, often sold less than 100 percent of the shares, while always making sure that the investor received majority ownership. The government intends to float the remaining shares on the Buenos Aires Stock Exchange at a later stage.

Governments also might find it politically attractive not to sell a SOE completely to counter domestic criticism of "selling out", and to soothe concerns of the labor force or the management of the enterprise. Many governments earmark a certain percentage, typically between 10 and 20 percent, to be sold at a discount to the company's management and employees. This technique effectively serves as a compensation scheme geared at creating a more cooperative attitude towards privatization within the firm by providing the workers with an incentive to favor a strategy that enhances the future profitability of their company. Especially in Mozambique and Poland, this was a major concern which determined the extent of individual sales to strategic investors. In both cases, labor forces have a substantial influence in the privatization process, and the amount of shares retained by the government
or the workforce often turned into a difficult issue during privatization. The investors we interviewed generally had no difficulty with selling shares to the employees, as long as they were guaranteed control over the company. They did, however, frequently complain about a lengthy and politicized process.

Investors know that they are acquiring a company that requires substantial restructuring. Hence, they will need to have control over its operations. In the survey conducted with foreign investors, invariably all rejected the option of a simple minority share in an enterprise. A few indicated that they would accept minority ownership, but only combined with a management contract and operational control, and sometimes with an explicit guarantee to acquire ownership at a later date. All other investors clearly stated that they were only bidding for majority ownership.

Thus, only in exceptional cases can a country hope to attract strong strategic investors to a sale of a minority ownership in a SOE. In general, the government should be willing to surrender the majority ownership and with it the control over its companies. By making this an explicit component of their overall privatization strategy, governments show their commitment to the process as well as their understanding of basic investor concerns.

Privatization Methods

While the choice of a specific privatization technique should rest with the responsible privatization agency and depend on the individual company to be sold, the government will have to define which type of techniques will be applied in the privatization program. At the most general level, the government can decide to either initiate a partial or full transfer of ownership through some type of sales agreement, or to maintain ownership while involving private operators through a management contract, or a lease or concession arrangement. While the latter approach is not a privatization in the narrow sense that the public sector hands assets over to private investors, it might still be an appropriate measure under some circumstances. With respect to the effective sale of an enterprise, again several possibilities present themselves. The choice of the technique depends on the government's political objectives as well as the specific conditions of the particular company sold.

However, while the government determines the form of privatization, it is important to take into consideration the investors' position to ensure that a particular choice does not lead to an avoidable loss of bidders in the process. In general, almost all techniques can be structured in such a way that they are interesting to foreign investors. The single most important issue is to give the investor full control over the transferred enterprise, allowing it to structure the company's business operations.

Management Contracts

Under a management contract, a private operator takes over the management of a company in exchange for a fee, while the government remains the company's owner. The contract is typically specified such that the private management has autonomy in the daily operations of the company, while all fundamental decisions such as investments remain with the public sector. Governments typically establish a management contract in order to improve a company's short-run efficiency. However, the private operator will not risk his own capital for any restructuring or future investments.

Thus, for most SOEs such an arrangement will not be sufficient to improve its long-term profitability, but can represent an intermediate step on the way to full divestiture. In fact, management contracts are most frequently used in infrastructure areas such as the water supply in Abidjan, Côte d'Ivoire or Conakri, Guinea. Here the governments decided to introduce private sector efficiency, but were not yet willing to take the step of relinquishing ownership. In both cases, the efficiency in the supply and treatment of water has improved drastically. At the same time, however, both also struggle on the issue of future investments and expansion of the existing network.

Lease and Concession Agreements

In a lease agreement, a private company effectively rents an asset or company from the government for a specified period of time and retains the company's profits for its management services. A concession agreement is similar, except that here the investor is also responsible for at least some of the investments. Such arrangements are particularly attractive for companies with substantial fixed assets as is the case
for most infrastructure services such as energy or water distribution. Most investors consider an outright acquisition of such companies too risky, given that the company’s main assets, the distribution networks, cannot be disassembled or moved in case of changes in the business environment, leaving the investor vulnerable to sudden changes in government policies and regulations.

Argentina, especially, made extensive use of concession arrangements in its recent privatization efforts. In a wide range of sectors, covering television channels, petroleum drilling areas, railroad operations, roads, port facilities or livestock markets, the government concluded concessions worth approximately US$1.5 billion between 1990 and 1993 with strong involvement of foreign investors. Currently Mexico is also in the process of awarding concessions in a number of infrastructure areas, which initially had been excluded from the privatization process.

Direct Sale

In all of the countries we visited, direct sales have been the dominant form of privatization, especially with respect to small- and medium-sized enterprises. For investors, a direct sale represents the most straightforward method for acquiring control over a SOE. The government, on the other hand, can directly select the future owner, making sure that the company is sold to a strong strategic investor as reflected in his commitment to future investments.

The most effective way of finding the best suited investor and to maximize government revenues from the sale is through competitive tender. Direct negotiations with a single buyer rarely generate the best possible deal for the government. We came across cases in several countries where individual transactions were criticized and sometimes even canceled based on claims that the government sold assets too cheap via negotiations with only one investor.

Public Stock Offering

A public offering of SOE shares entails the sale of all or part of the government’s holdings in a company to the general public via domestic or international stock markets. The price of shares can be fixed and backed by an underwriter or the government itself, or the offering may be on a tender basis. In order for a public offering to be successful, several ground rules have to be observed.

First of all, in order for the enterprise to be attractive to the general public, it has to be well known as well as financially sound with good future potential. Secondly, an adequate distribution network for the shares has to exist, combined with a good marketing strategy in order to generate sufficient interest. Finally, it is important that the share price reflects a fair market value of the company. Too high a price discourages investors and could stall the privatization, while too low a price might draw criticism of poor management of public assets.

While limited to only a small number of SOEs, governments typically value public offerings because they allow a wide dispersion of ownership including domestic investors, strengthen the developing capital market, and are by design very transparent transactions. Foreign investors gain additional confidence regarding the privatization, because the involvement of a large number of domestic investors makes it even less likely that the process will be reversed. On the other hand, they typically find the shares an attractive investment opportunity only if the future profitability potential of the company is high. One way to support this perception is to combine a public offer with a direct sale of part of the company to a strong strategic investor.

In the case of Mexico’s TELMEX, for example, the government decided to first sell a minority share of about 20 percent together with a management contract to a foreign consortium. It then sold another 25 percent in the domestic and international capital markets, resulting in a total revenue of about US$6 billion, predominantly in hard currency. The Argentinean government decided to sell majority stakes of 60 percent each in its two telephone companies (Entel North and South) to foreign investor consortia prior to offering the remaining shares in domestic and international stock exchanges, generating a total revenue of about US$3.3 billion.

The need for a strategic investor is of less importance in companies whose future potential is driven by the access to valuable raw materials. In 1993, Argentina sold 45 percent of its national oil company YPF in a domestic and international offer for US$3 billion. Similarly, Ghana’s Ashanti Goldfield offering in the London and Ghana stock exchange resulted in proceeds of
US$316 million in 1994. In both cases, the sale supported the local capital market; the Argentine government successfully revived its depressed stock exchange, while the Ghana's stock market capitalization increased almost tenfold with the Ashanti offering.

However, in all these cases, effective distribution mechanisms existed. Either the companies were so wellknown that their shares could even be offered on stock exchanges abroad, or a well-functioning stock market existed at least in the country. Thus, Peru managed to successfully privatize a number of smaller companies on the Lima stock exchange. On the other hand, Mozambiquean government officials had to realize that any attempt of a public offering is doomed to failure without a local stock market, relying solely on over-the-counter trading.

Joint Venture

In a joint venture, a whole SOE or part of it typically forms a new company together with a strong outside investor. In most cases, the outside investor brings in new capital and technology, while the SOE provides existing physical assets. Governments often favor this type of arrangement, because it allows them to maintain control, or at least strong influence, over the enterprise, while the company obtains the financing and expertise required for its modernization. Especially in former socialist economies, governments tend to place too much emphasis on this approach relative to the other alternatives, hoping to obtain the needed capital without surrendering control over the assets. However, this hope is misplaced. As in all other cases, the foreign investor will require control to justify his investment.

In some instances, however, this approach might prove preferable to other techniques. In a few cases, the company to be privatized is so large and wellknown that the government will try to maintain the brandname through the arrangement of a joint venture. For that reason, the Czech government favored such an arrangement between the country's largest car manufacturer Skoda and West Germany's VW. This technique can also be attractive in cases where it proves impossible to sell a company completely as going concern. Some of the assets might still be attractive, and a joint venture will allow to salvage those parts of the enterprise. Hence, joint ventures can form an interesting component of the overall privatization strategy, while not the dominant one.

Liquidation and Asset Sale

When a SOE is in a particularly bad financial condition with high liabilities, a direct sale might prove impossible. In such a case, the government might opt to liquidate the enterprise and sell its assets. The advantage for the investor is that he can acquire the company without the attached liabilities. While this might be the only option left for the government, it has to be aware that, similar to the situation with joint ventures, it will be left with the unsellable parts of the assets after investors are finished “cherry-picking”, i.e., having acquired all the valuable components of the enterprise.

Voucher Privatizations

Many Eastern European countries created mass privatization schemes in which vouchers were given to all citizens essentially free of charge. These vouchers could then be exchanged into shares at special auctions. The main advantages of this approach are that the process of privatization gains speed by simplifying the task of divesting a large number of SOEs, that the transfer of ownership is highly equitable, and that it supports the formation of local capital markets. However, this method clearly will not generate any government revenue, and the gain in productive efficiency and profitability of the enterprises will be delayed because the initially atomized ownership does typically not translate into a change in operations and management.

The involvement of strategic investors can be speed up through the creation of investment funds which are allowed to hold vouchers for citizens or directly buy them, to exchange them into blocks of shares in individual enterprises. Foreign investors, while excluded from the first phase of voucher privatizations, can theoretically buy shares from citizens or investment funds afterwards. This step is, however, difficult and risky, because the investor will have to acquire numerous minority shareholdings in order to eventually obtain the desired majority stake. Even in the Czech Republic, probably the most advanced voucher privatization program in the world, there is no indication that strategic
foreign investors have participated to any significant extent in share trading on the secondary market.

*Management/Employee Buy-out (MBO)*

Many governments are tempted to support domestic investment through MBO schemes, where the management and employees of enterprises have the right to make an offer for their enterprises prior to privatization. Given the uncertainty involved with privatization, the incentives are strong for managers and workers to make use of this option. Politically this approach is particularly attractive, avoiding the criticism of “selling out” to foreign interests. In reality, however, this strategy is often counter-productive. Due to the lack of funds, management and workers are usually allowed to pay at a discount or in installments. This implies that even less financing is available for investments to upgrade often dilapidated and antiquated facilities. Meanwhile the same management stays in place and no major restructurings are undertaken, resulting in no significant improvements in the overall productive efficiency.
The Legal Environment

The Basic Requirements for Privatization

The legal environment is not only the basis for privatizations, but it effectively represents the cornerstone for private economic activity. Investors will not only want to find a simple and clear definition of the privatization process itself, but also have to be assured that they will be able to conduct their operations in a market-friendly and open environment. Many countries that engage in privatizations also do not have an extensive experience with private investment due to the previous dominance of the public sector. Foreign investors, in particular, tend to place great emphasis on the existing legal framework in order to judge the viability of their projects.

As for any type of foreign investment, equal, non-discriminatory treatment of all investors—domestic as well as foreign—has to be a guiding principle. Furthermore, all foreign investors should have the right to remit profits in any currency desired at the existing market exchange rate and should be allowed to employ expatriates without restriction. There should also be no limitations on the acquisition of land or other assets required for the efficient operation of the investment. Expropriations should be allowed only in exceptional cases and emergency situations, and only under fair compensation. All these principles serve to minimize the risk of operating abroad, rendering the country an attractive investment location relative to the home country.

Review and Adjustment of the Existing Body of Law

The sale of public enterprises affects a wide range of existing laws and regulations in a country. Many of these laws were enacted to accommodate public enterprises without particular consideration of the needs of private entrepreneurs. Hence, an essential initial task is to review the existing legislation and to rewrite or amend it whenever necessary to make the transfer of ownership legally possible.

Constitutional Changes

In most of the formerly centrally-planned economies, all productive assets are by constitutional law defined as public property. In many other countries, certain sectors are reserved for the state. In such cases, the transfer of ownership would effectively be unconstitutional. This was the case in Hungary and Poland which until recently recognized the right to private property only to a very limited extent. Constitutional amendments to allow for full private ownership of productive assets were required to allow privatization to proceed.

The Legal Status of SOEs

The rights and responsibilities of public enterprises are often explicitly specified by law. They are typically granted special privileges such as
Box 2. Basic Guidelines on the Treatment of Investors: An Illustration

“All investors and enterprises are entitled to the basic rights and guarantees provided in the Philippine Constitution. Among other rights recognized by the government of Philippines are the following:

• The right to repatriation of investment: In the case of foreign investments, the right to repatriate the entire proceeds of the liquidation of the investment in the currency in which the investment was originally made and at the exchange rate prevailing at the time of repatriation;

• The right to remittance of earnings: In the case of foreign investments, the right to remit earnings from the investments in the currency in which the investment was originally made and at the exchange rate prevailing at the time of remittance;

• The right to foreign loans and contract: The right to remit, at the exchange rate prevailing at the time of remittance, such as may be necessary to meet the payment of interest and the principal on foreign loans and foreign obligations arising from technological assistance contract;

• The right to freedom from expropriation: There shall be no expropriation by the government of the property represented by the investments or of the property of enterprises except for public use or in the interest of national welfare and defense and upon payment of just compensation. In such case, foreign investors or enterprises shall have the right to remit sums received as compensation for the expropriated property in the currency in which the investment was originally made and at the exchange rate prevailing at the time of remittance.

• The right to non-requisition of investment: there should be no requisition of the property represented by the investment or of the property of enterprises, except in the event of war or national emergency and only for the duration, just compensation for the requisitioned property may be remitted in the currency in which the investment was originally made and the exchange rate prevailing at the time of remittance."

Tax exemption, guaranteed access to cheap raw materials, monopoly status, or special customs and tariff regulations. On the other hand, they also often have special responsibilities such as the requirement to supply their goods and services at a subsidized price or to provide certain social services. All these will have to be abolished in order to allow for operation under private ownership in a market system.

Furthermore, SOEs typically have to be corporatized prior to privatization, i.e., the company has to be reorganized in such a manner that it is subject to the ordinary company law and the business laws applicable to private companies. The typical procedure is to convert SOEs into joint-stock companies with all shares held by the government until privatization. An alternative is to dissolve the SOE at the time of privatization and to set up a new private company.

This process of converting SOEs into normal companies also includes the surrender by government of its existing control over the enterprises, previously maintained through the right to appoint the management and board members. The control of the existing management over their companies also has to be limited until the sell-off is completed. Several countries have experienced serious problems of asset stripping and pilfering prior to the sale, resulting in unnecessary complications during the privatization because the corresponding decline in asset value is impossible to monitor, often creating disputes between the winning bidder and the government.

Property Law

Privatization involves the transfer of ownership from one entity to another, requiring undisputed and clear property titles and other documentation necessary to establish ownership. The ownership status of any asset to be sold will have to be cleared prior to the sale and investors will have to be assured that their ownership rights are adequately protected. In many countries the need to define and clear-up property titles result in lengthy delays. Often previous owners challenge the privatization decision by contesting the government’s right to sell enterprises that have been nationalized in the past.

Labor Laws

SOEs are often subject to special labor provisions, providing employees with guarantees for
Box 3. Dealing with Claims of Former Owners: Two Approaches

Dealing with the claims made by former owners on property to be privatized is complex and can seriously impede the speed of privatization and even deter investors. Two forms of redress can be used: restitution or compensation. Overall, compensation is preferable in the context of privatization, particularly in the absence of a deadline pre-privatization for filing claims. While such deadlines obviously eliminate the risks to an investor of having his newly purchased property confiscated, restitution can be seriously detrimental in slowing down the pace of privatization. This was the case in Germany where the privatization law provided for restitution. The impact on privatization was negative as sales were held up as property titles had to be cleared. A law was then passed whereby “New investors able to preserve jobs or provide additional investment take precedence over prior owners.” Hungary’s approach, on the other hand, was to favor compensation right from the start, as stated in the Compensation Act of 1991. Former owners are paid a lump sum in the form of coupons which may be used to buy property sold by the State.

Environmental Legislation

Potential investors need to know the extent of their liability for environmental damage or violations of environmental legislation which the company incurred as a SOE. If SOE facilities do not conform to environmental regulations, will exemptions be granted or will there be a reasonable time frame in which to comply? The central issue is who carries the responsibility for repairing environmental damage and ensuring the operation conforms to environmental standards.

In many instances, particularly among the heavy polluting industries such as chemical, mining, steel, or smelting, the question of allocating the environmental cost will bear heavily on the privatization process since the new owners will tend to avoid the responsibility for previous owners’ operation, while the governments as owners/operators will try to shift as much of the burden on new owners as possible.

Disputes regarding the responsibility for past environmental damages delayed many transactions especially in Eastern European countries. A satisfactory solution is not easy to find, but governments should generally accept the financial responsibility for damages that are the result of previous operations under state ownership and eliminate the uncertainty of potentially significant financial liabilities clearly beyond the control of any new owner. One major European multinational, for example, refused to sign any privatization contract in Poland until the government issued clear guarantees that it assumed responsibilities about environmental damage from previous operations. In Peru, the privatization of Centromin, the country’s largest mining operation, stalled on similar issues, forcing the government to undertake a major environmental clean-up prior to resuming the negotiations.

The Law on Privatization

Most countries legally initiate their privatization program by passing a law on privatization which specifies the scope of the program,
establishes the institutional authority to conduct the privatization program, and defines the most important elements of the process. However, a separate law is not necessary in all cases. Existing legislation may be sufficient to conduct privatizations.

The advantage of a specific privatization law is a higher degree of accountability and formal authority for the entity in charge of conducting the program. In addition, the existence of such a law clearly indicates strong political support and commitment by the government. However, there is also the danger of major delays through a drawn out political debate in parliament prior to passing the eventual law. In fact, many countries began their privatization programs even without a specific law. This was the case in Hungary where privatization began in 1988 with “spontaneous privatization” which enabled (by virtue of Act VI of 1988 on Companies) the transformation of state enterprises into companies on the basis of management decisions and thus allowed the sale of part of state property. The country had by then begun its transition toward a market economy and privatizations followed naturally, even though there was no specific privatization law. However, because the process was unmanaged and led to abuses, in 1990, the State Property Agency was established and a legal framework for privatization put in place.

Privatization legislation typically specifies the extent of privatization by generally defining what is to be privatized. Rather than listing individual companies that will be sold, the law should provide a general right to privatize all existing SOEs. The government might choose to define a short and clear negative list of individual enterprises or sectors that will not be subject to privatization because of their special status or strategic importance.

The law should also define the specific entities responsible for privatization, clearly specifying their basic rights and responsibilities. It is particularly useful to establish clear authority and control over the process to avoid misunderstandings and political quarrels later in the process. The crucial steps in the process should also be outlined in the law in the form of general guidelines. This will give investors the assurance that the process is firmly established and follows clearly defined rules. In Ghana, for example, the 1993 divestiture law states in Article 1: “The divestiture by the State...shall be in accordance with such policy directives as the Provisional National Defence Council may from time to time determine”. While Ghana has pursued privatization vigorously, the vagueness of the process does not give investors much comfort, knowing that the rules of the game can be changed at any point in time.

At the same time, there is always the danger of overspecifying a law. If defined too narrowly, the agency in charge might lose the necessary flexibility to conduct individual transactions. Thus, rather than attempting to define a tight legislation to cover all eventualities, the guiding principle should be to provide a coherent and concise framework, leaving the details of implementation to the privatization body through subordinated legal means such as administrative guidelines and regulations.

The Regulatory Framework

In some cases the companies to be sold have the character of a natural monopoly, not allowing for the introduction of any significant competition. Thus privatization has to be accompanied by an effective regulatory framework. This is a particularly important issue in the privatization of infrastructure services such as telecommunications, energy and water distribution.

While more complex, the privatization of such infrastructure companies is generally beneficial to the country’s economic development. First of all, most of these services suffer from outdated facilities and a lack of new investments, creating substantial difficulties not only for the population as a whole, but also for any type of private economic activity. Foreign investors frequently complain about the additional costs and risks resulting from a defunct infrastructure in most developing countries. The privatization of these companies almost invariably results in large new investments and a substantial improvement in the service provision, raising the general standard of living as well as the overall business environment. Furthermore, most of these infrastructure companies are sizable, and their sale under difficult circumstances, including the politically sensitive issue of unsubsidized, higher user charges for the public, has a strong signaling effect, reflecting the government’s commitment to open up the economy.

However, in order to conclude such a privatization, the government has to strike the fragile balance between attractive and profitable business conditions for the investor on the one
Box 4. Privatizing Infrastructure: Experiences in Argentina and Peru

According to Argentina's privatization law, the state retains authority over the activity of privatized utilities through the creation of agencies vested with regulatory powers. The Government pushed the privatization of a large number of infrastructure companies such as the national telephone company ENTEL, numerous power utilities, the Buenos Aires waterworks, as well as various railroads and roads. However, while the speed of the process was impressive, difficulties arose in several sectors after privatization for the simple reason that the regulatory framework effectively was not in place yet. In addition, the staff consisted mostly of former employees of the now privatized utilities who often lacked a good understanding of the functioning of a private company, and who seemed tempted to operate rather than regulate the utilities. Instead of working cooperatively, antagonism arose with private operators questioning the regulators' competence.

Peru, by contrast, was able to benefit from the experiences of other countries. It created its regulatory agencies prior to the start of the privatization of utilities. Agencies such as OSIPTEL, the telecom regulatory body, were active participants in the preparation of the privatization process and the sales promotion of utilities. This established a strong degree of confidence among investors and, relative to its size, Peru's Entel turned out to become the highest-priced telephone company ever privatized. At present, the relationship between regulator and operator appears to be excellent, and OSIPTEL also has been put in charge to promote and supervise the competition when the long distance market is deregulated in 1998.

hand, and fulfilling the national development needs without creating an unconstrained private monopoly on the other. Hence, a regulatory agency has to be established which sets the framework within which the private investor is allowed to operate. Rules and regulations have to be established on issues such as pricing, modernization, or expansion.

The proper sequencing of setting the regulatory framework and privatization is critical. Before preparing a serious bid, any investor will want to know the conditions under which he will have to operate. This requires a clear definition of all the rights and responsibilities of the private operator and the creation of a counterpart from the government who is in charge of overseeing his activities. Equally important is that the investor will have to be convinced that the established arrangement is stable and reliable, not subject to unpredictable political influences and changes. This implies that the regulatory framework effectively has to be established prior to the privatization in order to avoid a lack of investor interest as well as major disputes after the sale.

Notes

7. See Guislain (1992) for a more detailed discussion of the legal issues in privatization.
11. Especially foreign investors consider the privatization of infrastructure an important step. Sader (1995) shows in an econometric analysis that infrastructure sales among all other privatizations have the strongest impact on attracting additional foreign investment into a country.
The Institutional Framework

Introduction

The established legal framework provides the basis for the institutional setup, required to implement and conduct privatizations. Specifically, the legal determination of the institutional framework requires the definition of the roles, responsibilities and authority of the various actors in the divestiture process, such as the legislature, the government, individual ministries, and the divestiture body.

Countries have adopted different institutional structures for carrying out privatizations. Certainly no single structure or organizational model will apply to every country. Nonetheless, it is possible to identify features which underlie the design of the institutional arrangement for privatization as well as advantages and shortcomings associated with various arrangements.

The institutional setup strikes at the heart of the three fundamental principles underlying privatization. The design of the institutional framework and definition of authority are highly reflective of the extent of government’s willingness to conduct a non-politicized, transparent and business-oriented privatization program.

Depoliticizing the Institutional Framework

While governments throughout the world have eagerly embarked on the process of privatization, not all players in the process are unequivocally enthusiastic. Privatization is politically dangerous and is bound to affect many interest groups. These include management of the companies slated for privatization, workers who face an uncertain future under new ownership, and members of the government itself.

Governments are very vulnerable to accusations of “selling out” to foreigners, or insufficiently promoting ownership by local entrepreneurs. This pressure has raised accusations in some countries that foreign bidders may lose out to a local consortium, despite having the higher bid because of the political pressures to sell to nationals. This is more likely to occur in instances where the process is not clearly defined or lacks transparency. In addition, within government itself, not all ministries embrace privatization with equal fervor. Line ministries will often resist the privatization of enterprises under their authority because of the loss of political leverage and power, which they derived from controlling the SOEs. The heads of state themselves, irrespective of their stated commitment to privatization, have at times backed off for fear of nationalist backlashes and/or loss of popularity.

The inclusion of various interest groups in the decision making process can transform a divestiture rapidly into a highly politicized event. This, however, invariably results in delays and uncertainty for the bidders involved. When foreign investors recognize that politics and indecisiveness are central features of a privatization process, they will be hesitant to participate, resulting in the loss of bidders and potential investors for the privatizing government.
To avoid such a politicization of its privatization program, any government should be concerned with establishing a clear-cut chain of command, unmistakably specifying the authority to privatize. The right to make individual sales decisions should be concentrated to reduce the risk of political interference and lengthy internal debates. Of particular importance is the exclusion of any party that has particular short-term interests in individual companies, especially the workforce, the management, and the line ministries. Only under these conditions will the government be in the position to effectively offer a SOE for sale in a business-oriented manner.

Institutionalizing Privatizations

Any privatization body can function effectively only if it is sufficiently empowered to execute its mandate. There should be no question of whether the agency requires outside clearance in order to make individual decisions. This ability to carry out decisions is directly linked to political commitment—that is entrusting a mandate to the privatization body and providing sufficient powers, latitude and freedom from political interference to implement privatization. For foreign investors, the knowledge that the agency has a clear mandate and authority will increase their trust in the overall process.

Beyond the feeling of confidence which foreign investors derive from the knowledge of a transparent process, the stability of any particular institutional arrangement is crucial. Foreign investors need to know the identity of their negotiating counterpart and be able to develop an ongoing relationship. Changes in the arrangement typically force investors to start the process all over again, resulting in costly delays and unnecessary uncertainty.

Countries have adopted different institutional frameworks characterized by varying degrees of independence of the divestiture body from the political apparatus or the head of state. At one end of the spectrum, the privatization body is an extension of the political apparatus with limited autonomy and authority. This can include a specialized government ministry or agency as in Poland and Hungary, or a sectoral ministry as in Argentina. The other options center around politically independent, empowered entities who are formally fully in charge of the implementation of the process within the broader framework of government-established objectives and policies, such as in Mexico, the Philippines, or Peru. It should be noted however, that the establishment on paper of a certain structure

Box 5. The Privatization of a Polish Chocolate Factory

The case of Goplana illustrates several of the difficulties which can occur when various interest groups have the power to turn privatization into a highly political event.

Goplana is a major Polish chocolate plant which had a 15% market share in the early 1990s. Nestle, already with an established presence in Hungary and the Czech Republic, became interested in Poland with its market of 40 million people.

In 1993, when Nestle decided to purchase Goplana, ED & F. Man, a British sugar and cocoa brokers and its partner, Elite Industries, a major Israeli food processor, had set up a joint venture with Goplana management which required only the privatization minister's signature.

However, the privatization minister had appeared to have reservations regarding the joint venture arrangement, since the foreign partner's funds would flow into the company as opposed to a trade sale where the funds would be received by the Treasury. Politically, as well, it was felt that selling to a "flagship" company such as Nestle would promote Poland to other investors. The situation was complicated by the fact that the workers, who in Poland hold veto power over privatization transactions, wanted the joint venture arrangement and decided to oppose the Nestle deal. At the price of considerable lobbying and PR efforts, Nestle eventually managed to get workers on its side, and the government announced to hold an open tender for a joint venture arrangement.

In the tender, ED & F. Man's offer was $31 million for 46% share of the joint venture vs. Nestle's offer of $35.9 million for a 47% share. In order to enlist the support of workers, Nestle offered pay raises, shares in the joint venture and employment guarantees comparable to ED & F. Man. It also established close contact with the workers' council to resolve outstanding differences. Nestle was eventually declared the winner, and the deal was sealed in late 1993.
Box 6. Poland: Five Privatization Ministers in Five Years

In Poland, privatization has been a highly politicized process since its beginning. The impact of this has been compounded by frequent elections—there have been five privatization ministers since the program formally got underway. This has resulted in frequent changes in policy direction, privatization priorities and strategies as well as of the teams in place. Further, the Polish process can require authorizations from several levels of government and ministries as well as approval from managers and workers. For foreign investors, the complexity of understanding the role of the various players, discontinuity in procedures and the difficulty of establishing ongoing relationships have been major impediments to investing in Poland in the context of privatization.

does not de facto guarantee absence of government interference. In fact, it crucially depends on the government’s commitment to let privatization run its course, and no particular setup will automatically generate a successful privatization program.

By definition, privatization is an odd mix of politics and business. While a privatization program obviously is political by nature involving the transformation of an economy’s structure, it effectively translates into the sale of enterprises. The main challenge lies in striking a balance between creating an implementing agency that has sufficient authority to carry out its mandate of selling SOEs in an efficient manner independent of any interference from within or outside of the government, while at the same time avoiding for the government as a whole a loss of control over the privatization process.

Figure 5 shows the most structured approach to institutionally solve this issue of political control versus independent sales procedures.

Effectively the privatization body is split into a political steering committee and an executive agency which is responsible for actually conducting the sales. The steering committee is typically composed of high-level government representatives and is ultimately accountable for the privatization process. Reporting directly to the Head of State, it is normally responsible for the development and tracking of broad policies guiding privatization, the supervision of the executive agency, the approval of companies to be privatized as well as the method of privatization, and the final approval of divestiture.

The executive agency is the entity that effectively implements privatizations by actually selling the SOEs. It should be established as an independent

Figure 5: Institutional Framework

Functions

Box 7. Hungary: The Problem of Dual Authority

Hungary’s privatization process, while overall quite successful, has suffered from the creation of an institutional twin structure. Initially the task of privatization was delegated to the State Property Agency (SPA) directly under the Minister of Privatization. After elections in 1992, however, the new government in addition created the Hungarian State Holding Company (HSHC) with the mandate to take control over strategic enterprises in which the government intended to retain at least some ownership.

Being more critical of privatization than its predecessor, the new government transferred many large SOEs from the SPA to the HSHC, which rapidly grew into another large privatization agency (see Table 1). Not surprisingly, the existence of two privatization agencies created political tensions, overlapping authority, and, at least initially, confusion over the effective responsibility for privatization in Hungary.

By late 1994, the decision had been taken to regroup the two bodies under the supervision of a specially appointed commissioner, motivated in large part by the desire to streamline the process for investors. However, this process proved politically difficult, and Hungary’s privatization program came to a virtual halt until mid-1995.

agency, reporting only to the steering committee. Typically, this agency develops the guidelines for the sales, proposes which enterprises are to be sold by which techniques, and finally controls the complete sales process until the signing of the sales contract. In order not to overburden itself with the time-consuming details of individual transactions, such an agency often creates special committees or task forces for each particular SOE. These committees report back to the agency and make detailed proposals on each sales transaction. In addition, the agency should have some support services such as legal and technical advisory capacity at hand, either in-house or through external services. These will typically provide specialized services to the task forces, facilitating their work while guaranteeing continuity of the agency’s procedures.

Thus, the first critical success factor in transforming a political program into a business-oriented structure is a clear separation of the responsibilities between the political steering committee and the executive agency. The demarcation of the roles of the steering committee and implementing body is a necessary precondition in that it separates decision-making on particular issues that are primarily political from the task of “selling”. Typically, the clearer the distinction between the two levels, the more likely that the implementation committee is equipped to handle transactions in a business-oriented way. Many countries have adopted some version of this type of institutional structure. Peru’s experience is illustrative (see Box 8).

However, Peru’s success story is not simply the result of its institutional setup. Ghana and Mozambique, for example, created a similar institutional framework without being able to side step the thorny issue of political interference (while certainly being more successful in this respect than other countries in Africa). Both privatization agencies, Ghana’s DIC as well as Mozambique’s UTRE, were formally established as similarly independent agencies in charge of carrying out privatization transactions. Legally, both have the authority to conduct sell-offs, and are quite capable of concluding privatizations in a reasonably efficient manner despite some investor criticism that they seem to suffer from a lack of sufficient technical and financial skills. In practice, however, political intervention is not unusual. Often individual ministers or even the heads of state themselves intervene by overturning decisions by the privatization agencies to force a politically more acceptable outcome.

Box 8. Peru: Example of a Well-Structured Institutional Arrangement

Peru’s privatization agency COPRI represents an excellent example of an “arms-length” relationship between government and the privatization agency. The COPRI is very independent and operates outside the political environment. This freedom was certainly a key factor in speeding up the process and rendering fast decisions. COPRI’s board, which consists of five key ministers, sets policies and objectives. Under it, the Executive Directorate has a relatively small staff of only 14 employees who coordinate the transaction work which is effectively conducted by the special committees called CEPRIs. Each CEPRI has three to four top executives, usually from the private sector, with one committee for each SOE to be privatized.

Based on this structure, Peru managed to develop one of the most effective privatization programs in the world. Privatization has, to a large extent, been unaffected by short-term political concerns. A dynamic and highly motivated staff combined with the experience of the senior managers in the CEPRIs have resulted in a very business-oriented process, and virtually all investors involved praise the agency for its efficiency, fairness, and technical skills. The result has been an intense competition for most of the enterprises for sale, translating into sales prices often beyond the most optimistic expectations of COPRI itself.

On the other hand, Argentina and Mexico, two of the world’s most successful privatizers in recent years, conducted their privatization programs under institutional arrangements which, at first glance, appear less than optimal. In Argentina, SOEs were primarily entrusted to the Ministry of Economy with only some falling under the responsibility of the Ministry of Defense. Similarly, Mexico’s UDP was established directly under the control of the Ministry of Finance. Both arrangements appear to lend themselves to substantial political interference. In fact, however, this did not occur, and both agencies managed to operate very efficiently. The Mexican government was well aware of the dangers of politics and bureaucracy in privatization, and, driven by the desire for an efficient administrative solution, it granted the agency broad powers and autonomy. In Argentina, the success of privatization is attributed in large part to the iron-clad will of the President in
harnessing privatization to support his economic turn-around program. His commitment and drive actually overcame some of the shortcomings of the institutional framework.

The examples of Ghana and Mozambique illustrate how well-designed institutional set-ups do not in themselves eliminate political interference. Government involvement is often a function of the agendas and style of individual heads of state. Motivated by the wish to minimize negative political fall-outs from some privatization decisions, to speed up the process by taking advantage of contacts with potential investors, the desire to favor certain investors over others (i.e., “flagship” investors), to promote local entrepreneurs, or any number of considerations, they can, at any point in the process, override the authority of the privatization body.

Thus, success is crucially dependent on the government’s commitment to surrender control over the SOEs. In cases where this commitment is not in question, such as Argentina and Mexico, any institutional arrangement will do. However, in countries where such a steady support and commitment from the whole government might not be possible, it is typically better to establish a well-defined separation between the privatization agency and the political apparatus. Any increase in the effective autonomy of the privatization agency will give assurance to potential bidders that the business aspects of privatization are separated from the political ones.

Creating a Business-Oriented Privatization Agency

Having created an autonomous and independent privatization agency in charge of the divestiture process, the critical challenge now lies in transforming this agency into an operational business unit that can effectively conduct actual sales. In order to obtain the best possible offer for an asset, as many bidders as possible have to be attracted to the process, requiring the agency to make it interesting for investors to participate. In order to do so, the agency has to develop a clear understanding of private sector mentality and how investors approach a potential project.

The main problem many privatization agencies encounter is that, at time of their creation, most of the staff come from the public sector with only very limited private sector experience. In many countries investors complain about the lack of skills as well as the bureaucratic organization of the privatization agencies. Table 1 shows the general staffing features of the privatization agencies in the surveyed countries.

The Philippines and Peru, two of the most business-oriented privatization programs, rely almost exclusively on private enterprise experience for their staff. Argentina and Mexico did rely more on civil servants, but due to the already well developed private sector in these countries, public sector employees also had a good understanding of the private sector. The

<table>
<thead>
<tr>
<th>Country</th>
<th>Hungary</th>
<th>Poland</th>
<th>The Philippines</th>
<th>Argentina</th>
<th>Mexico</th>
<th>Ghana</th>
<th>Mozambique</th>
<th>Peru</th>
</tr>
</thead>
<tbody>
<tr>
<td>Agency</td>
<td>SPA</td>
<td>HSHC</td>
<td>MOP</td>
<td>COP</td>
<td>Ministry of Economy</td>
<td>UDP</td>
<td>DIC</td>
<td>UTRE</td>
</tr>
<tr>
<td>Staff</td>
<td>300</td>
<td>200</td>
<td>400</td>
<td>20</td>
<td>NA</td>
<td>10b</td>
<td>10b</td>
<td>10b</td>
</tr>
<tr>
<td>Training</td>
<td>Civil Servants</td>
<td>Civil Servants/Enterprises</td>
<td>Civil Enterprise</td>
<td>Civil Servants</td>
<td>Civil Servants/Enterprise</td>
<td>Civil Servants</td>
<td>Civil Servants/Enterprise</td>
<td></td>
</tr>
<tr>
<td>Use of External Advisors</td>
<td>Limited</td>
<td>Limited</td>
<td>Almost none</td>
<td>Limited</td>
<td>Extensive</td>
<td>Extensive</td>
<td>Limited</td>
<td>Limited</td>
</tr>
</tbody>
</table>

a. The privatization process had been completed and the unit disbanded by the time of the mission.
b. Includes only resources at the Executive Directorate level. Individual commissions, sectoral groups or tasks forces consisting of 3–10 experts carry out implementation.
Eastern European and African countries, on the other hand, were forced to rely on civil servants to a significantly larger extent due to the small size of the domestic private sector. Even the staff members with company experience in most cases had to be recruited from state-owned enterprises. Thus, it is not surprising that it was in these countries that investors complained more often about bureaucratic procedures and the lack of technical and financial understanding by their counterparts, resulting in bothersome delays.

However, even when available, privatization agencies often find it quite difficult to attract private sector expertise. Most importantly, being a public entity, the agency typically is limited to the standard public sector pay scale, while civil servant salaries in most developing countries are comparatively low. Thus, private sector expertise comes at a price, but the incorporation of this experience into the agency is essential.

Some countries resolved this issue by involving domestic top executives for the purpose of managing specific sales transactions. The German government, for example, apparently used its political influence to entice executives from the largest West German companies to advise on individual transactions. In a similar fashion, Peru’s COPRI managed to staff its special committees with senior managers from the country’s largest enterprises. Mexico initially used the then still state-owned commercial banks as agents to oversee the sale of individual enterprises.

This strategy of using domestic human resources is, however, limited to countries that already have a reasonably sizable private sector. Privatization agencies in much of Eastern Europe or Africa, on the other hand, do not have access to a comparable pool of talent. In such a situation it might be necessary to hire this expertise from abroad. The hiring of such external advisors is often more efficient and less costly than developing and maintaining a large staff of specialists in-house. Many international investment banks and consulting firms are well suited for this purpose with strong industry-specific expertise and a global network of contacts. They can be very helpful at any point of the process from evaluating and restructuring a company through sales promotion to bid evaluation and contract negotiation.

Some countries, notably Argentina, Mexico, and Peru, tend to rely on external advisors to supplement their knowledge and speed up the process. However, overall the role of outside advisors is often limited to preparing evaluations or occasionally acting as advisors on some specific aspects of the process (see Table 1). Only in relatively few circumstances did privatization bodies use advisors extensively or even entrust them with the full task of divesting. However, especially in the final steps of the process, the promotion of the company to be sold and the finding of potential investors, can external advisors be particularly useful.

Privatization agencies are typically reluctant to involve external advisors extensively. Governments tend to be concerned with losing control over the process, while the costs of such services are typically high. In order to limit the costs, privatization agencies should always use a competitive tender in which advisors bid for the right to provide their services in a specific project. The project itself and the tasks expected to be carried out by the advisor must be carefully defined and their progress supervised continuously to ensure that they are performing according to expectations.

In addition to the technical expertise gained, the use of external resources also increases the agency’s flexibility. Eastern European countries have typically opted to establish very large privatization agencies. While this is partly explained by the task to transform an entire economy, this approach often results in the creation of a stiff bureaucracy which is not sufficiently flexible to accommodate individual investors. Thus, the privatization agency might itself become a bureaucratic hurdle rather than a cooperative counterpart. Instead, the institutional structure of a small executive body which supervises special committees provides more flexibility.

The executive body itself supervises the privatization process and gives it continuity by initiating the divestiture of individual SOEs, establishing the special committees, and ensuring that the individual transactions are in line with the country’s overall policy goals. The special committees are responsible for all the detailed work involved in an individual transaction and are in charge of carrying it through the divestiture process as efficiently as possible. In addition, the executive body might provide support services to the individual committees through specialists and experts on specific legal or technical issues. In such a setup, the bidders for particular companies have one main counterpart with the special committees who will be receptive to all their specific questions and concerns, rather than facing a large bureaucratic entity with a large number of counterparts for individual issues.
The Process of Privatization: Step-by-Step

The implementation of privatization really should follow a fairly standard process (see Figure 6). Companies are selected for privatization and entrusted to the executing entity to prepare them for privatization and carry out an asset valuation. The next stage consists of preparing and promoting the sale of the asset through a sales memorandum, advertisements and other promotional tools. Once potential investors have expressed their interest, they are typically required to pre-qualify before being allowed to submit a bid. Bids are then evaluated, and, after approval of the winning bid by the steering committee and final negotiations, can the divestiture contract be signed. While the length of such a process clearly would depend on the complexity of the transaction and how well organized the privatization program is, on average a period of six to eight months should suffice to conclude a standard divestiture.

Company Selection

The first step is the selection of the particular companies to be sold from the pool of available SOEs that has been cleared for privatization by the government. The privatization agency itself should have the primary role in selecting the individual enterprises, allowing it to develop an overall sales strategy. The involvement of other entities in this decision will most likely introduce political elements, jeopardizing the efficiency of the sales process. In Poland, for example, interested investors generally have to initiate the process, but the management and workers of the company have veto power, often forcing investors to effectively “buy” their cooperation through some form of compensation. In order for the privatization process to start off reliably and effectively, the privatization agency clearly has to be in the driver’s seat.

While the selection of individual companies can never be entirely free of political criteria, the privatization agency should base its selection exclusively on technical criteria, driven by the agency’s overall sales strategy and whether the particular company is ready to enter the process. In general this depends on such issues as the resource constraints within the agency, the expected degree of difficulty of the particular transaction, and on how urgently the company requires new investors. The final decision to go ahead with individual privatizations typically rests with the political steering committee who will want to make sure that the actual process is in line with the overall reform process.

The strategy underlying the timing of the sale can be based on a sectoral approach, the size of SOEs, or on the government’s capacity to handle transactions. Hungary, for example, adopted a sectoral approach on the grounds that it was the most effective way of ensuring that weaker companies were not destroyed as stronger companies were bought up and further strengthened by the new investor. The major advantage of this approach is that it enables the development of sectoral experience among the staff. It also results in efficiencies in promotion since it
enables investors in a certain sector to be approached for more than one potential acquisition. On the other hand, privatizing an entire sector as opposed to a single company may not actually favor the privatization of the enterprises most in need of restructuring and new investments.

Mexico and Argentina initially structured their approaches based on the size of SOEs. Mexico decided to focus on selling smaller SOEs in order to build up its institutional and marketing capacity and expertise. This permits the privatization body to gather experience over time without jeopardizing the privatization program through highly visible blunders. However, delaying the major privatizations can also have a negative budgetary impact, especially if the larger SOEs are running significant deficits. This is what prompted Argentina to launch its privatization program with some of its largest SOEs which were running substantial deficits, namely airlines, telephone, railways and oil. This “big-bang” strategy clearly has a strong promotional effect by immediately alerting investors around the world of the extensive investment opportunities in the country, made possible by an intensive reform program.

Box 9. The Selection of Companies for Privatization: Two Approaches

In Mozambique, individual ministries are in charge of submitting the names of specific SOEs under their responsibility for privatization. By controlling the companies submitted for potential privatization, primary stakeholders often not amenable to privatization have de facto assumed control over a key element of the divestiture program. In the absence of a “Master List” of parastatals, there is no way to ensure that the appropriate companies are being put on the privatization block.

In the Philippines, another approach to company selection was used. The selection of privatization candidates was carried out right at the beginning of the privatization process. A special commission was formed by the President to determine which government corporations should be privatized. The primary criterion used by the Commission was whether the private sector could more efficiently manage the company or economic sector. Based on this determination, all selected SOEs were entrusted to the privatization agency which then assigned individual companies to the appropriate marketing or disposition entity.
Peru, on the other hand, placed all SOEs on the auction block at once. The sequencing of privatizations was essentially determined by the judgment of the privatization agency regarding the ease with which individual enterprises could be sold. If pursued consistently, the major advantage of such an approach is speed, but it requires a highly skilled and flexible privatization staff. Again, however, priority might not be given to those companies which would most benefit from privatization.

Preparation for Privatization

Most SOEs require substantial restructuring in order to transform them into an efficient and profitable entity. The crucial question is who should undertake this work. Generally, governments will want to improve their SOEs prior to the sale in order to enhance their marketability and maximize sales revenues. However, some restructuring measures are very complex and time-consuming, significantly delaying the sell-off.

As a general rule, governments should not undertake any active restructuring, involving capital investment or physical restructuring. The new owners are typically in a far better position to carry out an effective investment program based on their business plan and long-term vision for the company. Any such restructuring undertaken by the government prior to sale might not enhance the value of the company from the investors' perspective, and they will therefore not be willing to pay a price high enough to recover the investment costs. On the contrary, the remainder of the enterprise might decrease even further in value during the period of time needed for the restructuring. Thus, this strategy to increase the sales price might actually backfire, resulting in an overall lower final sales price.

In the privatization of a major Mozambiquean cement company, for example, the government insisted on completing a rehabilitation program involving new investments with bilateral financial support. The final buyer of this company stated, however, that these new investments did not contribute to the asset value because they did not match with the future plans the investor had for the company. The conclusion of the investment program resulted in delays in the privatization process without having a positive effect on the sales price.

There are, however, other forms of, so-called passive, restructuring, involving issues such as the shedding of liabilities, reductions of the work force, or reorganizing the company through breaking it up into smaller units. Such measures can substantially enhance the value and marketability of a company simply because many of these issues, if unresolved, will force the investors to handle them, translating into an overall reduction in price they will be willing to offer.

Public enterprises are often involved in a myriad of unrelated business operations, including social services to the work force. Private investors typically find it a burden to have to absorb these assets when acquiring the company, this being reflected during the privatization process in lower bid prices and a smaller number of bidders. In such cases it might be advisable to break the SOE up into smaller business units which will more easily attract the attention of strategic investors.

The breaking up of individual SOEs is especially interesting in the privatization of large infrastructure utilities. Not only can the government target specifically the most qualified investors for individual activities by separating the various business units of major SOE conglomerates, it also allows for the introduction

Box 10. Hungary: Leaving Major Restructuring to Investors

In Hungary, restructuring is guided by the philosophy that it is generally best left to investors for the following reasons:

1. The new owner knows best how to operate the company most effectively and how to restructure it to achieve this target;
2. There were always limited resources for this purpose and;
3. According to the law, the SPA's task is to privatize, and since it owns the assets only temporarily, it was better not to start time-consuming restructuring. However, in certain cases, it was important to ensure the viability of enterprises. This was mostly needed when their inherited debt burden hindered their effective operations, or when their deteriorating results originated from objective conditions such as the loss of Eastern European markets"
of some degree of competition in areas that were previously treated as public monopolies. In Argentina, the electricity company SEGBA was divided into eight business units, four generation stations, one transmission company, and three distribution centers, prior to privatization. Similarly, the country’s rail system was separated into six freight lines, six passenger lines, and one subway line before arranging concession tenders.

Another important task in the preparation phase is to develop an internationally acceptable accounting system and balance sheets. It is not unusual for SOEs to have large, and often hidden, liabilities which seriously jeopardize the company’s viability. Should this be the case, some financial restructuring in the form of liability shedding might be the only way to make the company attractive.

Excessive manpower is another aspect of SOEs that frequently poses a major impediment for private investors. Maintaining all employees is generally impossible for simple cost reasons, while massive layoffs clearly have a negative impact on morale, which is especially detrimental right after the transfer of ownership, when the new investor is trying to build a new company. Thus, this is one area where foreign investors have strongly expressed their desire for the government to carry out restructuring measures through social and labor policies.

Virtually all countries have experienced labor problems, but some were more successful in dealing with them than others. In Argentina and Peru, for example, extensive labor reduction prior to the sale is typically singled out as one of the most important elements that has contributed to the success of selling their SOEs. The opposition by workers and unions in these two countries was held to an acceptable minimum, partly because the released workers typically benefited from the privatization gains through attractive compensation schemes. Before offering Aguas Argentinas, the Buenos Aires water distribution network, for sale, the state reduced personnel from 7,500 to 3,600, and the released employees received a compensation package worth two years salary. The private operator carried out some further lay-offs, and by the end of 1995 salaries had increased by 40 percent.

In contrast, in countries such as India, Mozambique and Sri Lanka, the law prohibits the laying off of public employees for several years after the sale. Investors normally have to agree to maintain the work force when signing the contract. This imposes an often substantial financial burden on the future investor, and makes the successful conclusion of privatization transactions more difficult. Mexico experienced that kind of difficulty in 1991 during the privatization of Concarril, a major construction company of railroad rolling stock. Despite massive labor surpluses, the government decided to solicit tenders for the company without any prior restructuring. The tender had to be canceled after only one investor proposed an acceptably low bid. In response, the government initiated an open bidding on the company assets only. All employees were formally laid off, and could be re-hired individually by the new owner. After receiving various offers, the government officially sold Concarril to a large Canadian company, which paid US$22 million in cash and assumed the company’s debt of US$46 million.

Above and beyond enterprise restructuring, some other issues have to be handled by the privatization agency to prepare a company for sale. Most importantly, it has to make sure all ownership titles with the necessary documentation are available and undisputed. Should the property titles not be clear, a process has to be initiated to settle the issue conclusively, potentially through compensation or restitution. Restitution in-kind is obviously much more complex since it involves transferring part or all of the assets to the former owners, which can compromise investor interest and possibly even the entire privatization transaction.

The government must also clarify any possible outstanding legal or environmental liabilities against the company to be privatized. Such liabilities can involve high future costs for the potential investor, and often create substantial uncertainty regarding the effective asset value. In Peru, for example, the government had to agree to clean up mine sites to comply with environmental regulations as part of the conditions of sale since investors were not willing to assume the associated financial risk.

Finally, the privatization agency will have to collect all the available financial and technical information about each enterprise. It is important to be as thorough as possible in the data collection, because it will provide the background information for all interested buyers. In many countries, investors complain about the difficulty to obtain this information as well as its unreliability, and not infrequently the criticism
shapes investor attitude towards the privatization agency as a whole.

**Asset Valuation**

The issue of valuation can be a major stumbling block in the privatization process. Naturally, the government will want to assess the value of the asset at hand in order to get a good sense of the potential sales revenue to be expected. In many instances, however, valuation becomes a central and time-consuming component of the process. Especially in the African and Eastern European countries we visited, investors frequently complained about the length of the valuation process and the often exaggerated price expectations.

The main problem is that valuing a company is far from being an exact science. Any valuation is highly dependent upon the underlying assumptions as well the particular method employed, and hence the outcomes can vary substantially. In an attempt to politically justify the decision to privatize as well as to ensure that the maximum price is being extracted, government valuations are often far too optimistic.

The experience of the Government of the Philippines in its attempts to privatize 65 percent of the National Steel Corporation (NSC) provides a good example. When the government announced the sale in mid-1993, the Commission on Audit (COA), an agency explicitly created to assess asset values and to set minimum bid prices in privatization tenders, estimated a value of P10 billion. Consultants to NSC itself estimated a value of P6.8 billion, and the highest bid received in the first tender among four interested groups was only P6.3 billion. The government opened a second round of bidding for a reduced minimum price of P7.5 billion. The two remaining interested investors both declined, the privatization failed, and NSC itself almost went bankrupt due to its dismal financial state. The government eventually decided to put another "Disposition Entity" in charge of this privatization, and direct negotiations were initiated with all four investors who had indicated an interest. An agreement was eventually reached on October 31, 1994, when an agreement was reached with a Malaysian company for a 51 percent stake.

Most governments try to protect themselves from accusations of selling out "the family silver" by using some form of valuation to set a reference or even a reservation price in the bidding process. Hungary, and especially Poland, had great difficulties in conducting reliable valuations. All balance sheets tended to follow non-Western accounting standards, requiring a substantial amount of due diligence and auditing work. Many investors complained about the valuation as being the lengthiest and most contentious part of the privatization process. In an attempt to obtain an asset valuation closer to a possible market price, Mozambique frequently conducts a calculation of the net present value of the future cash flow, assuming certain investments undertaken by the new owner. This method does, however, result in highly hypothetical and subjective values which often grossly overstate the willingness to pay by potential bidders. Ghana's divestiture program tends to rely heavily on several asset valuations per project. Typically, three valuations are undertaken, one for the Divestiture Implementation Committee (DIC) by external consultants, one by DIC itself to validate that evaluation, and one by the potential buyer. While this almost invariably results in a lengthy process, there is no guarantee that the final result is closer to the final sales price. In the sale of a major glass factory facing bankruptcy, the DIC decided to use replacement value as the appropriate valuation method. The resulting asset value was far too high with not a single investor being interested.

Investors who participated in the privatization programs of Argentina, Mexico, and Peru, on the other hand, typically had no major complaints about the asset valuation process. While valuations were undertaken in each of these countries, the results obtained were typically considered benchmark values for informational purposes, and the government never considered them as the value towards which the sales price had to converge. Peru's COPRI, for example, set a minimum price before a tender. This price was derived from valuation analyses, but was adjusted according to the extent and quality of competition the agency expected during the tender. Thus, in cases where only one investor appeared to be seriously interested, the agency would set the price close to the valuation to deter a low bid. In the more frequent case of several investors being expected to bid, COPRI would set the price relatively low in order to attract more competition, expecting the bid value to increase through stronger competitive pressure instead.

All these experiences show that a competitive bidding process is the most effective way to
determine the market value of a company. If the government uses an unrealistically high valuation as the reservation price, potential investors may shy away, reducing the number of potential bidders. This loss of competition will translate into lower offers by the remaining bidders, allowing them to discount the possibility of losing out to competitors. Thus, rather than emphasizing the valuation of companies, governments should be concerned with attracting as many bidders as possible. In addition, by placing an unduly strong emphasis on valuation, the agency will tie up scarce resources which might be used more effectively in promotional activities instead.

Preparation of the Sales Guidelines

Based on the information collected from the enterprise, the privatization agency will have to create a sales memorandum or prospectus which will serve as an official sales announcement, but also as advertisement material. Specifically, the sales guidelines should include a) specific information on the firm's activities and financial, labor and commercial situation, etc.; and b) the rules and guidelines pertaining to the tender process. The importance of being able to provide foreign investors with relevant information on the SOE cannot be overemphasized since investors will be reluctant to bid if they cannot adequately assess the value of the asset. The description of the privatization process should outline all the steps required for an investor to participate in the tender.

Sales Announcement and Promotion

The privatization law should require a public sales announcement in local and international newspapers and clearly specify the exact time period allowed between the announcement and the pre-qualification or the tender. This is especially important for foreign investors who often are not very familiar with the country and require sufficient time to react to the announcement, carry out their due diligence and determine their bidding strategy. The announcement officially sets in motion the process within the defined timeframe. At the same time it serves as a first advertisement of a particular company for sale.

Besides the advertisement, however, the privatization agency should engage in promotional activities to increase the circle of bidders. Foreign investors will be interested in participating in the privatization program only if the particular asset for sale is attractive, and if the general business climate is inviting. First of all, the agency should therefore engage in a general image building strategy, using the privatization program as a clear signal that a serious reform program is underway through which the country has turned into an attractive investment location. The second stage involves a highly proactive and carefully orchestrated plan to attract investors to bid on specific privatizations. This requires identifying major global investors in the sectors of the particular SOEs for sale. Once potential investors have been identified, the next step could be a series of "road shows" where information is presented in order to attract the targeted companies to participate in the privatization.

The second part of this promotion effort is more skill-intensive than the general image building part, and foreign advisors can play an important role in this aspect. Multinational investment banks and consulting firms have access to a worldwide network of companies and typically possess detailed sector-specific knowledge.

These skills are often lacking within privatization agencies, typically resulting in promotion being a weak link in the privatization process. Most countries appreciate the importance of promotion in theory, and have developed extensive agendas of promotional activities, including missions, databases, advertisements and brochures. Some countries, such as Hungary, have also set up Customer Service Bureaus to deal with individual investor requests (see Box 11).

Box 11. Hungary: At the Service of Investors

Hungary has invested in creating a system to service the information requirements of investors. In 1992, it created a Customer Service Center which provides information on SOEs to be privatized via publications or on-line. In addition, through its own publications, it provides information on upcoming privatizations as well as the process itself. This publication is widely available internationally at embassies and chambers of commerce and provides a good promotional tool.
Few countries, however, have successfully designed and executed a promotional program. In all the countries surveyed, foreign investors who participated in the privatization program consisted overwhelmingly of companies with previous ties to that country, or multinationals pursuing a strategy for the country to become a strategic investment location. This implies that the targeted outreach part of the whole advertisement campaign is not functioning well, representing a tremendous missed opportunity.

Argentina, Mexico, and Peru all have been especially active in their promotion efforts. However, many government officials openly admitted that the effectiveness of these efforts was quite limited. Road shows for particular companies in industrialized countries rarely generated additional investor interest. In many cases, they seem to have been undertaken primarily for internal political reasons in order to prove to the public that everything was done to attract the most suitable investor. Almost invariably, however, it turned out that resources for promotion activities were used for the largest and most visible projects such as telephone companies or large mining operations. In most cases, the number of potential buyers in these areas is quite limited, and the existing players in these fields already tend to be well informed about new investment opportunities. Thus it should not be too surprising that no additional interest was generated. At the same time, however, medium-sized enterprises and companies less known in the international markets frequently did not receive much promotional support beyond the initial advertisements for tender. Practically all the countries we visited could have enhanced the effectiveness of their promotion activities by focusing the available resources more towards those projects that would benefit most from additional visibility.

Registration of Interest

The body responsible for the divestiture prepares the Sales Memorandum which is essentially a descriptive prospectus containing the relevant information about the company such as financial statements, credit history, labor and commercial situation. Prospective investors are generally required to register their interest by purchasing the Sales Memorandum, agreeing to abide by the stated procedures, and signing a confidentiality agreement. Generally, a copy of the standard contract of sales is also provided to the bidder. The purchase of the Sales Memorandum, which contains more detailed information than the initial advertisement, acts as an early signal to the privatization body to gauge potential interest in the transaction. In the absence of sufficient interest, the privatization body has the opportunity to adjust its promotional efforts.

The price of the Sales Memorandum should be set so as to dissuade insincere inquiries but still ensure a broad enough pool of potential investors. The combined effect of the requirement imposed on interested investors to purchase the Sales Memorandum and sign a confidentiality agreement allow the privatization body to maintain control over the process. Because purchasers of the sales memorandum are bound not to reveal its contents, all prospective purchasers will be known to government, which can then follow-up should the expressions of interest translate into poor response to participate further. Finally, confidentiality ensures that individual investors will not know the number of interested parties, and hence will not be able to devise a pricing strategy, based on the number and identity of bidders.

Pre-qualification

For most of the SOEs to be privatized, the privatization agency will want to establish a pre-qualification stage in which investors are required to demonstrate that they are financially and technically capable and experienced to operate a particular enterprise. The challenge in pre-qualification is to devise criteria to ensure the selection of desired investors while avoiding to limit the pool of candidates unnecessarily. The elaboration of selection criteria should encompass the financial and operational ability of prospective investors to meet the minimum requirements specified in the sales memorandum such as investments, labor training, or technology transfer.

The agency should try not to overspecify the requirements through a large number of technical criteria so as not to exclude investors with particularly imaginative business plans. The few criteria employed should be made public from the outset and should be clearly specified to reduce the possibility of subjective decision making. For example, in the case of a gas distribution privatization in Argentina, interested companies had to demonstrate that they had experience in operating a minimum of a 1,000 km pipeline.
Bid Evaluation

The final evaluation of all bids received and the determination of the winning bid is undoubtedly the most crucial step in the process, and also the one which is most often criticized by investors. In order to avoid jeopardizing the overall reputation of the privatization program, the privatization agency should make sure to establish a decision-making process which is absolutely transparent and unquestionably fair.

This being the critical step in the privatization process, governments understandably want to make sure that they award the bid to the investor they consider to be the best one. In many privatization programs various bids received are being compared based on a number of different criteria. Some of the most frequent ones are shown in Table 2. While the bid price always plays an important role, much emphasis is often placed on the technical criteria to ensure that the eventual owner follows a business development strategy in line with the government's objectives.

The main difficulty with this approach is that subjectivity almost unavoidably creeps into the process. Many of these criteria cannot be defined narrowly enough so as to allow for ready comparison. And even if this can be done, the question is how to compare different criteria to reach an overall objective decision regarding the best proposal. While the individual criteria, on which the final evaluation is based, are made known to all bidders in the Sales Memorandum, the details are often not sufficiently specified. Consequently, privatization agencies receive lengthy proposals including detailed business plans that resemble marketing documents which effectively are impossible to compare.

Both, Ghana and Mozambique, placed especially strong emphasis on the technical components of bids, and in many transactions were subject to criticism because of the subjective and non-transparent nature of the final decision. Investors often found that the skill level at the privatization agencies was far too limited to allow for a serious analysis of the technical specificities of individual proposals, and many expressed a suspicion that the government used such vague technical criteria to cover up politically motivated choices. Some investors also openly admitted that they would leave some details in their proposal unclear, forcing the agency to ask for a more detailed explanation. This would allow the individual investor to set himself apart from the other bidders by developing personal contacts with the privatization body while persuading the agency officials of the merits of their particular business plan.

In general, the result of allowing too many underspecified elements to enter the final bid evaluation is that the privatization agency is left with a number of lengthy bid documents which cannot be compared objectively. Consequently, the final decision has to be based on a vague and subjective comparison. This renders the agency vulnerable to criticism from the losers as well as the general public that the decision was made illegitimately. At the same time, the government typically refuses to make the decision criteria publicly available, knowing how easily the decision could be challenged, further supporting the claim of irregularities in the process.

One way to avoid this problem is to set priorities among a very limited number of technical criteria and define a point distribution system, clearly establishing the weight each criterion has in the final decision. All criteria should be defined so narrowly, preferably in quantitative terms, that the individual offers can be compared without any difficulty. However, even in such a system, which appears to be more transparent and objective, criticism will be unavoidable. The point distribution system itself will always be questioned and any criterion that fails to allow for a straightforward comparison will be used to challenge the decision and the privatization program as a whole.

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Table 2. Sample Evaluation Criteria

<table>
<thead>
<tr>
<th>Basic Criteria (Pre-Qualification)</th>
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<tbody>
<tr>
<td>• Technical skills</td>
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<tr>
<td>• Sources of financing and financing ability</td>
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<tr>
<td>• Managerial capabilities</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Technical Criteria</th>
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</thead>
<tbody>
<tr>
<td>• The overall business plan with emphasis on growth prospects</td>
</tr>
<tr>
<td>• Investment plans</td>
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<tr>
<td>• Maintenance of the workforce</td>
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<tr>
<td>• Employee training programs</td>
</tr>
<tr>
<td>• Impact on the community</td>
</tr>
<tr>
<td>• Technology transfer</td>
</tr>
<tr>
<td>• Environmental impact</td>
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</tbody>
</table>

<table>
<thead>
<tr>
<th>Price and Payment Terms</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Offer price</td>
</tr>
<tr>
<td>• Method and currency of payment</td>
</tr>
<tr>
<td>• Payment terms</td>
</tr>
</tbody>
</table>

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An alternative is to carry out bid evaluations based on price alone (see Box 12). The decision is straightforward and cannot be challenged, while the privatization agency will have no reason to hesitate in making its decision publicly available, allowing everybody interested to inform himself. In fact, the process can be entirely transparent through a public opening of the bids followed by an immediate decision.

Choosing a winner based on price alone does not imply that the government must give up selecting investors with a good strategic fit for the country's development. Instead, the agency determines the technical requirements already during the pre-qualification and writes them as clearly determined elements into the final contract. These criteria will then become pre-conditions any bidder will have to fulfill, and the final awarding of the bid can be handled in absolute transparency based on price alone. Handling the process of bid evaluation in such a manner will also simplify and streamline the post-bidding negotiations. Fixing the crucial elements in the contract will limit the flexibility of the investor as well as the government to change the preliminary agreement reached.

Authorization and Contract Adjudication

The recommendation of the winning bidder must be ratified by the ultimate authority, usually a committee of ministers or the head of state. The contract is finalized between the two parties. In some cases, the declaration of a winning bidder and the signing of an agreement in principle are followed by further negotiations. This often is the result of not having specified all details sufficiently during the process and can have a very negative impact on the perception of the privatization program by investors who already went through a lengthy process to acquire the SOE.

One of the most important lessons the Argentinean government learned from its first privatizations was that declaring a tender won can be quite meaningless, in case the details of what exactly has been tendered are not sufficiently specified. A sample contract was included in the Sales Memorandum not so much as a final document, but rather as an indication of the main clauses and conditions which would be in the final contract. This resulted in the perception on the part of bidders that they could negotiate further, which often led to a second round of unplanned negotiations with the investor.

Once the government has officially declared a winner, it will lose its bargaining power with the elimination of the competitive environment of the tender. The investor knows his position as well as his potential competitors, while it is not very likely that the government will retract its decision easily. Thus, effectively all components of the transaction might be open for renegotiation, often resulting in lengthy delays while casting doubt over the relevance and fairness of the whole privatization process.

Box 12. Price-Based Selection in Peru and Argentina

Argentina and Peru include a contract in the terms of reference, stating the main clauses and conditions of the privatization as well as all critical technical components. The prospectus as well as the contract are unofficially circulated several times for comments among the pre-qualified bidders. An official prospectus is then distributed which, once sold to investors, can no longer be modified. The contract has to be signed by all bidders and presented as part of their bid, leaving only the price as the determining factor in the evaluation of bids. At the time of the tender or auction, the privatization agencies then typically open the bidding envelopes publicly, with the national media present, and immediately declares the winner based on the highest bid price received.

Divestiture

The privatization agency is responsible for the expedient transfer of property to the new owners. With the conclusion of the deal, some countries choose to make all relevant documents publicly available. This reinforces the perception of a transparent and fair process and, ultimately, enhances the country's image as an attractive investment location.

Mexico and Peru attach particular importance to the transparency of their privatization processes. Once a sale has been completed, the special committee responsible for the actual transaction prepares a document known as the "White Book" which contains all the official documents related to each stage of the sales process. It contains a description of the privatization process,
including the names of all the participating bidders and the main components of their bids. It provides an explanation for all the decisions made during the process, including the final award of the SOE to the winning bidder. This document is sent to the Ministry responsible for the company, and is publicly available to any interested party.

Notes

Conclusion

Foreign direct investment can play a crucial role in supporting a country's industrialization and private sector development. Privatization of public enterprises can serve as an important mechanism to enhance this process, not only through direct involvement of foreign investors in the privatization program itself, but also by using the privatization program as an effective advertising program to show the international investor community that the country is developing into an attractive investment location. Experience has shown that FDI inflows tend to increase rapidly in conjunction with a successful privatization program.

There certainly is no such thing as a standard model or a blueprint for creating a successful privatization program. However, certain fundamental rules and principles exist which have to be observed, if privatization should serve as an effective macroeconomic tool. Foreign investors will carefully watch the government's privatization efforts in order to evaluate its sincerity to improve the business climate in the country. Public announcements and declarations in support of a reform program will not suffice. Based on the treatment of bidders in the privatization process and the overall effectiveness of the program, investors will decide whether the country does actually represent an interesting investment opportunity.

The government has to prove its commitment to open the economy to private economic activity by reducing public sector involvement. A wide-ranging privatization program has to be established that is legally and institutionally equipped to efficiently and effectively transfer ownership in SOEs to private entrepreneurs. Equally important, the process has to be managed in an objective and fair manner, assuring investors that they can compete on a level playing field, free of any undue interference by the government.

These principles of commitment, business orientation, and transparency have to be the guiding principles of the entire privatization program. They are not disjoint and unrelated conceptual activities, but have to shape every aspect, from the creation of an appropriate legal and institutional framework down to every single step of the actual sales process. Negative experiences related to any of these elements can be sufficient to derail privatization and damage the country's reputation as a good investment location.
Annex: Foreign Investors Surveyed

1. GE
2. ABB
3. Alcatel
4. Holsten-Brauerei AG
5. Pepsico
6. AEG
7. Reemstsman
8. Henkel Austria Group
9. Irving & Johnson
10. Julius Meinl Int.
11. Unilever
12. Cimenteries CBR
13. Siemens
14. Cargill
15. MD Indol Int.
16. Guinness PLC
17. Acco
18. G.M. International
19. Taylor Woodrow International
20. SIPEF
21. Gold Fields of South Africa
22. Marriott International
23. S.A. Bottling Company (Suncrush)
24. Houston Energy
25. Bombardier
26. British Gas PLC
27. Sancem International
28. Premier Food Industries
29. Dominion Energy
30. Railroad Development Corp.
31. Southern Electric International
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