INDUSTRIAL
RESTRUCTURING
Policy
and
Practice

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Industry & Energy Department
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CONFIDENTIAL LULUR AGRICULTURAL DEVELOPMENT PROJECT
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INDUSTRIAL RESTRUCTURING

POLICY AND PRACTICE

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Washington, DC
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Introduction

Industrial restructuring involves actions by enterprises to bridge gaps between current performance and what is required to become internationally competitive. These gaps emerge as a result of global changes in technology, organization, marketing, and factor prices. Industry, in turn, is prompted by policy, regulatory, and institutional changes to improve its competitiveness. Restructuring is successful when a firm or an industry has shifted to a product mix and cost structure that is competitive — and positioned to remain competitive.

Experience shows that restructuring at the firm level will not take place automatically in response to macroeconomic policy changes or rapid shifts in global conditions.

Governments need to establish policies that facilitate flexible resource movements in response to competition, promote institutions that are capable of filling information and capability gaps, and ensure that appropriate financing is available. Policies and institutional programs can help scale down uncompetitive industries, reshape those that can be internationally competitive, and expand promising new activities.

This paper examines the reasons for restructuring and outlines the policies and institutions needed to make it effective. The purpose is to provide guidance on the design and implementation of industrial restructuring programs. The paper identifies key industry and trade policies; outlines elements of successful approaches to subsector and enterprise restructuring; and describes the financial instruments and institutions required to promote industrial restructuring.

Preconditions for effective restructuring

Industrial restructuring programs have moved from narrow physical rehabilitation projects targeting a few public enterprises into operations with increased attention to policy and institutional change at subsector and industry-wide levels. Experience demonstrates that industrial restructuring operations can be effective only as complements to policies that promote efficient, competitive supply responses by industrial enterprises.

In addition to sound macroeconomic policies, the following measures are needed:

- Removal of, or significant reduction in, barriers to entry, exit and expansion of industrial enterprises.
- Elimination of policy-induced public or private sector industrial monopolies. When domestic competition is inadequate to force efficiency in production, import competition is required, particularly in key intermediates, such as steel, fertilizers, petrochemicals, and cement.
- Elimination of, or major reductions in, subsidies, unilateral transfers, and special arrangements for certain enterprises.
- Introduction of market-oriented pricing policies.

These policy measures can be incorporated as preconditions of an industrial restructuring op-
eration, supported under parallel adjustment operations, or undertaken independently as part of an overall reform program. Experience indicates that physical rehabilitation and financial restructuring will not result in significant improvements unless competitive pressures force firms to improve their organizational and operational efficiency.

**Industrial subsector restructuring**

World Bank support for private enterprise restructuring is generally indirect. Credit is provided through the financial system, and technical and marketing services are channeled through financial, commercial or government agents. In many cases, a subsector focus is useful to help identify key factors in the competitiveness of products and major gaps between domestic and international practice in technology, organization, and marketing. Also, since competitive requirements are specific to different product-market segments, services to provide market information and build capabilities often are best geared to specific subsectors. Thus the objective is to dismantle specific subsidies while promoting functional services, beginning with promising subsectors. Restructuring operations need to incorporate institutional programs that help firms develop competence in critical functional areas. Such programs can include:

- Measures to help individual firms devise export marketing strategies and productivity improvement programs.
- Human resource development programs aimed at creating flexible, technical labor and management personnel.
- Funding for research and development focused on internationally available technologies.
- Mechanisms to help firms form strategic alliances with companies operating globally.

Given rapid changes in technology and markets and the increasing focus on exports, financial intermediaries need to develop product specific technical and marketing expertise in project evaluation. However, subsector-specific credit allocations should be avoided, as they can create distortions, rigidities and problems in attempting to predict future investment areas. It is preferable to involve financial intermediaries in subsector diagnoses and to make them responsible for technical assistance components which provide them with direct exposure to technology and marketing issues in the major product groups.

**Restructuring state-owned industrial enterprises**

Major debt, fiscal, and financial sector problems in many developing countries mean that they cannot afford to maintain insolvent, uncompetitive public enterprises. Programs to close and downsize unviable public enterprises — and restructure those that can be competitive — merit priority attention. In restructuring large and powerful public enterprises, competition policies should be combined with explicit measures to remove or reduce the special benefits that public enterprises usually receive: subsidies, sales arrangements with other public enterprises, and monopolies on sourcing, production, and sales. Due to their monopoly status, soft financing constraints, and mixed mandates, many public enterprises have absorbed related enterprises or expanded into unrelated businesses. Tough decisions, based on solid subsector and enterprise analysis, are needed to unwind these distortions.

Physical rehabilitation and financial restructuring of public enterprises have only succeeded where they were accompanied by policies requiring competitive performance and changes in the enterprises' management, organization, technology, and marketing. Limited results have been achieved or can be expected through management information, performance evaluation, or performance contract systems. improved transparency and information systems are useful only as complementary systems once real power and financial relationships — subsidies, transfers, special credit access — change.

The following approaches are basic to sound restructuring programs.

- Firms should provide goods and services at competitive prices and quality. The objective should be to reduce and ultimately remove producer and consumer subsidies. Public industrial enterprises should pay their own way — or have clearly demonstrated prospects for doing so after restructuring.
- Incremental investments should be supported only if international competitiveness in price and quality will be achieved or approached as a result of the restructuring operation. This is particularly critical in basic intermediates, where ineffi-
cient enterprises undermine the competitiveness of downstream users. When a company is a domestic monopoly, competition from imports often is a prime mechanism for promoting efficiency.

- Joint ventures or strong collaborative arrangements with successful domestic concerns and foreign firms with global operations should be promoted. These alliances can provide funding, create external pressure for competitive performance, and introduce best international practices.

- For enterprises that remain in the public sector, the government must become an arms-length shareholder in the firms it oversees. Holding companies—often seen as a mechanism for distancing the bureaucracy from the enterprises—are important only if they have budget responsibilities for public enterprises and are free to liquidate, privatize, or form joint ventures. Otherwise, holding companies are just another layer of control.

- Public enterprise restructuring programs should address issues of labor redundancy, compensatory payments as incentives for voluntary redeployment, and retraining of management and labor.

- Given the extreme complexities, strong social and political dimensions, and tenuous nature of public enterprise restructuring programs, a strong government commitment is critical. This commitment needs to be evidenced by concrete actions that have been implemented and by a convincing program of measurable actions agreed to by all participants.

Privatization can be an important means to achieve competitiveness and to reduce political interference. But selling public enterprises poses formidable problems. The number of potential buyers often is limited, and capital markets in developing countries often are inadequate for absorbing divestitures. Unless the sale is implemented properly, privatization may merely replace public with private monopolies. Other means to increase private ownership and management of public industrial enterprises include employee buyouts, asset leasing, direct sales of all or part of the enterprise, off-loading of marginal activities, and formation of joint ventures with local or foreign private partners. The potential benefits of such measures include efficiency, a reduced drain on scarce public sector resources, less crowding out of the private sector in domestic capital markets, and more transparency in the industrial sector. Perhaps the most effective and pragmatic means to increase private participation are downsizing existing public enterprises, and limiting future expansion to give room to private initiatives.

Financial sector and industrial restructuring

Removing serious distortions in the financial sector is a prerequisite for industrial restructuring. In countries in deep financial distress, sound new investments can take place only after restructuring the industrial portfolios of insolvent intermediaries, and only after dealing explicitly with non-performing assets. Otherwise, banks will bail out unhealthy investments, raising financial costs and pushing aside healthy new prospects. To improve the financial health and efficiency of the banking system, governments must introduce regulatory incentives and restructure the finances of affected intermediaries.

In restructuring operations that involve credit through financial intermediaries, only sound and solvent institutions should be used, basic principles of corporate finance should be employed, and appropriate instruments and eligible expenditures should be incorporated.

Despite a theoretical capacity for project appraisal, a number of development banks have repeatedly lent for nonviable projects and have experienced a deterioration in the quality of their portfolios. Many commercial banks have avoided these problems, and have shown that they are capable of handling corporate finance and equity investments. Successful commercial banks have strong market knowledge, financial engineering expertise, and regular relationships with industrial clients. The commercial banks — and the small but growing group of investment banks — could become increasingly important vehicles for financing industrial restructuring programs.

Along with investments in equipment and working capital, parallel financial restructuring may be required, including maturity extension, debt consolidation, and debt-equity conversion.
Policies for industrial restructuring

A business environment that rewards efficient performance is necessary if enterprises, subsectors, and industries as a whole are to restructure to attain global competitiveness. Successful restructuring depends on:

- Macroeconomic policies geared to providing a stable business environment. Governments should adjust exchange rates to maintain equilibrium between domestic and international prices, and follow prudent public revenue and expenditure practices.
- Effective competition policies that combine phased-in import liberalization, changes in regulations and incentives to reduce domestic barriers to entry, exit, and expansion, and export rivalry measures.
- Liberalization of factor and final output prices.
- Institutional services and infrastructure to aid firms in restructuring, including effective market information and consulting services, human resource development, telecommunications, transport, and power.

Table 1 shows the instruments available.

**Macroeconomic policy**

Industrial restructuring operations are not feasible in the midst of serious macroeconomic instability. Developing countries often maintain overvalued, unrealistic exchange rates that make import substitution activities artificially profitable. Inflation, fueled mainly by public sector deficit spending, is also a destabilizing element.

Industrial restructuring operations can be effective vehicles for supporting import liberalization, domestic regulatory and incentive reforms, and export rivalry measures — all geared to use competition as a tool for inducing competitive decisions by industrial firms.

Mexico offers an example of appropriate Bank support for policy change and industrial restructuring programs. Mexico’s adherence to the General Agreement on Tariffs and Trade (GATT) in 1986 and its decisions to remove most quantitative restrictions on industrial goods, reduce protection, and harmonize tariff classifications were supported by two quick-disbursing Bank trade policy loans. Officials reviewed the major barriers to entry, exit, and expansion by domestic and foreign firms, with reforms scheduled to be supported under a proposed FY89 industrial sector loan. Industrial restructuring operations, which were initiated in 1986, will help public and private enterprises meet rapid global and policy changes. Mexico’s example reflects a serious commitment to trade reform and enterprise restructuring. It also reflects the critical importance of internal regulatory and incentive reforms to give domestic enterprises the flexibility to respond to competitive challenges.

Industrial regulations cover an array of regulations that govern commercial operations, of which the most relevant are those that deter com-
Table 1  Major components of the policy and institutional environment

1. Macroeconomic policies
   - Exchange rates: To increase competitive pressures and allow external markets to signal resource allocation.
   - Fiscal and credit policies: To address the problem of public expenditures crowding out private sector restructuring and development financing.

2. Competition policies
   - Import liberalization: Quantitative import restrictions, import tariffs, import taxes, administrative import controls, and other import restrictions.
   - Free-trade regime for exports: Duty drawbacks and duty exemption schemes for imported inputs for export production; pre- and post-shipment credit and insurance for exports and related imports, production; and export-import administration, including customs.

3. Domestic factor prices
   - Pricing: Subsidies, prices for inputs, utilities, transportation, and basic consumer goods.
   - Labor: Minimum wage, ease of layoff (by regulation or in practice), mobility, retraining, severance pay, hiring practices, unionization.
   - Taxes: Level and coverage of corporate taxes, concessions and exemptions, dividends, depreciation rules, carry-over, profits of foreign investors.
   - Enterprise autonomy: Freedom of entry or exit, operational autonomy.

4. Infrastructure, institutional, and proactive services
   - Information services: Economic statistics, trade data, export market information.
   - Physical infrastructure: Power, transport, communication, water ports.
   - Human resources: Education, vocational training, management development.
   - Marketing: Distribution, promotion, warehousing, trading.
   - Technological development: Standards institute; quality protection of intellectual property rights limit access to state-of-the-art production technology and to marketing networks.
   - Consulting services: Engineering, marketing; maintenance; legal; accounting (auditing and taxation).
   - Accounting: Auditing standards.

petition, including barriers to entry, exit, and expansion. Barriers to entry and expansion include licensing of new capacity, limits on the size of firms, and restrictions on ownership. Barriers to exit encompass laws on bankruptcy, liquidation, and downsizing of firms.

Typically, entry barriers protect dominant local enterprises. Policies designed to foster infant industries often ossify into protection for monopolies or oligopolies. Such progressive rigidities can be the byproduct of import substitution strategies, with governments and firms cooperating to make domestic production capacity equal domestic demand. Entry barriers protect incumbent enterprises in domestic markets from the challenge of new entrants. As a result, the gap in competitiveness between firms operating in the world market and enterprises operating in protected subsectors increases.

Complex licensing processes discriminate against small enterprises that cannot afford the costs or the time. Often several ministries are involved, each deploying different, opaque criteria. This complexity has led to the growth of a
large informal sector in many developing countries, where firms operate outside the purview of regulations and taxes, and forego access to formal sector financing, incentives, and services.

Many developing countries reserve basic industries and services (steel, fertilizers, petrochemicals, oil and gas, and telecommunications) exclusively for state-owned enterprises. Arguments for parastatal monopolies refer to their strategic nature and large-scale financing requirements. Many of these concerns are no longer valid. The financial and economic costs of monopoly practices are high. Ownership regulations often preclude access by domestic firms to the technology, organization, and marketing channels that foreign firms can provide. Privatization can emphasize those objectives directly related to efficiency, provided that monopoly status is removed, since private monopolies have not demonstrated better performance than public monopolies (Ayub and Hegstad 1986).

Limits on firm size can result in major distortions. In India targeted incentives, such as reserving certain products for exclusive production by small firms, resulted in enterprise fragmentation, capital-intensive small industries, and inefficient industrial segments. In Poland the limits on private enterprise size combined with import protection and regulations that carve up product markets among public firms leave most markets in the hands of uncontested cartels.

Exit barriers include anticlosure regulations, inadequate bankruptcy and foreclosure legislation, government subsidies for failing enterprises, and low-cost loans to prop up bad investments. Restrictive labor policies often reinforce these distortions. A government-owned enterprise that is losing money often requires debt forgiveness, preferential credits, and other special arrangements. In these situations government budgets and the financial system deploy scarce resources to bolster inefficient firms, squeezing credit access for competitive undertakings. Further, foreign exchange constraints can lead governments to make imported inputs available only to existing firms. Failing firms may try to survive by engaging in predatory pricing and other short-term strategies to attract business, thus reducing overall industry margins and new investments. Particularly in situations of financial stringency, barriers to the exit of inefficient firms become barriers to the entry of new companies.

Exit barriers tend to be major hurdles for industrial restructuring. If policies make it difficult for firms to get out of unsuccessful ventures, enterprise owners and managers will avoid risks in undertaking new activities. Exit barriers often block decisive restructuring and investment approaches; managers choose to expand operations incrementally — even if it is uneconomical — to avoid the risks of more significant investment decisions. The links between entry and exit barriers and successful restructuring programs are fundamental. Laws that facilitate mergers, acquisitions, reorganization, and bankruptcy are vital tools for competitive industrial restructuring. Firms that have failed financially and economically must be allowed to fail legally, or the country's industry will remain stagnant and unproductive.

Direct foreign investment and technology transfer

Foreign collaboration can be an important ingredient of successful enterprise restructuring, particularly when competitive technologies are closely held, when export marketing links are crucial, or when outside organizational methods and accountability are needed. Yet government policies often preclude or discourage direct foreign investment through regulations that include:

- Reserving strategic or priority subsectors for state-owned enterprises or domestic investors.
- Nontransparent licensing procedures, subject to case-by-case negotiations.
- Limits on capital and profit repatriation.
- Nationalization or expropriation of private holdings.

Brazil's decision to reserve the computer industry for national companies, and India's decision to bar International Business Machines (IBM) from entering the country as a 100-percent foreign-owned company, are clear examples of policy barriers to direct foreign investment. In 1985 Mexico reversed its policy barring direct foreign investment in the computer industry. IBM then entered as a completely foreign-owned firm, and Mexico subsequently attracted many other major international manufacturers (Dahlman 1988). As part of the agreement, IBM agreed to export a large percentage of production.

In addition, the computer industry has spawned national companies that import com-
ponents and assemble and sell IBM clones in the domestic market in competition with the major foreign producers. Still, until recently, Mexico's direct foreign investment policy remained subject to case-by-case approvals and lacked the transparency to attract foreign firms. Mexico and other developing countries, however, have found that macroeconomic stability is more important than specific regulations in regaining business confidence and attracting foreign investment (Hyun and Whitmore 1989, Mody 1989).

**Pricing.** The link between pricing policies and restructuring operations is direct. Too often, firms — particularly state-owned enterprises — operate under controlled pricing policies that either guarantee a return regardless of efficiency, or preclude commercial viability. Governments bail out enterprises with budgetary transfers or subsidies. Increasingly, Bank-supported restructuring programs for public enterprises emphasize reforms to move prices toward world market levels. One issue concerns the transition for price adjustments, given social and political constraints and inflationary impact. Should market prices be introduced immediately and across the board or in selected subsectors? Can this be done without new pricing distortions? These issues have been particularly difficult for centrally planned economies that are attempting more market-based approaches. New pricing policies in basic subsectors have been difficult for large, heavily regulated economies, such as India, Pakistan, and Argentina. Yet market pricing is critical if industrial enterprises are to behave as commercial concerns.

**Labor Policies.** Labor policies may form a substantial barrier to restructuring, with unions representing a powerful political force. Layoffs may be restricted or prohibited under law. Regionally or ethnically concentrated layoffs may provoke political resistance. Worker retraining, retrenchment schemes, and employee buyouts are important to the success of restructuring programs. The Senegal Industrial Restructuring Project, which was one of the first to calculate the loss of jobs with and without restructuring, showed eventual job losses were greater without restructuring. The project also incorporated components for vocational training and redeployment of the labor force.

**Taxes.** Tax policies may be a major disincentive to restructuring investments. Policies encompass exemptions, corporate taxation, loss carryovers, depreciation and amortization allowances, deferrals and allowable deductions, treatment of dividends, and repatriation of profits by foreign investors. In Poland, for example, frequent and erratic changes in tax policies since 1981 have frustrated the country's economic reform and have eroded confidence in reform.

**Positive versus defensive restructuring**

Determining the size of the gap between local performance and global competitiveness — in cost, design, quality control, delivery, and marketing — is essential. A critical point is when restructuring is a necessity, versus the point at which no measure of restructuring will restore international competitiveness. In the latter case, the options are to free-up resources by drawing capacity down to zero, or to extend the life of an entity that is not viable through government and consumer transfers. Investing in subsectors that have reached the second stage is rarely a fruitful use of scarce resources. In many industrializing countries some subsectors have reached the first threshold; restructuring is a necessary and still viable option, provided the competitive gap can be eliminated or reduced dramatically within a short period.

A key requirement in closing the gap is to use competition as a tool to promote industrial efficiency. Domestic, import, and export rivalry are three elements at the core of a competition policy for industrial restructuring (Frischtak 1989). Two aspects are critical in policy and regulatory change: consistency and appropriate sequencing of the reforms, and continuity to provide predictability. Both are important in reducing business uncertainty, increasing confidence, and increasing the chances that the necessary supply response will occur. Hungary's industrial restructuring program has worked over a five-year timespan to implement a coherent program of economic, regulatory, and financial reforms. Necessary adjustments and corrections have been made and, at times, second-best solutions adopted; nevertheless, the reforms have operated in an announced coherent framework.
Infrastructure and services

While the Bank has funded extensive infrastructure investments, inadequate and costly infrastructure often undermines industrial competitiveness. The costs and efficiency of ports, roads, water, electricity, and telecommunications need to be linked more closely with industrial competitiveness. Some developing countries are exploring private sector financing using so-called build, operate, and transfer (BOT) schemes to reduce the fiscal burden on government and facilitate the efficient delivery of services. (BOT partnerships rely on public agencies to build the infrastructure, and on private investors to operate it.)

Other services are equally crucial — information, marketing, technology transfers, and investment banking. Policies governing direct foreign investment, research and development, and education and vocational training should be strengthened to take advantage of the new competitive challenges. Governments should devote substantial resources to developing a flexible, technical labor pool; helping fill information gaps on technology and market developments; and upgrading infrastructure. Privatization, closure, and downsizing public industrial enterprises make resources available for these vital new services.
Restructuring industrial subsectors

When to restructure subsectors

The question of when to restructure subsectors depends on the specific situation.
- Dominant subsectors. One or a few subsectors may dominate industrial output or exports, meaning that a focused restructuring effort could have a significant economic impact.
- Subsectors with heavy losses. One or a few subsectors may have a dramatically adverse effect on the public sector budget.
- Downstream impact. Many producers of basic industrial inputs — usually government-owned and protected enterprises — make high-cost, low-quality products, undermining prospects for downstream industries. Often, monopoly status and other special deals mute overall market signals.
- Demonstration effect. In some countries with an inward orientation and limited political will to reform, a major restructuring program can have a substantial effect. Reforms in competition policies can be combined with financial, technical, and marketing support for restructuring. If the result improves the competitiveness of output and exports, governments may be less reluctant to take similar steps in other subsectors or industries.
- Making room for winners. In East Asia programs to create new areas of comparative advantage have been accompanied by substantial, explicit maneuvers to downsize aging industries.

This approach — to make room for new industries, and fill gaps through focused technology and human resource development — can accelerate the restructuring of the industrial base toward more efficient resource allocation and more competitive performance.

Which subsectors?

How is the government to select the right industry? Most subsectors selected under Bank loans have been those dominated by public enterprises generating large economic and financial losses, or product groups in which the Bank has expertise. Although no rigorous, scientific criteria exist, more useful criteria include the following:
- Major subsectors. Improvements in subsectors with a major share of industrial output, exports, and employment could have a significant overall economic impact. These subsectors often represent a major share of the drain on the economy, and will enable economies of scale in building subsector knowhow and functional services.
- Promising subsectors. Product groups characterized by relatively small gaps between performance levels of local firms and levels required for global competitiveness are strong candidates for restructuring. Effective protection, domestic resource cost, and total factor productivity tools are useful in determining potentially promising subsectors. These relatively static snapshots should be combined with knowledge of technol-
ogy change and organizational and business dynamics in selecting potential candidates for restructuring.

- Strong key players. Successful industrial restructuring processes depend on policymakers, bankers, and enterprises committed to a significant response to global competitive requirements.

In subsectors in which public enterprises dominate, the selection criteria should be similar. Yet it may be necessary to select chronically uncompetitive subsectors because of the need to cut heavy losses. Here, policymakers should ensure that chronically uncompetitive subsectors are downsized and that fresh investment is avoided.

It is also important to assess the subsector’s present and potential contribution to GDP, employment, and nontraditional exports. This requires analyzing present and potential efficiency and examining the domestic structure — size, degree of concentration, and patterns of ownership. Structural analysis is needed to determine policy and institutional measures to insure competitive performance. At the same time, analysis should be complemented with realistic diagnoses of commercial viability — cost, quality, organization, technology, and marketing characteristics. (Table 2 presents a summary of the criteria used to select subsectors for the Mexican industrial restructuring project.)

Subsector Diagnoses. The global marketplace increasingly comprises highly differentiated product niches. Analysis makes it possible for managers, bankers, and policymakers to see:

- What it takes to compete in different niche markets.
- Where the gaps are between best international practice and domestic firms’ size, organization, and technologies.

- What the most binding policy and regulatory constraints are on firms moving toward competitive performance.
- What kinds of institutional services are needed to increase local capabilities, provide needed technical and marketing information, and facilitate collaborations.
- What financing requirements are needed to restructure firms and provide related institutional support.

Recent restructuring operations have relied on global and local subsector studies for project design and development. Such studies provide strategic, structural, technical, and marketing information, and can also be used in building a consensus among policymakers, bankers, and enterprise managers.

Subsector Analyses. With the analysis in hand, planners may decide on broader scope for industrial restructuring. Often, the actual operation needs to concentrate on:

- Policy changes: Competition, price decontrol, direct foreign investment, and technology.
- Functional components: Human resource capabilities, export marketing, and productivity improvements. These can focus on key subsectors, with broadened coverage in subsequent operations.
- Financing for competitive ventures, with appropriate instruments and broad eligibility criteria, without allocations for specific subsectors.

These analyses can uncover policies that impede efficient industrial development. Special deals — tax breaks, subsidies, regional incentives, pricing controls, import protection, domestic content regulations, and access to public procurement contracts — can severely distort resource allocations and subsector development.

Table 2  Criteria for selecting subsectors (analysis for Mexico)

<table>
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<th>Impact on economy</th>
<th>Textiles</th>
<th>Auto parts</th>
<th>Chemicals</th>
<th>Agro-industry</th>
<th>Pulp, paper</th>
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<td>Export potential</td>
<td>medium</td>
<td>medium</td>
<td>medium</td>
<td>medium</td>
<td>low</td>
</tr>
<tr>
<td>Sector composition</td>
<td>high</td>
<td>high</td>
<td>medium</td>
<td>medium</td>
<td>medium</td>
</tr>
<tr>
<td>Import substitution</td>
<td>high</td>
<td>high</td>
<td>medium</td>
<td>medium</td>
<td>high</td>
</tr>
<tr>
<td>Competitive advantage</td>
<td>medium</td>
<td>medium</td>
<td>high</td>
<td>medium</td>
<td>low</td>
</tr>
<tr>
<td>Policy constraints</td>
<td>low</td>
<td>low</td>
<td>medium</td>
<td>medium</td>
<td>medium</td>
</tr>
<tr>
<td>Issues across sectors</td>
<td>low</td>
<td>low</td>
<td>medium</td>
<td>medium</td>
<td>medium</td>
</tr>
<tr>
<td>Overall rating</td>
<td>high</td>
<td>high</td>
<td>high</td>
<td>medium</td>
<td>medium</td>
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</table>
Benefits normally accrue to established incumbents, effectively blocking new and potentially more competitive entrants. Industrial adjustment and restructuring operations should unravel special deals and aim for a neutral incentive framework. Special deals under licensing, bankruptcy, capacity, and ownership laws should be eliminated across the board. While governments may be reluctant to make sweeping policy changes, changes in a major subsector can have a substantial demonstration effect, making subsequent reforms easier. It is important that firms know that industry-wide policy changes are expected to follow; this undercuts the possibility of shifting resources to protected subsectors.

Components of Restructuring. Subsector-specific subsidies for firms should be avoided. At the same time services are needed to help firms fill the gaps between their operations and the best international practices, including:

- Institutional measures and information dissemination to help individual firms devise export marketing strategies and productivity improvement programs.
- Human resource programs to develop flexible, technically skilled employees and managers.
- Publicly and privately sponsored research and development, with a focus on adapting foreign technology to indigenous conditions and requirements.
- Retraining, outplacement, and entrepreneurial development programs to facilitate reductions in the labor force in restructured firms.
- Infrastructure components, such as improvements in transportation, port facilities, and communications, targeted at breaking bottlenecks.

The East Asian newly industrializing countries have established successful programs targeted at certain sectors. But many developing countries lack effective public sector institutions capable of providing such programs. Reforming those institutions that exist can be time-consuming. In such cases it is often more effective to provide private or autonomous, commercially oriented arrangements to support marketing, productivity, training, and apprenticeship activities. Industry associations and efficient banks are often the best agents for identifying and arranging appropriate technical assistance and training.

Credit Allocations. Subsector approaches usually should stop short of allocating credit, to avoid the problem of picking winners. If subsector allocations are necessary, the selected product groups should be broad enough to allow substantial flexibility and avoid forcing banks into artificial portfolio concentration. One argument for subsector credit allocations is that concentrated attention on one product group enables bankers to develop expertise in project evaluation. This may also be achieved by supplying bankers with global subsector studies, involving them in domestic diagnoses, and making participating credit institutions responsible for administering export marketing and productivity funds.

Another argument used to justify subsector credit allocations is that the participating banks’ overall financial and operating conditions would not justify a general credit line. This is not an acceptable argument; restructuring operations should require a detailed appraisal of potential financial institutions and should only use those that are financially sound and competent.

Institutions for Implementation. Policymakers, financial institutions, and business leaders need to develop a constructive dialogue. During the diagnostic phase consultants’ progress reports can serve as the basis for discussions. After the consultants have submitted recommendations, the discussion should cover the necessary changes in policies and institutions: organization and timing to implement the program, and its resource requirements. During implementation a temporary institutional structure that can provide technical assistance may be necessary.
Industrial restructuring alters incentives and institutions to force structural change and improve the industry's competitive position. Some recent operations treat policy, subsector strategy, and enterprise dimensions systematically. Boxes 1-5 sketch a number of different operations.

**Box 1 India**

This industrial export project evaluated more than 120 engineering firms to assess the effects of industrial regulations on company decisions and analyze the role of export development in overall strategy. The project also provided financing for exporters to improve their productivity and marketing expertise.

Researchers asked U.S. and European importers of Indian engineering products to evaluate the export performance of these firms. A Bank summary of the findings recommended a series of regulatory changes to liberalize the sector, including ending the practice of requiring licenses to manufacture or obtain capital goods, technology, and raw materials. It recommended relaxing controls on the growth of large firms (medium by international standards), eliminating the preference that allowed only small-scale producers to manufacture products, and allowing exporting industries to import steel.

The lesson learned from this project is that industrial regulations can adversely affect the development of an industry. One of the primary benefits of Bank-sponsored restructuring projects is the influence they exert to liberalize policy constraints on growth.

**Box 2 Hungary**

In 1986 Hungary initiated a series of restructuring projects. These projects, which were tied to an overall economic reform program, provided assistance to a number of industries while pursuing comprehensive policy changes to liberalize the industrial sector. This included shifting from a centrally planned economy toward a more market-based structure. The loans had the following objectives:

- **Industrial Restructuring Project I (1986)** — Comprehensive design and initial implementation of a series of policy reforms for the plastics processing industry.
- **Industrial Restructuring Project II (1987)** — A second loan added rubber processing, agricultural equipment, and food processing machinery manufacturers.
- **Industrial Sector Adjustment Loans (1988)** — This program, to complement policy reforms, included:
  - Reducing budgetary support for inefficient enterprises.
  - Strengthening incentives for convertible currency exporting.
  - Facilitating entry of new enterprises and encouraging private sector entrepreneurship.
  - Reforming tax laws, pricing, and wage systems.
  - Reducing consumer and producer subsidies.
- **Industrial Restructuring Project III (1989)** — Sector-wide support, specifically for industries oriented toward exports to convertible currency markets. The program gives the banking sector responsibility for project appraisal and credit evaluation. It also provides support for small business and private sector development, and offers funding to alleviate unemployment due to restructuring and to create new jobs in regions most affected by job losses.

These restructuring programs were conceived as a series of projects over a five-year period (1986-90) and were tied to overall economic reform. They also covered a comprehensive package of industrial policy and regulatory reforms covering the following:

- Entry.
- Liquidation of unviable enterprises.
- Export promotion and overall trade liberalization.
- Price reforms for industrial products.
- Wage differentiation and worker mobility.
- Taxes.
- The establishment of a commercial banking system.
- Capital market development (the creation of venture capital funds).
- Enterprise management systems.
- Direct foreign investment.
- Technology development.

The major lesson derived from the Hungarian restructuring program is that restructuring needs to be thought of as a process of change. A series of restructuring projects addressing industrial policy issues as well as diverse industrial subsectors is perhaps the best approach, rather than developing an excessively complex, front-loaded, first project.
Box 3  Mexico — Steel

In 1986 the Mexican government moved to reduce financial losses in the steel industry and improve its overall competitiveness. The first steps focused on the state-owned Siderurgica Mexicana S.A. (SIDERMEX). The newly appointed managing director, who was given the assignment to restructure the company, addressed the firm's critical problems by:

- Closing Fundadora, a steel manufacturing plant in Monterrey, after unsuccessful efforts to restore its viability. The closure, which meant the loss of 8,000 direct jobs, signaled management's commitment to restructuring SIDERMEX.
- Selling, closing, liquidating or transferring to the government a large number of subsidiary and affiliated companies not directly involved in the steel business.
- Reorganizing SIDERMEX into distinct profit centers.
- Signing a Convenio (agreement) with the government on a medium-term restructuring program. In turn the government forgave the company $2 billion in external debt.

The World Bank's assistance to the industry supported the government's initiative with respect to SIDERMEX while also providing support for integrated private sector producers, principally HYLSA. The support for HYLSA followed a debt/equity conversion of $375 million with commercial banks. The objectives of the project are to eliminate policy distortions by:

- Removing domestic price controls.
- Eliminating official reference prices.
- Reducing and specifying uniform tariffs on steel products.
- Reducing and eventually eliminating government subsidies and transfers to producers.

On the technical side the project calls for:

- Closing down uneconomical operations.
- Reducing or eliminating production inefficiencies.
- Optimizing existing facilities in terms of product mix and markets.
- Carrying out economically justified investments to maintain existing facilities.
- Stressing quality improvement, quality control, and productivity improvement.

Additionally, the industry will need a market study to plan the long-term investments, and technical assistance to help develop the plan. Financial restructuring will be required for SIDERMEX, HYLSA, TAMSA, and other semi-integrated producers.

The lessons from this project are that:

- A mandate to restructure is essential.
- Physical rehabilitation alone will not bring required change. Restructuring programs often need to consider the complex dynamics of rehabilitation, managerial change, and financial engineering.
- Restructuring projects may require a two-stage approach — initial changes to stem losses, such as closing totally uncompetitive units, and longer-term, more strategic changes, thus combining elements of defensive and positive restructuring.
- Restructuring basic subsectors is often a vital precondition for overall industrial competitiveness because of the effect on downstream producers.

Box 4  Senegal

Senegal's 1988 industry restructuring project followed a series of structural adjustment loans aimed at improving the overall economic environment. A study by a major international consulting firm identified several subsectors for restructuring, including agro-industries, textiles, and chemicals (Lieberman 1989). Given the size of the industrial sector, assistance was not targeted to a subsector. Any firm that opted to restructure — if it was credit-worthy — was eligible for financial assistance. A restructuring line of credit was provided to the government to be downstreamed to commercial banking institutions, which are considered better suited to evaluate the restructuring programs and creditworthiness of private enterprises.

Other project features included:

- Strengthening the Ministry of Industry to provide project leadership.
- Social support for displaced workers, in the form of a small-scale enterprise fund and a worker retraining program.
- Information on the restructuring study and objectives.

Two major remaining constraints are rigid pricing policies and labor laws oriented toward government ownership.

The essential lesson from this project is that for relatively small economies, projects are best handled at the level of the industrial sector rather than the subsector. Sector-wide projects preserve neutrality and avoid potential distortions inherent in subsector selection.
**Box 5 Mexico — Industrial Restructuring**

As a result of the 1982 debt crisis, many overleveraged industrial groups in Mexico required financial restructuring. At the same time, sales of industrial products fell as a result of a sharp decline in domestic demand. In addition, the liberalization process, which began in 1986 with Mexico's adherence to the General Agreement on Tariffs and Trade, exposed the sector to import competition after many years of protection.

Based on a variety of criteria (Table 2), the project concentrated on improving the competitiveness of the textile, auto parts and agro-industries. (Wood furniture and shoe manufacturing were added subsequently as a result of studies by international consulting firms.) Mexican officials initiated a series of policy changes in the textile and auto parts industries to support the physical and financial restructuring measures.

The lessons from this project can be summarized as follows:

- Restructuring programs require strong institutional support from government, industry, labor, and the financial sector. Institutional arrangements that facilitate this dialogue are an important part of restructuring programs.
- Trade liberalization programs will often require a concomitant — but temporary — support for industry unaccustomed to competition, to avoid large-scale market failure that could derail liberalization efforts.
- Restructuring programs provide an essential bridge between the private sector and Bank-supported liberalization, structural adjustment, and other policy-based loans.
This chapter focuses on restructuring state-owned enterprises, since support for private enterprise restructuring is usually handled by local banks. While the World Bank does not normally provide finance for private enterprises, restructuring projects should consider private-sector issues in preparing and supervising all operations. The changes that are involved in restructuring an enterprise may be summarized as follows:

- Changes in a firm's technology and organization to increase efficiency and competitiveness.
- Changes in a firm's products and markets; revisions in internal strategies to compete in niche markets.
- Changes in management to improve productivity through retraining and retrenchment.
- Changes in the relationships between public enterprises and the government to enable state-owned enterprises to invest and perform efficiently.
- Acquisitions and divestitures, leveraged buyouts, recapitalization, and down-sizing.

First, industry-wide and subsector restructuring operations need to reflect how enterprises are likely to respond to policy and institutional change. Demonstrating the links between policy distortions and poor performance by local firms can move the discussion beyond philosophical or theoretical differences. Officials are often disappointed at the slow supply response in the wake of adjustment and restructuring programs. In fact, the glut of imports, remaining rigidities in financial and regulatory systems, and a "wait-and-see" response could have been predicted if the preparation of the policy package involved systematic interviews with private entrepreneurs.

Second, an enterprise focus is needed to understand where firms are versus where they need to be to meet competitive pressures. Interviews with firms, combined with quantitative analysis, can help segment industrial subsectors by size, efficiency levels, and management practices.

A frequent assumption underlying many adjustment programs is that once policy changes occur, firms will respond automatically with efficient, competitive supply responses. In fact, firms and their bankers -- accustomed to catering to protected domestic markets -- are frequently only vaguely aware of global changes in technology, organization, and markets.

Public enterprise distortions

In many developing countries operations of public industrial enterprises involve heavy borrowing and subsidies, impenetrable barriers to internal and external competition, and a waste of financial, material, and human resources. Public debt and deficits have made such practices unsustainable. Most policymakers recognize that public enterprises must be restructured. In the case of large and powerful concerns, competition
policies normally will not be enough to offset the special deals these public enterprises usually receive: subsidies, sales arrangements with other public enterprises, and monopolies on sourcing, production, and sales. Public enterprises often have mixed mandates: to employ more workers than needed, to report to several ministries, to operate under politically appointed managers, to produce for specified industry or consumer needs, and to provide these products at financially unsustainable prices.

To unwind these distortions requires tough decisions based on solid analysis. Governments may be unwilling to open the sector to imports or local private competition if such competition would result in closing government-owned firms. Officials often are more willing to allow competition if concomitant measures are taken to enable the core businesses of public enterprise to become competitive -- and to survive.

What works and what doesn't

Before discussing the key elements for successful public enterprise restructuring, it is important to note what has not worked:

- Limited results have been achieved or can be expected through management information, performance evaluation, or performance contract systems. Improved transparency and management information systems are useful only as complementary systems once real power and financial arrangements (subsidies, transfers, special credits) change.

- Physical rehabilitation and financial restructuring have failed unless policies requiring competitive performance are introduced at the same time, and unless financial measures are combined with effective changes in management, organization, technology, and marketing.

Certain factors are basic to sound programs. Public ownership and monopolies of industrial enterprises should not be viewed as strategic. Officials should determine which enterprises to close, scale down, or privatize. Public or private firms should provide high-quality goods and services at competitive prices. Other objectives almost always are pursued poorly and at high cost. For example, steel plants should be expected to make steel of world quality and price. Steel plants should not be seen as employment generators, sources of backward area development, or captive suppliers of downstream industries. The cost of overemployment is extremely high: poor morale, low productivity, poor product quality, and the high cost of intermediate goods to domestic users.

The objective should be to reduce and eventually to remove producer and consumer subsidies. They muddle decisionmaking and make performance evaluation difficult. If importing is advantageous, governments should allow imports. If governments will not allow competition, or if additional investments will not result in world-class output, restructuring programs do not warrant support. Governments should not invest in new capacity in a chronically uncompetitive subsector. The rationale for public enterprise restructuring often is to downsize and liquidate uncompetitive firms for damage control. Such operations can be important in stopping a major drain on the budget and in reducing government resistance to liberalizing imports of basic industrial intermediates.

In most developing countries more than 80 percent of assets, employment, and output in public industrial enterprises is accounted for by steel, fertilizers, petrochemicals, mining, and telecommunications. Public enterprise restructuring operations could support trimming all but the basic core capacities from these companies. The practice of basing major adjustment or restructuring operations on liquidating or privatizing small, unimportant industrial public enterprises does not appear to be justified. Utilities usually are much more important than industrial enterprises in terms of debt, fiscal drain, assets, employment, and social impact. Restructuring utility tariffs requires major changes in management, operations, regulation, and privatization of certain functions. Liquidation is not an option, since these sectors provide basic, nontradeable services. In contrast, public enterprises in tradeables may opt out of the industrial base -- which greatly increases the restructuring options.

For industrial enterprises that remain in the public sector, government must become an arm's-length shareholder, and firms must behave as commercial concerns. Governments need to tighten their levers on public enterprises in the areas of debt, major new investments, and operational results. Intervention in procurement, employment levels, and operating decisions needs to be reduced. It is crucial that the operating
management and boards of directors of public enterprises consist of professional managers with relevant knowledge and experience.

Holding companies are important only if they break the pattern of public intervention and public subsidies. Holding companies must have budget responsibilities for public enterprises and must be free to liquidate, privatize, or form joint ventures for all or part of these companies. They need to be free to make or delegate all ownership, management, organization, and company strategy decisions. Without this level of autonomy, holding companies are just another layer of control; they represent another layer of overhead as well.

Turnarounds in major public enterprises have never been achieved with rehabilitation alone, when policy and organizational issues are left to be developed at a later date. A concrete, convincing program of measurable action must be agreed to by enterprise managers and by all key government officials.

Public or private monopolies cannot be expected to develop competitive behavior. If domestic markets are large enough for strong competition among multiple public and private enterprises, removing domestic entry barriers can provide a start in breaking up monopolies. For most developing countries, however, competition in basic intermediate industries will come from imports.

General trade and industrial policy measures may not provide enough stimulus. To create real competitive policies and capabilities, joint ventures or strong collaborative arrangements with successful foreign firms can be key. Such collaboration can provide domestic firms with funding and provide needed technology and marketing knowhow.

Policymakers have to deal explicitly with eliminating overemployment and reducing inflated wage bills. Attractive severance payments can be successful in getting voluntary redeployment of labor. Retraining can also be critical. Operations focusing on one or a few specific public enterprises normally are poor vehicles for policy and institutional change at the industrial level. Reshaping a few dominant enterprises can have a major economic as well as demonstration effect, but usually it is important that restructuring operations be pursued under a subsector framework. This perspective helps to maximize over-all economic welfare and competitiveness objectives, rather than serve the survival interests of a dominant enterprise. The most critical element is a commitment for major change by the central government, relevant ministries, and affected enterprises.

Privatization redefined

Privatization to achieve competitiveness and to reduce political interference is part of restructuring. A major government dilemma is whether restructuring should precede divestiture. Privatization without restructuring usually results in a low price for the enterprise. But restructuring to gain a better purchase price is difficult. Most of the factors that caused the poor performance in the first place remain. It is difficult to motivate management and staff to improve performance if their jobs will be at risk from privatization. And restructuring measures pursued before privatization may differ markedly from the direction intended by the subsequent buyers.

Selling public enterprises poses other formidable obstacles. The number of potential buyers is often limited. Governments may offer purchasers special privileges that result in private sector monopolies with distortions even larger than under government ownership. Political opposition may delay the sale. Finally, capital markets in developing countries often are inadequate for absorbing divestitures.

The means to increase private participation in the ownership and management of public industrial enterprises include employee buyouts, leasing of assets, direct sales of all or part of the enterprise, offloading of marginal activities, and formation of joint ventures with local or foreign private partners (Vuylsteke 1988). The potential benefits include efficiency, a reduced drain on scarce public sector resources, improved private sector access to domestic capital markets, greater depth and breadth of capital markets, and more transparency, disclosure, and accountability in the industrial sector.

Physical, organizational, and financial restructuring

Physical restructuring encompasses upgrading or replacement of obsolete plant and equipment, introduction of new technological processes, and
investments to improve overall capacity utilization and energy efficiency. Plant closure can be considered part of physical restructuring. A broader definition of physical restructuring could include relocation of production facilities to take advantage of lower wages, better skills, advantageous market access, infrastructure, or manufacturing synergies. Restructuring through relocation has been significant for firms in industrial economies, particularly in East Asia.

In most stand-alone rehabilitation projects, the actual financial and economic rates of return on Bank-assisted rehabilitation projects tend to be similar to those prevailing in the subsector. In most cases problems in these operations did not arise from poorly conceived physical restructuring programs but were a result of the fact that these physical investments took place without complementary changes in organization, management, and methods, without a strong marketing and product mix strategy, and without policy changes to induce competitiveness.

Recent restructuring operations give more attention to these dimensions. Frequently, pricing policies have been modified to reflect world market prices and to eliminate subsidies. Privatization, closures, mergers, joint ventures, and technology licensing have been used to galvanize enterprises into meeting competitive pressures. India's cement industry rehabilitation focused primarily on improvements in energy utilization but also dealt with pricing structures. Jamaica's sugar project supported industry consolidation through closure of some plants and rehabilitation and modernization of others. In addition to substantial funding for plant rehabilitation, the Mexico steel sector program supports the government's decision to close a state-owned steel company and divest itself of nonessential and unrelated subsidiaries.

Managerial or organizational restructuring incorporates measures to revise organization, improve capacities, and adjust human resources for production, marketing, and financial gains. These changes often are more important for competitive performance than improvements in capital stock. Successful penetration of export markets requires not only productive efficiency but also attention to quality, service, innovation, product differentiation, and market segmentation. Unsatisfactory results often reflect inadequate attention to these dimensions (see Table 3). Two recent projects reflect attention to managerial and organizational elements of restructuring. The Bangchak oil refinery in Thailand (see Box 6) illustrates the benefits of public enterprise autonomy. It was removed from the control of the Ministry of Defense in 1984 and established as an autonomous commercial company. Box 7 describes the textile project in Tunisia which dem-

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Table 3: Organizational and managerial aspects of enterprise restructuring

<table>
<thead>
<tr>
<th>Product and market reorientation. Changes in product, market or customer mix; shifts from domestic market focus to export standards, sales, and distribution channels.</th>
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</thead>
<tbody>
<tr>
<td>Reorganization. Decentralization, creation of profit and cost centers, development of strategic business units, establishment of international marketing and sales offices, breaking-up parastatal monopolies.</td>
</tr>
<tr>
<td>Staff reductions and redeployment of redundant personnel.</td>
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<tr>
<td>Management planning, information, and control systems. More timely information for effective decisionmaking and improved enterprise accountability.</td>
</tr>
<tr>
<td>Enterprise autonomy. Changes in the composition and powers of boards of directors, appointment of professionally qualified managers, and contractual arrangements with governments to increase managers' accountability and minimize government political interference.</td>
</tr>
<tr>
<td>Management development and worker training. Programs to build professional and technical skills and to introduce new organizational methods.</td>
</tr>
<tr>
<td>Incentive compensation schemes.</td>
</tr>
<tr>
<td>Management contracts. To service business operations that lack specific managerial or technical skills.</td>
</tr>
<tr>
<td>Joint ventures, marketing arrangements, and investments with foreign companies.</td>
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</table>
onstrated the benefits of an integrated approach, combining plant and equipment rehabilitation, technology adaptation, and export marketing measures.

**Box 6 Thailand**

In 1984 Thailand reorganized and restructured the Bangchak Refinery, a state-owned oil company that had been operated by the Ministry of Defense. The Bangchak Petroleum Company was established as an autonomous commercial entity.

The main objectives of the project were to:
- Assist the government with the legal, organizational, managerial, and financial restructuring necessary to improve production.
- Reduce the cost of Thailand’s domestic petroleum requirements (the refinery was operating at 78 percent of rated capacity).
- Determine the modifications necessary to balance long-term supply and demand.

This required expanding the plant to increase capacity utilization and improve operations; implementing energy conservation measures; improving infrastructure, including provisions for flood protection; providing technical assistance; and commissioning a study on output and demand.

The primary lesson learned from this project was the benefit gained from establishing state-owned enterprises as autonomous firms free from government intervention.

**Financial restructuring**

Financial restructuring may be necessary since many large parastatal and private enterprises in developing countries acquired significant external debt in hard currencies, at variable interest rates, and with increasingly short maturities during the last decade. Subsequent debt restructurings have allowed many of these enterprises to postpone repayment, while others have converted external debt into domestic debt under government-sponsored conversion schemes.

Additional objectives include: eliminating subsidies and government transfers of resources to the entity; financial autonomy, including the ability to borrow from commercial banks, to float shares and bonds, and to enter into joint ventures with domestic and foreign investors; and finally, the creation of a heterogenous capital mix suited to the financing needs of the enterprise. Because capital markets are poor in many developing countries and many public enterprises earn little or no profit, financial restructuring normally requires debt relief, including writing down non-productive assets. These steps are particularly critical for privatization, as are asset sales to down-size companies, debt-equity swaps and joint ventures, and additional financing. New instruments, such as convertible debentures, convertible preferred shares, shares and bonds can help diversify funding sources and provide greater accountability.

**Social dimensions of restructuring**

Virtually all industrial restructuring programs displace workers. Layoffs related to industrial restructuring, however, normally do not affect the poorest of the poor. The affected groups often are unionized and politically active, or are members of the protected managerial elite. These powerful vested interests can resist proposed reductions in the work force and seek significant compensation. They often have the political power to block restructuring measures. Governments need to recognize and address this potential source of resistance by developing severance

**Box 7 Tunisia**

SOGITEX is Tunisia’s largest and only publicly owned textile group. Its major subsidiary, SITEX, invested in spinning equipment to improve the quality of yarn for denim exports. Complementary investments were needed to raise the quality and to produce the broader fabric widths required to serve the European market. The project had three components:
- Rehabilitation, modernization, and expansion of SITEX’s production facilities.
- Investment in production know-how and spare parts.
- Technical assistance for all of SOGITEX’s subsidiaries.

Management officials and foreign consultants encouraged SITEX to purchase new looms, and funding was increased accordingly. Parallel improvements in technology allowed SITEX to become a major supplier of denim to the European Economic Community. A joint venture agreement with a Swiss firm was also crucial, as was the decision to strengthen SITEX’s management.

The lessons learned from this project are:
- The importance of comprehensive restructuring efforts rather than one-dimensional rehabilitation projects.
- The need to choose technology appropriate to international competitive demands.
- The benefit of international commercial ties to promote exports.
and retraining schemes, and by showing that eventual job losses often are greater without than with restructuring.

While few industrial restructuring projects have dealt directly with the labor consequences of restructuring, the Senegal project is an exception. Here planners estimated likely job losses with and without restructuring. They reported that of the 5,000 estimated layoffs resulting from the project, approximately 3,000 would have taken place as a result of declining competitiveness. This information proved instrumental in overcoming opposition to the restructuring program, which also incorporated innovative solutions for labor retrenchment and retraining. The restructuring projects in Hungary, begun in FY86, address the issue of layoffs, and the Mali public sector project calls for establishing a government fund for worker retrenchment.

Some layoffs may affect a particular geographic constituency or ethnic group: the regional concentration of layoffs in sectors such as mining creates major social and political problems. The skills required in new jobs may differ substantially from those of the displaced workers. In countries that lack a safety net to meet basic retrenchment needs, the government may have to take a direct role in retraining, relocation, and employment-generating programs.

**Defusing the Political Problem.** In surmounting political opposition to a restructuring project, it may be possible to identify vested interests and respond specifically. Consulting with opposing groups, such as unions, at an early stage of project preparation can help overcome opposition. The best response is cost-effective assistance programs that show the government is responding to worker needs. Measures can include severance payments, assistance in finding new jobs, relocating, retraining, or developing small-scale enterprises. The savings generated by the programs can often justify the costs of such assistance. But not all programs are effective. Job retraining is not useful, for example, if there are no related jobs available; in fact, it could result in unrealistic expectations.

**Severance Payments.** Severance payments can compensate workers for job losses. The relevant issue is what is an appropriate payment? This issue is especially difficult in public sector restructuring, which involves civil servants who expect lifetime employment. Frequently the provisions of their termination are limited, without contractual arrangements for compensation. In lieu of any other methods, estimating how long the worker will be out of the civil service serves as a benchmark. This procedure yields an approximate calculation of the savings to be achieved by laying the worker off.

Equally important is how to structure the payments to retain qualified workers when voluntary departure schemes are in effect. To prevent the loss of the best qualified workers, higher salaries and a merit-based incentive scheme may be offered. Such measures were part of a project involving the Bolivian Central Bank, where the work force was reduced from over 1,000 employees to less than 400. The savings were adequate to give attractive severance packages to redundant workers and to pay increased salaries for those remaining on the job. Some qualified staff did leave, but the increased salary levels attracted new talent. The potential loss of trained human capital, both managers and workers, is a serious concern. Several steps to help employees reenter the work force are outlined below.

- Assistance in finding new jobs. This can include support facilities for job search, career counseling, and relocation.
- Retraining programs. Based on expertise, performance, ability, training, education, and ambition, retraining programs might focus on areas of immediate need or those in which demand is expected in the future. Refresher or skills maintenance courses could assist those expected to fill vacancies in the short term.
- Development of entrepreneurship. Programs could provide screening for entrepreneurship potential, help with project development, and training in key business, finance, and marketing skills. Professional assistance in project preparation and presentation could improve the likelihood of obtaining funding for new microenterprises. Special arrangements can be made to use severance pay as equity investments in new businesses.
- Employee buyouts. Programs to facilitate employee buyouts could give workers assistance in basic finance, management, and marketing techniques. Programs could provide help for the transition to new ownership and for management of the enterprise during the early stages.
The industrial restructuring process can succeed only if adequate financial resources, supplied by an efficient financial intermediation system, are available at reasonable cost. When the financial system is in deep distress, and when most banks in the system are unsound, financial sector adjustment operations are the appropriate vehicles, since further lending through financial intermediaries would only worsen the problem.

Industrial restructuring and other loans through financial intermediaries may help with incremental institutional improvements, provided that such operations involve sound and solvent banks. Industrial restructuring operations could be particularly useful in: building knowhow among good bankers on what it takes for industrial firms to be internationally competitive; and in introducing new financial instruments and eligible expenditures consistent with sound corporate restructuring. Industrial restructuring operations can assist governments in:

- Working directly with competent, financially sound banks, with increased use of commercial and investment banks;
- Introducing basic principles of corporate finance into financial intermediation projects; and
- Expanding the range of financial instruments and eligible expenditures available to industrial firms engaged in restructuring.

Adjusting financial sector policies

In many developing countries excessive market regulation and government intervention in the financial system are prime obstacles to efficient financial markets and intermediation systems. At the same time, tight interest rates and extensive directed credit schemes seriously distort resource allocation and limit competition among intermediaries.

As a consequence market deregulation is a key element in financial sector reform. Reduction of forced reserve requirements and mandated investments, accompanied by contraction of public sector borrowing (or publicly financed directed credit schemes), would help lower interest rates and halt the crowding-out of private sector borrowers. Interest rate deregulation is particularly important in ensuring an adequate risk-return profile for commercial bank lending and in fostering competition among intermediaries.

The impact of economic and financial crises is reflected in the low operating returns and high gearing ratios evident in the income statements of many intermediaries. These published data in fact often underestimate the problems: they do not reflect banks' insufficient loan loss provisions, and they include accrued but unpaid interest on doubtful loans. Many banks' financial problems are due mainly to difficulties with loan recovery, a situation that persists despite various refinancing attempts and debt dilution schemes. In addition overvalued fixed assets, revalued on the basis of general price indices, misrepresent the real financial situation.

Despite the troubled financial condition of many banks, the shake-out process, whereby the system adjusts to the demand for intermediation,
is slow, largely because the orderly exit of intermediaries and clients is difficult. The threat of bankruptcy is the ultimate incentive to improve product value and production efficiency. In many developing countries, however, government regulation and reluctance to let large banks and enterprises fail have impeded the liquidation or serious restructuring of inefficient market participants.

A special problem is the poor discipline and performance of many public banks. In these institutions the political pressure to make heavy investments in capital-intensive but unviable SOEs (state-owned enterprises) has impeded sound analysis of creditworthiness and decision-making. Adequate supervision, financial and operational restructuring, and a redefinition of the public role of banks and their relation to commercial banks are important issues in financial sector reform.

Traditionally, supervision and control have focused on compliance with central bank rules governing reserve requirements and interest rates. Portfolio analysis and operating efficiency have received less attention. Inadequate systems for assessing the quality of portfolios is the more serious problem. Current systems typically confute loan arrears (which may or may not result in losses) and risky loans (which may or may not be in arrears). Information on the performance of individual banks is severely limited — balance sheets and income statements appear infrequently, if at all, and do not address portfolio quality. The practice of allowing loans in arrears to accrue interest until the borrower is liquidated distorts banks' income statements. Unclear liquidation procedures, especially regarding loan and asset recovery, are problematic. Loan loss provisions often become obligatory only when the borrower goes bankrupt.

Banking supervisors are reluctant to intervene in a bank situation before portfolio difficulties cause financial collapse. As a first step in strengthening supervision and control, bank supervisory agencies should introduce portfolio classification systems that focus on the probability of default rather than on analysis of arrears in evaluating portfolio quality and exposure to risks.

Assisting financial restructuring

Investments in equipment and working capital may require parallel financial restructuring. In situations of massive instability and devaluation, financial restructuring can be essential. Restructuring a company's liabilities can include:

- Extending the maturity of a company's liabilities, and avoiding the negative cash flow impact of high nominal interest.
- Consolidating the company's debt particularly if there are a large number of creditors and loans of varied sizes. A smaller number of creditors may be essential to achieve the necessary agreements on debt write-off, debt-equity conversions, maturity extensions, and additional funds for future growth.
- Converting part of the debt into some form of equity. Although the average debt/equity ratio of the industrial sector in many developing countries has improved over the last few years, many companies are still overleveraged. Their high debt level and the associated financial costs are causing substantial liquidity problems that prevent their generating resources for new investments.
Experience suggests there are a number of important points concerning industrial restructuring:

- Restructuring is a dynamic, often highly politicized process. The prospects for successful implementation can be enhanced if the main participants are committed to the project's objectives, are involved in all its phases, and feel that the restructuring program fits local conditions. Governments can help build a consensus for restructuring by identifying players with the power and competence to mobilize political will. Government involvement and dissemination of information to government agencies, private enterprises, and financial leaders is critical. Institutional arrangements to ensure broad participation in preparing and supervising industrial restructuring operations are essential to the success of restructuring operations.

- Industrial restructuring operations should respond explicitly to rapid changes in global markets and technology and to sharp shifts in economic policies. Due to the uncertainties and difficulties inherent in change, the timing and dimensions of the supply response from restructuring are difficult to predict. Restructuring is an inherently risky business.

- Global economic studies of the business environment provide the parameters for judging whether restructuring moves by enterprises are consistent with internationally competitive performance. A firm's ability to compete in world markets is key. Increasingly, this ability depends not only on factor prices and scale economies but also on the firms' flexibility and organizational, technological, and marketing strengths. The studies outlined earlier on the textile industry in Turkey, the rubber industry in Hungary, and the auto parts industry in Mexico compared these enterprises with leading competitors worldwide. Global studies that assess cost and quality dimensions, analyze production, marketing, and management methods, and identify key factors in the success of emerging firms can establish the foundations for successful structural adjustments.

- Restructuring projects that deal primarily with physical aspects — without giving adequate attention to regulatory policy issues, ownership, and organization — have only a limited impact. It is also important to address other constraints to restructuring, such as protection of monopoly public enterprises, restrictions on direct foreign investment, trade liberalization, and major barriers to entry, exit, and expansion. Improvements in management, new product development, marketing and export capabilities, product quality and service, and applied research and development are likely to yield higher returns to developing country enterprises than increased investment in plant and equipment.

- Industrial restructuring operations should reinforce competitive pressures. Monopoly status of critical industries — steel, mining, petrochemicals, and fertilizers — often has serious adverse effects on the competitiveness of user industries. Most monopoly parastatals are a significant drain...
on government budgets, and in most cases are grossly uncompetitive. Ideally, inefficient basic industries should be dismantled. At a minimum barriers to competition should be removed by liberalizing imports, breaking up monopolies, and encouraging private sector entry. If possible, efficient private producers should be lured into the market while competitive pressures are being created.

- Governments should establish minimum policies for competitive restructuring, that is, the need for regulatory, pricing, and public enterprise reform. Reform programs should be part of the restructuring or supported by parallel adjustment operations.
- A risk in complex public sector reform programs is that industrial restructuring will not get adequate attention. A coherent, sequenced restructuring program can take into account the need to adjust the program in response to the changing environment.
- The quality of financial intermediation is critical to the success of private sector restructuring projects, particularly in countries suffering from severely distorted fiscal policies and banking insolvency. In situations of severe financial sector distress, financial sector restructuring normally needs to precede restructuring of the industrial sector. Also, firms accustomed to operating in protected suppliers' markets — and their bankers — often do not have information on organization, technology, and marketing strategy needed for an effective outward-oriented supply response.

* Government criteria for determining eligible expenditures frequently do not reflect the range of financing needed for effective restructuring. Marketing, research and development, retraining, and production system financing should be included in eligible working capital financing.
* Most restructuring projects do not address political and social aspects. Too often preparation is elaborate. Major delays may mean missing the opportunity for decisive government action. Restructuring almost always has adverse short-term employment consequences. It may be appropriate to make financing available for worker retraining and to encourage counterpart funding for severance payments. Innovative programs could mitigate the political barrier to restructuring that labor organizations often represent. The impact on employment, with and without restructuring, should be analyzed since employment losses without restructuring may be even more severe.
Subsector Restructuring


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