Making Privatization Work

Since 1982, some 68 countries have received support for privatization through 234 Bank operations. Privatizations in these countries totalled about 2,440 by 1992. An OED study finds that Bank policy in support of privatization is adequate and well articulated, but needs to be applied sensitively to specific conditions.* Success depends heavily on the government's commitment to privatization, on the borrower's administrative capacity, and on the level of development of the private sector in the country at large. It has been hardest to achieve in low-income countries, where political commitment to privatization has been weak and where the environment for private enterprise has often been difficult. The study draws lessons for the future.

Mixed record

By 1992, governments in Bank borrowing countries had raised $60 billion through about 800 privatization transactions, with $23 billion raised in 1992 alone. Support has broadened and grown rapidly in recent years, with the widespread adoption of privatization as a central part of economic restructuring. Most of this support has been associated with adjustment operations (see figure).

Though it is too soon to judge long-term effects, the immediate benefits have been substantial for some countries. Successful privatization, like public enterprise reform, has often required continuing Bank involvement over many years and many operations.

Bank policy on privatization is amply documented and soundly articulated. In most cases, Bank assistance conforms to best practices. But in several instances, policies and practices have not been well enough adapted to specific country conditions, resulting in poor outcomes.

The poor outcomes have been of two types: (1) transactions were not completed or were reversed; or (2) transactions were completed but the expected benefits—efficiency, fiscal deficit reduction, social benefits—were not achieved. The main reasons for these shortcomings were: inadequate assessment of country conditions—which raised the risk of slow/partial implementation or policy reversals—or design defects—which led to smaller benefits than planned. Experience emphasizes that for privatization to work, close attention must be paid to the specific country conditions and to the design of the program itself.

Country conditions

Privatization has worked better with political commitment to the privatization process; administrative capacity to implement the program; macroeconomic conditions, policies, and regulations that encourage economic competition; and a private sector that can take advantage of market opportunities. Not surprisingly, higher-income countries with strong government commitment, robust private sectors, and greater administrative capacity have had more success with privatization. In low-income economies, results have been disappointing at times.

Political commitment

Privatization can redistribute wealth and rents immediately. But because the beneficiaries of public enterprises (including workers, managers, and civil servants), are identifiable and well organized, and potential beneficiaries frequently are not, considerable political skill is needed to keep a privatization program on track. Privatization programs that are not strongly supported by the government are likely to fail at the first political challenge.

Where political leaders are committed to privatization, the Bank's support can be highly effective. Argentina, for example, executed a broad privatization program very quickly, with technical and financial inputs from the Bank. In Morocco, the government invited the Bank to

*World Bank Assistance to Privatization in Developing Countries' Report No 13273, August 19, 1994. OED reports are available to Bank executive directors and staff from the Internal Documents Unit and from Regional Information Services Centers.
Loan conditions on privatization feature increasingly in adjustment lending

<table>
<thead>
<tr>
<th>Year</th>
<th>Number of Adjustment Loans</th>
</tr>
</thead>
<tbody>
<tr>
<td>1987</td>
<td>20</td>
</tr>
<tr>
<td>1992</td>
<td>30</td>
</tr>
<tr>
<td>2002</td>
<td>50</td>
</tr>
</tbody>
</table>

analyze the public enterprise sector and build on privatization proposals made in internal studies.

Among low-income borrowers, government commitment to privatization programs has consistently been lacking.

The following questions may help to measure government commitment to a privatization program:

- Have the country’s leaders expressed their commitment to privatization widely?
- How broadly based is that commitment?
- To what extent did the country move toward privatization on its own, before seeking Bank support?
- How much of the country’s own resources will the government commit for privatization?

Implementation capacity

Privatization is a complex undertaking. A government must be able to analyze policy issues, make legal changes, choose among alternative privatization methods, and complete deals transparently. All of these capabilities are weaker in poorer countries. Foreign consultants can help to some extent, but their overuse increases costs, raises the risk that plans will not fit local conditions, and lowers national involvement in and accountability for the program.

Privatization requires more skill and more information than many other reforms. While prices, tariffs, or interest rates can be deregulated fairly easily, the choice of enterprises to be privatized is not only politically controversial but requires sophisticated technical analysis based on up-to-date information (e.g. on sales, profits, assets, and liabilities).

Policies and regulations

Privatization does not itself guarantee that an enterprise will perform better. Ownership needs to be transferred under conditions that promote competition and discourage monopolies. Experience shows that the benefits from privatization are most sustainable where competition is free, the economy stable, and the regulatory sector strong.

Level of private sector development

Privatization succeeds better where the private sector and market-supporting institutions are well developed. In developing countries, privatization alone cannot be expected to create a strong private sector; where the private sector is weak, it may be advisable to postpone major privatization moves and concentrate instead on reforming public enterprises and developing the private sector.

Program design

Preparation

Preparation for privatization requires:
- analysis of potential candidates for privatization;
- asset valuation for enterprises to be privatized;
- restructuring plans for enterprises to be retained;
- development of sales techniques, a marketing campaign, and a timetable;
- assessment and establishment of appropriate institutional arrangements within government to implement the program.

Privatization as a process. The early steps of a national privatization program, though often time-consuming, can be vital in paving the way for sustainable privatization. Progress in the early stages should be judged not by the number of firms divested or the amount of assets sold, but by the extent to which suitable macroeconomic policies and the legal/institutional basis for privatization have been put in place.

In countries with market-friendly policies, strong administrative capacities, and strong private sectors, rapid privatization may be the right goal. But in other countries, where more effort is needed to create the necessary capabilities, privatization is better thought of not as an event, marked by the transfer of assets, but as a process of policy changes and institution building activities.

Structural reforms and sequencing. Privatization works best when macroeconomic conditions are

Definitions

Privatization is any transaction that reduces a government’s ownership in, or control over, a public enterprise. The Bank provides technical and financial assistance for restructuring the policy environment to make it more favorable to private economic activity, developing the institutional framework needed for privatization; and evaluating, classifying, and marketing potentially salable enterprises and drawing up specific plans for privatization.
stable. Liberalizing first and privatizing later has advantages; when privatization proceeds ahead of reforms to free trade and domestic interest rates, there is a high risk to the outcome. Privatizing prematurely and giving buyers such special privileges as protection from competition can in fact slow the pace of liberalization, as in some cases in Latin America.

**Speed and scope of privatization.** Experience in some Latin American countries shows that with strong local support, successful large-scale privatization can be accomplished swiftly. But in several cases, rapid privatization has resulted in poor quality. In the rush to complete transactions fast, too little attention is given to procedures for selling public enterprises, selecting buyers, defining regulations for monopolistic enterprises, restructuring firms before sale, and dispersing the ownership of the privatized firms. All these problems have arisen in Argentina and the transitional economies, despite considerable Bank help and government efforts to avoid them.

Haste may also lower the returns to privatization. A tight deadline weakens the government’s bargaining power with buyers, putting too many assets up for sale at once. Mexico has used a long lead time to good effect.

Some developing countries may do best by beginning on a small scale and learning by doing. Small firms can either be liquidated or fully divested. With larger firms, the government can either sell a minority share through the stock market, as in India and Turkey, or fully divest its minority shareholding in mixed enterprises, as in nearly half the privatizations in Senegal. With a gradual approach the stakes are relatively low; the measures needed are less likely to be controversial, to involve restructuring or difficult regulation issues, or to prove unaffordable to local investors.

**Sale**

Privatize while promoting competition. The Bank’s support for the removal of monopolies, the reduction of rent seeking, and the introduction of legal frameworks that encourage efficient private sector activity has successfully fostered competition. Privatization in the tradables sector should introduce safeguards for the general encouragement of competition.

Restructuring. Where an enterprise can be sold without impairing its value, it should be sold without restructuring. Generally, however, some form of legal, financial, and organizational restructuring is needed. In very large enterprises, assets may need to be divided, to promote competition and improve sales prospects. By undertaking limited financial, legal, or organizational restructuring before a sale, governments may be able to enhance the real value of the enterprise. But when an enterprise has already been chosen for privatization, physical restructuring that calls for additional investment should be avoided.

Core enterprises and regulation. Core enterprises are those public enterprises that are large in relation to other firms in the country and whose market share borders on monopoly. Core privatization can do much to shore up government finances. In Mexico, privatizing the national telephone company raised more money for the government than the sale of the 723 firms privatized before it. Core privatization can also yield foreign exchange, and create large gains for consumers if it ends artificial monopolies.

Where public monopolies are being replaced, new anti-trust regulatory systems are needed as well as industry-specific regulations. The Bank should build on improved models of monopoly regulation, support the strengthening of regulatory agencies, and

**Recommendations**

**Approach privatization differently according to country circumstances.**—Taking account of the borrower’s commitment to privatization and of its implementation capacity and level of private sector development. Where commitment is assured, Bank assistance should concentrate on building capacity. Phased programs of assistance may be part of such strategies. No significant assistance for privatization should be provided where borrower ownership of reform is weak.

Document and disseminate best practices. Documenting and disseminating “best practice” privatizations—an effort already underway—will help staff deal effectively with specific issues as they arise. Best practices include:

- Perceptive institutional analysis.
- Systematic assessment of government commitment.
- A focus on the entire privatization process (rather than on raising the number of privatized enterprises).
- Flexible use of lending instruments (rather than excessive reliance on adjustment lending).

**Strengthen staff skills.** Many Bank task managers have mentioned the need to strengthen their own skills in the analysis of privatization transactions, enterprise management and finance, and institutional analysis critical to the privatization process. The implications for training, recruitment, and deployment of scarce expertise should be drawn.

Study companies after privatization. To ascertain the development impact of privatization.
examine rules for "unbundling" monopolies so that the activities being privatized can be exposed to competition.

Buyers. Selling public enterprises to local investors makes it more likely that the new owners will be motivated to improve performance. Listing of companies designed for privatization with the country's stock exchange will help broaden ownership. By opening privatization to foreign investors, countries such as Argentina, Mexico, and the Philippines have expanded the pool of bidders, found more qualified buyers, captured higher prices, and raised more foreign exchange.

Allocating risk. Governments often assume residual risks in privatized firms while relinquishing their claims on profits. Selling public enterprises on credit, for example, turns government equity investment in a public enterprise into a debt investment in the buyer (as in Bangladesh, Ghana, and Guinea). The same is true where state-owned banks are the main source of funds to buy privatized firms.

The Bank has discouraged governments from taking undue risks and urged them to privatize only on a cash basis. In the case of financial crises and insolvent enterprises, the Bank should encourage the adoption of bankruptcy as the model.

After-effects

Fiscal implications. Privatization operations need to consider explicitly how future financial flows will affect the public sector, and how the proceeds from privatization will be used. Government revenues from privatization can be large—for example, 15 percent of Venezuela's total revenues, and 13 percent of Mexico's, in 1991. Such proceeds can be effectively used to reduce debt, but should not be used to finance recurrent expenditures or to mask the continuation of unsustainable deficits.

Social implications. Some recent adjustment operations have indirectly helped finance severance payments for workers who stood to lose their jobs. This practice is controversial, and not reflected in the Bank's policy. Programs should include severance packages and training, arrangements for redeployment, and seed capital for laid-off workers, to the extent that these measures are affordable.

Transitional economies

The Bank at first favored the traditional sales method of privatization in transitional economies but, after this proved too slow, has increasingly supported mass privatization. In Hungary, which used the usual sales technique to the best effect early on, privatization had almost ceased by 1993. Poland's early experiences with public enterprise sales left many disappointed.

Mass privatization was first tried, with great success, by the Czech Republic, which equitably distributed ownership shares to all qualified citizens. In Russia, large concessions were granted to enterprise insiders. The lessons of mass privatization are not yet clear. The challenge is to develop ownership schemes that will lead to efficient management, and to establish a policy environment that will induce the new owners to undertake physical restructuring and technological innovation, shed labor as necessary, and take other measures to become competitive.

Bank management responds... Bank management agrees that there is a need for continued review of privatization processes and to distil and disseminate the lessons of experience. It notes that many of the Bank's departments and client country personnel have embarked on extensive training programs in privatization over the last three years. The Bank intends to hire more outside experts in FY95 with hands-on privatization experience. With regard to reforming public enterprises, management noted that improvements last longest when ownership changes. It accepts and strongly endorses the need for more intensive case studies of privatization experience and indeed has a number of efforts underway, particularly in Eastern Europe and the Former Soviet Union, to determine how best to support post-privatization needs.

The Joint Audit Committee discussed the study and the management response, and noted that executive directors would use the study as they considered projects submitted to the Board for approval. Speakers noted the need for better monitoring of progress and for the Bank to continue building up the staff skills needed to advise on privatization. They also noted that because successful privatization often requires measures to develop borrowers' capability, and legal and regulatory frameworks, the Bank may need to be engaged for longer than the typical timeframe of adjustment loans. Several speakers expressed strong support for the dissemination of best practices in privatization, and particularly welcomed efforts to promote the exchange of know-how among borrowers.

---

OED Précis is produced by the Operations Evaluation Department of the World Bank to help disseminate recent evaluation findings to development professionals within and outside the World Bank. The views here are those of the Operations Evaluation staff and should not be attributed to the World Bank or its affiliated organizations. Please address comments and enquiries to the managing editor, Rachel Weaving, G-7137, World Bank, telephone 473-1719. Internet: rweaving@worldbank.org

January 1995