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ASIAN DEVELOPMENT BANK INSTITUTE
Kasumigaseki Bldg. 8F 3-2-5 Kasumigaseki
Chiyoda-ku, Tokyo 100-6008 Japan
Tel: 81 3 3593 5500, Fax: 81 3 3593 5571
Email: info@adbi.org http://www.adbi.org

Policy Issues on Privatization

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Executive Summary of Proceedings

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Macroview

[¶] References are to paragraphs.

Privatization is grounded on the changing role of governments in the economic development process. The **rationale for privatization** emanated from the experience that state-owned enterprises (SOEs) could not live up to their development expectations in many countries. Governments increasingly recognized the need to get out of economic activities that competitive markets could do better, and instead have been focusing more attention on creating an enabling environment for private sector growth. [¶ 2, 3]

Privatization is vital for long-term development of the private sector, development of local capital markets and financing institutions, fostering an enabling environment that facilitates private initiatives and rewards risk-taking, enhancing dynamic as well as static efficiency in the economy, improving fiscal balances, and may promote democratization through the devolution of power. [¶ 4, 5]

The **driving force** for privatization and economic policy reforms must come from within developing countries, taking into account their particular socioeconomic and political context, and stage of development. [¶ 7]

While privatization is only a single element of economic policy reform, albeit an important one, **private ownership does make a difference**. There is an increasing amount of empirical evidence linking increased economic efficiency with private ownership. [¶ 11]

Privatization may result in increased **efficiency gains** due to less political interference in decision-making, the clearer link between staff remuneration with productivity and profitability, exposure of firms to financial market discipline as opposed to government support, and higher incentives to reduce costs. [¶ 12]

Three major preconditions are required for privatization to yield benefits: (i) irreversible political commitment to economic stabilization and liberalization; (ii) the accomplishment of necessary legal and regulatory reforms, such as the establishment of property rights, streamlined investment laws, and enforceable bankruptcy laws; and (iii) structural reforms across all economic sectors. [¶ 13]

Privatization is a **political process** and, therefore, requires political will, commitment and clarity. [¶ 14]

One of the main factors hindering the privatization process, particularly in developing Asia, is the limited expertise and capability of the governments in the design and implementation of privatization programs. Thus, **building of ca-**

pacity in government institutions is necessary before any successful privatization program can be undertaken. [¶ 16]

Menus of privatization programs are recommended according to objectives: upstream privatization requires refurbishment and divestment first, whereas non-core asset privatization should entail the sales of infrastructure first in order to enhance consumer surpluses and the value of non-core investment. Privatization of companies, on the other hand, may be best executed under a regulatory agency since this may add value and quality, and reduce both implementation and investment risks. [¶ 28]

It is also recommend that programs should have the following **ingredients**: tariff regimes that reflect costs with a competitive/transparent bidding process; a well-functioning public regulatory framework; setting up appropriate performance benchmarks; application of a consistent legal framework; flexibility with restructuring or unbundling; and risk-sharing, when appropriate. [¶ 32]

Economic growth may be achieved by **efficiency improvements** in the enterprise sector through: (i) improvement in corporate governance; (ii) imposition of financial discipline on enterprises such as phasing out of financial subsidy and budget loans, and introducing market-based financing mechanisms; and (iii) the promotion of domestic and international competition by strengthening liberal trade and investment regimes, and liberalizing input and product prices. [¶ 55]

Emerging Core Lessons:

- Privatization to a capable strategic investor generally works best, rather than to insiders or dispersed owners.
- The more open and transparent the privatization process (including openness to foreign investors), the better.
- Permit markets to be competitive by not restricting entry or imports. But if this is impossible by nature, regulatory capacity needs to be developed.
- It is also important to ensure minority shareholder rights.
- Finally, a key principle to follow is that practicality is better than perfection. [¶ 69]

South East Asia and the Pacific country participants reported that their countries have political will; a framework plan; appropriate institutions; appropriate employment policies; and are open to foreign investment usually up to 49 percent ownership. However, they noted two major problems in the privatization process. First, there is a need to increase public awareness of the privatization program. Second, if the privatized enterprises ran into difficulties, what should governments do? Should they bail them out? [¶ 76]

Representatives of the **South Asian countries** listed the following as ten major issues in privatization: (i) resistance from stakeholders; (ii) lack of proper preparatory groundwork such as policy, legal and regulatory frameworks, pre-privatization restructuring, and management capacity building; (iii) transparency of process such as the hold-up problem; (iv) lack of institutional reform in capital markets and the financial sector; (v) lack of political will, commitment, courage and clarity; (vi) inadequate valuation of assets/liabilities of SOEs; (vii) proper utilization of proceeds; (viii) social impact; (ix) absorption capacity of the market; and (x) long-term strategy, sequencing and post-privatization monitoring. What also comes out of this listing is that politics tend to dominate the process in South Asia. In fact, selling the 'concept' politically requires great effort. There are several groups who have roles to play in this process and privatization will be very difficult unless a consensus is reached. [¶ 77]

Participants from transition economies of **Central Asia, East Asia and South East Asia** indeed differ from each other concerning privatization in terms of commitments, approaches, speed and achievements. But one common problem faced by these economies, which is perhaps different from other developing economies, is that the market institutions are substantially underdeveloped. There is a broader question about precisely how to privatize and there is a need for high quality technical assistance. The group reported that the main motivating factors for privatization were *efficiency considerations*, *economic growth*, and *technological progress*. They identified change of the political and economic system and increasing burdens of the state sector as triggering factors. [¶ 78]

They reported that the **achievements of privatization** so far have been reduced burdens on the fiscal and financial system and improved economic efficiency, high economic growth and economic freedom for enterprises. Lastly, the group noted major difficulties such as: (i) low personal income; (ii) lack of strategic investors; (iii) employees' welfare; (iv) lack of market infrastructure; (v) corruption and lack of transparency; (vi) political factors; and (vii) the lack of high quality technical capacity. [¶ 79]

Further References

➢ **Institutional Aspects of Privatization: The Case of Viet Nam**
ADBI Working Paper, December 1999, Code 05-1999
by Sadrel Reza

➢ **The Institutional Foundations of China's Market Transition**
ADBI Working Paper, May 2000, Code 09-2000
by Yingyi Qian

Introduction

1. In his opening remarks, **Dr. Masaru Yoshitomi, Dean of the ADB Institute**, highlighted that privatization is not a new subject; nor are the fundamentals novel. However, experience so far suggests that it is easier said than done. He observed that the progress of privatization in the region has been slower than expected. There is great diversity of experience with privatization in the Asia-Pacific region whereby both policy and non-policy related factors have been responsible for its successful application in developing countries. More importantly, privatization is also a political process. Even where politics may not be a hindrance, weak institutional frameworks or technical capacities could pose major problems.

2. Dr. Yoshitomi went on to explain that privatization of state-owned enterprises (SOEs) has been an essential part of

the economic reform process that began worldwide in the 1980s, but somewhat earlier in developed countries where it was introduced as a deregulation process. Privatization is grounded on the changing role of governments in the economic development process. The rationale for privatization emanated from the experience that SOEs could not live up to their development expectations in many countries. Due to many inherent problems, scarce resources were being used less efficiently, and their fiscal implications were mounting. In response to these problems, governments increasingly recognized the need to get out of economic activities that competitive markets could do better.

3. Further, governments have begun to focus more of their attention on improving their role in development by ensuring an enabling environment for private sector growth. This recognition got further impetus in the early 1990s when governments, where possible, reduced their involvement by pursuing partnerships with the private sector in providing infrastructure, social services, and in protecting the environment. This approach greatly contributed to the process of re-balancing the respective roles of the government and the private sector in many developing countries. This period also coincided with the mass privatization efforts of 'transition economies' subsequent to the breakdown of the Soviet Union and the communist governments of Eastern Europe.

4. Privatization is critical to:
- the long-term development of the private sector, drawing on and contributing to efforts to strengthen market forces and competitive conditions
- develop local capital markets and financing institutions
- foster an enabling environment that facilitates private initiatives and rewards risk-taking
- enhance dynamic as well as static efficiency in the economy
- improve fiscal balances
- lead to a smaller, more efficient public sector

5. If implemented properly, privatization efforts can also contribute to the democratization process by encouraging greater participation by the population in the economic and political life of developing countries. This implies a broader income distribution and educative process, which helps people, particularly the younger generation, to understand the economic process in a different way from previously prevailing models in their respective countries. Strong and successful privatization efforts create new opportunities for potential private entrepreneurs and increase the number of people with a commitment to and a stake in the reform program.

6. However, there are difficulties in privatization. Privatization programs are frequently confronted with implementation complexities. While many countries have succeeded in reaping the benefits of privatization, there are countries where privatization processes have yielded only limited success and have not progressed much.

7. Dr. Yoshitomi emphasized that privatization is necessary and highly desirable, even though it is difficult and time-consuming to implement. Benefits from the implementation of successful privatization programs warrant the effort. Continued efforts to assess and apply the lessons of experience and the range of available options can contribute to future progress. However, the driving force for privatization and economic policy reforms must come from within the developing countries, taking into account their particular socioeconomic and political context, rather than submitting to outside pressure and blurred political will. In this context, the understanding of policy issues on privatization by the policymakers and senior government officials of developing countries must be enhanced and their institutional capability to develop a coherent privatization strategy and program should be strengthened through activities such as this.

Overview of Policy Issues

8. **Dr. R. B. Adhikari, Senior Capacity Building Specialist of the ADB Institute** who was also the officer-in-charge of the seminar, presented an overview of the major policy issues in privatization and enterprise reform. He explained that the term privatization encompasses a wide range of definitions. Narrowly speaking, privatization refers to divestiture or other techniques that transfer state-ownership to the private sector. In a broad sense, privatization includes subcontracting, management contracts, lease, and concessions of state-owned enterprises (SOEs) or part of it to the private sector. In many transition economies, instead of privatization, terms such as 'unbundling and corporatization', 'equitization', 'commercialization', 'restructuring', or 'reform without privatization' are used. Motivations for privatization vary significantly, but most of them are related to the changing role of the state in the economy. He said that the experience of Asian countries suggests that there are mainly three triggering factors for privatization: increasing burdens on the state from private sector development, as in East Asia; the change of political and economic systems, as in Central Asia; and low efficiency and profit loss in the economy.

9. He went on to highlight the very diverse trend that has evolved in privatization so far, related to the stages of development of political and economic systems. In the 1980s, divestment was a major policy reform, and early privatization focused on farming, retail trading, transport services, tourism, and processing and manufacturing. In the 1990s, the same trend continued in transition economies, particularly in Central Asian republics (such as Kyrgyz Republic and Kazakhstan) and Mongolia. The basic method was mass privatization of small industries or services, gradual privatization of medium and large manufacturing industries, and unbundling and corporatization of utilities, power and infrastructure industries.

10. In the 1980s and 1990s, a much more cautious approach was taken in other transition economies, such as the PRC.

Privatization has been selective and minimal, including some commercial banks and farming. It could also take the form of decentralization of ownership and partial privatization (as with town and village enterprises), or the simple reform of SOEs. In South Asia and the Pacific countries, privatization of SOEs has been minimal (e.g. India still has a large SOE sector). Privatization has gone beyond manufacturing and trading in Southeast Asia to include enterprises in utilities, power and infrastructure sectors. However, privatization in transition economies such as Lao, PDR; Cambodia; and Viet Nam has been slow for different reasons. Furthermore, where market structure is a problem, privatization may not necessarily lead to increased gains. Owing to this, adequate regulation to ensure efficiency and social welfare has emerged as a major post-privatization issue.

11. Dr. Adhikari noted that while privatization is only a single element of economic policy reform, albeit an important one, private ownership does make a difference. There is an increasing amount of empirical evidence linking increased economic efficiency with private ownership.

12. The main reasons for increased **efficiency gains** as a result of privatization are attributed to:

- less political interference in decision-making
- staff remuneration is more clearly linked to productivity and profitability
- firms are exposed to financial market discipline as opposed to government support (e.g., soft budget constraints)
- firms' cost-reduction efforts (also called x-efficiencies by Harvey Leibenstein)[1] are higher under competitive private ownership

13. Citing the recent papers by Aaron Tornell and John Nellis[2], Dr. Adhikari examined three major preconditions required for privatization to yield benefits. First, it requires an irreversible political commitment to, not just policy statements about, economic stabilization and liberalization. Second, governments should accomplish necessary legal and regulatory reforms that are required to facilitate the implementation of privatization programs, such as the establishment of property rights, streamlined investment laws and regulations, enforceable bankruptcy laws, measures to ensure open-competition and corporate governance, and public education. Third, governments should carry out structural reforms across all economic sectors. This is important because privatization programs and sector-level economic reforms reinforce one another. For example, financial and capital markets grow and improve as share ownership and the need for risk capital increase.

14. Banks and governments become obliged to look more objectively at enterprise viability based on a market-oriented incentive frameworks. Administrators of privatization programs often learn through practice, and their efforts gain credibility among potential investors as the reform program progresses. Further, as increasing numbers of independent actors demand better quality information, governments as well as private enterprises become obliged to provide it, which leads to increased transparency and good governance. Above all, he underlined that 'privatization is a political process; it therefore requires political will, commitment and clarity'.

15. Nevertheless, there are several **key obstacles to privatization**:

- lack of strong high-level political commitment to the privatization program
- inappropriate design of privatization strategy (in terms of scope, technique, sectors and institutional capability of the government)
- unclear and weak institutional framework: decentralized (ministerial/ provincial level) or centralized (such as an independent privatization committee under the head of state)
- poor preparation of enterprises for privatization or divestiture (such as inadequate accounting and auditing, treatment of losses, or social and environmental safety nets)
- insufficient transparency and flexibility in terms of the method of privatization, balancing ownership and control (corporate governance)
- vested interests of managers, employees and customers
- lack of appropriate legal frameworks (e.g., property rights, foreign ownership, bankruptcy laws)
- underdeveloped capital markets

16. Experience also suggests that one of the main factors hindering the privatization process, particularly in developing Asia, is the limited expertise and capability of the governments in the design and implementation of privatization programs. Thus building of capacity in government institutions is a must before any privatization program can be undertaken.

17. **Professor Colin Kirkpatrick of the Institute for Policy and Development Management (IPDM), University of Manchester,** added six issues for consideration for discussion in the seminar, namely: (i) it is important to distinguish between economic and financial profits (environmental impact, for instance, is not reflected in financial cost); (ii) policies need to be designed carefully in the case of imperfect competition as against the case of perfect competition; (iii) some gains, in terms of efficiency, from privatization may be short-term, but some others may only materialize over the long-term; (iv) there is an important match of demand and supply concerning privatization; buyers are needed for enterprises that the state is willing to privatize; (v) in assessing the impact of privatization, the concept of opportunity costs must

[1] Harvey Leibenstein, 1978, *General X-efficiency Theory and Economic Development*, Oxford University Press.

[2] Aaron Tornell, 1999, *Privatizing the Privatized*, Working Paper 7206, National Bureau of Economic Research, July 1999 and John Nellis, 1999, *Time to Rethink Privatization in Transition Economies*, Discussion Paper Number 38, International Finance Corporation.

be borne in mind; and (vi) means and ends should always be clearly identified and not mixed up; privatization, for instance, is a means toward an end (which can be characterized by, say, a higher level of efficiency).

Regulation, Governance, and Post-Privatization Measures

18. Dr. Paul Cook, also from IPDM, considered the question of why regulation may be required after privatization. He explained that markets are more likely to fail, i.e. suffer from ineffective competition, when a monopoly is privatized, as in the case of a utilities sector. When a monopoly exists, profit-maximizing enterprises set their prices above marginal costs, which is harmful because it reduces allocative efficiency. Monopoly may also reduce productive efficiency through two other channels, namely, insufficient incentives to cut costs and discouragement of technological progress (such as introduction of new products). Therefore, regulation is needed to limit market power even for privatized industries where a monopoly exists. The best result of regulation in this case is to reduce the price to the level that is equal to the marginal cost.

19. A good regulatory system must be based on three important characteristics, namely, benevolence, complete information and public interest. Information asymmetry between the regulator and the regulated is often the key obstacle to establishing an efficient system. Enterprises usually have the incentives and means to hide true information from the regulator. The problem of imperfect information may also be affected by the macro-economic environment and legal framework within which industries operate. Needless to say, enforcement of regulations is critical and depends on the efficiency of the judicial system, the rule of law and the extent of corruption. The usual regulations for corporate governance include policies to improve shareholder rights, take-over and bankruptcy rules, financial regulation, competition and regulation of monopolies.

20. How should an effective and efficient regulatory scheme be designed? It requires encouragement of enterprises to reveal private information and to reduce costs. But policymakers are often faced with a number of trade-offs in designing regulatory schemes, mainly because the objectives are diversified. The regulatory schemes, for instance, are expected to achieve allocative efficiency where the price is kept close to marginal costs, and productive or technical efficiency where the enterprise costs are kept as low as possible. They also need to minimize any detrimental distributional effects of monopoly pricing that may cause adverse social implications. In addition, regulations providing more information for consumers may simply impose excessively high costs on enterprises and discourage investment.

21. The simple role of regulation, however, is to prevent monopolies from setting prices too far above cost and to encourage sufficient cost-reducing activity. Dr. Cook said that the most commonly applied regulatory method is price regulation. But typically, price will continue to be higher than cost. Often the scope for transfers and complex tariff structures is limited. Price regulation, or price caps, involve a complicated process. Financial models are often used to calculate minimum returns that investors need to induce them to invest in the industry. Minimum profits also need to be devised for rewarding shareholders. At the same time, the operating costs are estimated. Adding the operating costs and minimum profits gives the required revenue. Based on the forecasted demand, a price cap can then be calculated into the financial stream.

22. Of course promotion of competition is, in theory, a better option. It is important to remember, however, that the dominant enterprise will always engage in anti-competitive behavior. So there is a great need for monopoly regulation and pro-competitive regulation. Competition itself can impact the effectiveness of regulation through improvement in information available for regulation and reduce risk of regulatory failure. Finally, Dr. Cook observed that the efficiency of the regulatory framework may be affected by many factors, including the degree of pre-privatization restructuring. Regulatory contracts may be too loosely specified. The conflict resolution mechanism may be cumbersome. In some cases, regulators intervene too much so that efficiency falls significantly.

Implementing Privatization Programs: The ADB Experience in Pakistan Power

23. Mr. Sadiq Zaidi, a Senior Project Engineer of the ADB's Infrastructure Department (West), made a presentation on the key issues in implementation of privatization programs, drawing on the ADB's substantial experience of assisting the Government of Pakistan in the restructuring of its power sector. The power sector in Pakistan suffered from a number of problems before privatization. The operation of the utilities was inefficient, power theft was common, and the non-payment of arrears was widespread. The institution was very weak and the appointment of senior management and staff was politicized. Pakistan learned some lessons from the financial crisis in the power sector. Weak governance was mainly due to absence of an independent power sector regulator. The power sector lacked a private sector for competition and efficiency gains, nor was there a consumer advocacy group. Critically, the financial crisis affected the poor segment of the population more than the affluent.

24. A conclusion was then reached that a new form of public sector management could rescue the power sector from its crisis. Radical reforms and tough adjustment measures were needed to restore viability in the sector and make it self-sustaining. The ultimate goal of such change was to achieve economic efficiency and consumer satisfaction. However, there were other motivating factors, of which the most important was that Pakistan was facing an unprecedented financial and economic crisis that threatened the country's financial solvency. Mr. Zaidi said that the reform strategy covered four directions. First, the power sector was to be restructured by breaking up the sector's monolithic, vertically integrated power utilities. Second, the state-owned assets in generation, distribution and transmission were to be unbundled and sold as separate business entities to the private sector under market-based conditions. Third, an independent regulatory body was to be established. And, finally, the government's financial support to the power sector, including guarantees, would be phased out over time, except when needed as a last resort.

25. Reforms took place in five areas of the power sector: (i) resolution of the independent power-producer issue, (ii) establishing a legal and regulatory framework, (iii) financial restructuring and privatization, (iv) restructuring and privatization of corporatized entities, and (v) creating an enabling environment for a competitive electricity market. The program was pro-poor in orientation and had a positive impact on the society. The government was still expected to subsidize, through budget appropriation, the poor consumers of lifeline electricity in the less developed and rural regions.

26. Based on Pakistan's power sector experiences, a number of policy issues stand out. A public campaign is important before any privatization program is actually executed. The reform program must be accepted at all levels of the government. The establishment of an independent power sector regulator is crucial for ensuring investors' confidence and consumers' protection. The effectiveness of the law and legal system also plays a critical role. Social aspects of the reform must be carefully considered. The new system must ensure proper information disclosure.

Infrastructure Privatization: Real-Life Lessons in a Difficult World

27. **Mr. Mauro Chiesa of the International Finance Corporation (IFC)** said that the privatization of infrastructure over the last nine years were of magnitudes seldom seen before, representing 80 percent of all privatization over the past five years. In 1998, however, these levels substantially declined. This appeared to have little effect on the telecommunication and transport sectors, as investments remained stable given its hard currency revenues, low variable costs and value-added service. The situation for the power sector, though, was somewhat grimmer since revenues were in domestic currency, some of the users were able to absorb a cost-recovery tariff, and the capital requirements were also sizeable and fixed. The situation for the water sector has been the least promising. On a regional basis, Latin and Central America have shown a marked increase in investments while all other regions showed declines. It should be noted that the infrastructure and equity markets have been consistent.

28. Mr. Chiesa explained that the IFC advises on many privatization programs. If the clients prefer upstream privatization, IFC advise refurbishment and divestment first. If the clients prefer non-core asset privatization, IFC's advice is that infrastructure is privatized first to enhance consumers' surplus and the value of non-core investment. If the clients prefer to sell the companies, IFC's advice is that the regulatory agency would add value and quality, and reduce both implementation and investment risks. Clients may also choose from a menu comprising of lowest tariffs (with no up-front proceeds) or holding tariffs (some up-front proceeds or some downstream proceeds).

29. He then went on to explain three cases in which the IFC participated. The first involved the Manila Water and Sewerage System. The benefits of this privatization program included: two bidders who submitted tariffs that were 27 percent and 54 percent of former levels; standards to improve quality and coverage; benchmarks to improve efficiency, maintenance and investment with responsibility transferred to the private sector; and separation of service into two zones for comparative competition. A regulatory agency was established and privatization law was adopted.

30. The second involved COELCE, a utility company in Brazil. The benefits of this program included: sale proceeds of US$880 million for 51 percent voting capital; tariffs kept at pre-bid levels for the first five years (efficiency gains to be shared afterwards); universal service in urban areas; stipulated investment in rural electrification; and about 240 MW independent power production awarded to third parties immediately after the sale of the distribution company. In this case, the Federal Concession Law provided the privatization framework. A national regulatory agency was established in 1998 and a state regulatory body is being established under IFC supervision.

31. Panama's national power utility, IRHE, provided the third example. The benefits of the program included reduced tariffs by 10 percent that are fixed for the first four years and benchmarks to reduce distributional losses from 22 percent to 12 percent in the first four years. IRHE was unbundled into two distribution companies, three generation companies and one generation 'option'. In Panama, a very clear tariff structure was established, a multi-sectoral regulatory agency was created while the Privatization Code governed the unbundling.

32. Most **IFC programs** contain the following **ingredients**:
- tariff regimes reflect costs and competitive/transparent bidding processes
- there is always a well-functioning public regulatory framework
- it is important to set up appropriate performance benchmarks
- the privatization program is based on a consistent legal framework
- some restructuring or unbundling flexibility is always retained
- some schemes of risk-sharing are introduced when appropriate

A. Japanese Experience in Privatization: Precedents for Developing Countries

33. **Professor Kiyoshi Nakamura of Waseda University** presented the Japanese experience in privatization. His presentation focused on two cases of privatization in Japan, namely, the Japan National Railways (JNR) and the Nippon Telegraph and Telephone Public Corporation (NTTPC).

34. In the mid-1980s, JNR incurred a huge deficit. The reasons included lack of competition, failure of reforms from the inside, a politicized labor union and political intervention in decision-making. Fare adjustment was always a political issue, which caused a vicious cycle between deficit and government subsidy. Under the pressure of local politics, some unprofitable local lines were constructed. In 1987, however, the JNR was privatized under the plan of a horizontal breakup that would involve no vertical separation. An intermediate institution, the JNR Settlement Corporation, was established for the transition in addition to the Management Stabilization Fund, an incentive subsidy scheme. The outcome of the JNR reform was clear: there was no increase in JR fares, it introduced benchmark competition between railways and between railways and airlines, and the reduction in employment was insignificant.

35. The case of the NTTPC was quite different. Privatization resulted from the rapid development of technology, higher procurement costs and higher charges for calls. With respect to the workforce, redundant workers became a significant liability and the burden of wages became increasingly heavy since wages were linked to workers' age. In addition, the economies of scale in this industry had already been exhausted. As a result, competition was needed. Privatization of NTTPC started in 1985 when it was sold in the domestic market. In the initial stage of reform, there was no regional breakup. In 1999, however, the whole system was divided into regional segments. The market was also liberalized and asymmetric regulation was introduced to foster competition. The benefits of this privatization were also evident. The charges for calls fell significantly. New competitors entered the market and competition started to emerge on a global scale. Loss of employment, however, was significant, with the total number of employees falling from 313,600 to 145,400 after privatization.

36. The privatization of the JNR and NTTPC left a number of unresolved problems. In the case of JNR, deficit problems still remain, especially with the Three-Islands railway companies and a freight company. Political interference still exists. The public has a further concern about the safety measures of the JNR. As for NTTPC, the net access fees are quite high (especially for access to the internet, e-commerce, satellite and CATV).

37. Professor Nakamura said that the Japanese experience demonstrates clearly that privatization is essentially a political process. It requires not only an autonomous commission but also political will and public commitment. Namely, former Prime Minister Nakasone was a strong key-player in both these reforms.

38. So what lessons may developing countries learn from Japan?

- the more drastic the reform, the stronger the interest groups that oppose it. This creates an issue of how to overcome their opposition
- strong political initiatives are very important, so popular support must also be mobilized
- the government plays a changing role in the process of privatization. It has to maintain competition in the market, to provide incentives to try out new ideas and keep its accountability and policy transparent

B. People's Republic of China: State-Owned Enterprise Reform

39. **Dr. Yiping Huang, a Research Fellow of the Australian National University**, said that PRC's SOE reform started earlier than agricultural reform, but the process was much more complicated. For many years, state sector reform was the number one policy priority and today still is. The problems faced by SOE reform are probably more difficult now compared with those of twenty years ago.

40. When reform began, it was realized that the major problems of SOEs were simply the lack of autonomy and incentives. So earlier policy proposals all attempted to rectify this. The first 'responsibility' system was introduced in Sichuan province in 1978 and was then extended to the other parts of the country. In fact, the responsibility system made progress mainly on autonomy and incentives but neglected responsibilities. That provided the rationale for the massive implementation of a contract system from 1987. From the early 1990s, a more flexible reform strategy that 'liberalized the small and emphasized the big' was adopted. The share-holding system was perceived as the main instrument for the next stage of SOE reform. Privatization of small and medium-sized SOEs also started. (See further ADBI Working Paper 9, *The Institutional Foundations of China's Market Transition*, by Yingyi Qian.)

41. In general, was SOE sector reform successful? The findings on SOE productivity performance during the reform period are mixed. It is important to note, however, that some SOEs under-performed relative to non-state enterprises, and that productivity growth declined significantly over time. Therefore, SOEs productivity performance was not wholly satisfactory. The financial independence of SOEs increased significantly, as the debt-equity ratio increased from 23 per cent in 1978 to 440 per cent in 1998. At the same time, overspending on wages and non-wage income items became a widespread phenomenon. From 1996, the state sector as a whole made net losses.

42. What was the contribution of SOEs to the economy? Dr. Huang argued that they made important contributions through the provision of a safety net (keeping redundant workers within SOEs and off the street) and a base for growth outside the planned economy that facilitated the development of the non-state sector. More importantly, however, the SOEs have become an sub-

stantial burden on the whole economy. They have become sources of macroeconomic instability and contributors to financial fragility. While the state sector declined in relative terms, its burden on the economy increased sharply. Problems have developed to such a stage that it is no longer possible for the government to nurture the inefficient state sector without adversely affecting the economy to a significant extent.

43. The PRC experience demonstrated that it was very difficult and costly to reform SOEs. The next step, therefore, has been for the government to privatize most SOEs, which, in fact, has already started. For privatization to succeed, though, the government needs to make important adjustments to correct discrimination against private sector enterprises by establishing appropriate legal and financial systems.

C. *Institutional Aspects of Privatization: The Case of Viet Nam*

44. Dr. Sadrel Reza, a Senior Research Fellow of the ADB Institute, said that the dilemma for many transitional economies is that, on the one hand, privatization is warranted on an urgent basis, but, on the other, privatization can best be implemented in conformity with the pace of institutional reforms. This brings up two important questions: how should SOE reforms and privatization programs proceed? What are the major institutional obstacles to privatization and what kind of sequencing is necessary in this regard?

45. He suggested that we may distinguished between small and large SOEs. While small SOEs can be privatized relatively easily, large ones are more difficult due to public interests, large debt burden and employment. Larger SOEs may need to be restructured before privatization in order to harden their budget constraints. SOE reform can be counter-productive if proper institutions are not in place. Dr. Reza then turned to Viet Nam's reform measures, which included managerial autonomy, policy and legal frameworks, some major restructuring measures, reduced subsidies and hardened budget constraints.

46. Some government policies, however, hindered such reforms. These included various incentives from the government such as credit, land use, foreign trade transactions; injections of large investment; and many other supports to the extent that the state sector still dominated the economy. Hardly any SOEs were forced into bankruptcy (only one recorded case), while three-fifths of all SOEs incurred losses. It is clear that improvement has been made in Viet Nam, not because of, but despite SOEs. In theory, it does not matter whether the government retains ownership, but in reality publicly-owned enterprises tend to under-perform more than private sector ones.

47. Equitization was introduced in 1992 but only made substantial gains after 1999, and it is largely restricted to small and medium SOEs in non-strategic industries. In spite of this development, many practical problems remain: (i) the incentive system discriminates against privatized enterprises; (ii) the state retains stakes in equitized enterprises (40–50 percent for employees, 30–40 percent for the state and 20 percent for outside investors); (iii) entry barriers were set up in strategic industries; (iv) there are contradictory laws that cause confusion; (v) the capital market is not well developed; (vi) the privatization process is not transparent; and (vii) the social safety net is inadequate.

48. How can Viet Nam resolve their privatization problems? Dr. Reza suggested freeing the private sector to develop, and thus bypass privatization. The other options may be: (i) allow the development of township-village-enterprises or an informal sector; (ii) permit the establishment of foreign-invested enterprises; (iii) allow trade liberalization to force SOEs to either perform efficiently, privatize, or go out-of-business. (See further his ADBI Working Paper 5, *Institutional Aspects of Privatization: The Case of Viet Nam*.)

D. *Privatization/Deregulation of the Power Sector in Pakistan*

49. Mr. Owais Khan from Cosmos Management Consultancy, Pakistan, highlighted three main difficulties encountered by the 1994 privatization program of the power sector in Pakistan and the power policies recommended by the Task Force on Energy, viz: (i) *Increase tariff/pricing*: public perception viewed the tariff as unbearably high but, in fact, it was the lowest in the region. As a result of the low tariff, it was hard to attract foreign investment. (ii) *Excess capacity*: reported effective-capacity is significantly over-estimated, the provision for reserves is grossly inadequate, and per capita consumption is very low in Pakistan relative to other countries. (iii) *Impact on balance of payments*: would there be possible adverse effects on the balance of payments?

50. What were the principal sources of difficulty? Mr. Khan identified the miscalculation of excess capacity and politicization as the main problems. The matter of excess capacity was not addressed in a proficient manner, but was instead scandalized and politicized for nearly three years. The capacity anticipated for future years fell short of estimates, which were based on sound assumptions. Demand for power was reduced as a result of several factors, including economic slowdown, industries opting for their own small generating plants, the high consumer tariff regime that reduced incentives for the enhanced use of power, an uneconomic dispatch system, an increase in losses after additional power generation, and a supply of power to less than half of the population. Power demand has been the lowest ever in the history of Pakistan, leaving behind large MWs of idle power even from WAPDA's (utility) system. Until 1999, about 1400+MW have been added by independent power producers (IPPs) and it is estimated that the surplus is in the range of 2,500–3,000 MWs out of the total installed capacity of 11,000+MW. The privatization experience depicted a case of design fault, particularly in the area of demand analysis and tariff pricing, which led to significant foreign exchange implications for the government.

E. Kyrgyz Republic: Privatization, Corporate Governance and Enterprise Reform

51. Dr. R. B. Adhikari of the ADB Institute explained, the privatization initiatives undertaken in the Kyrgyz Republic, one of the transition economies of Central Asia. He then continued with how corporate governance was incorporated in the process of enterprise reform and how further privatization programs were formulated. Finally, he addressed the lessons that could be drawn for other developing countries. Subsequent to its independence, Kyrgyz Republic drafted and implemented most of its laws, rules and regulations *ab initio*. The country has some mineral resources, its agriculture sector is strong and most of the surplus labor is skilled and educated. The Kyrgyz Republic is the most liberal economy in the region. It is also the first CIS country to become a WTO-member.

52. Enterprise is the dominant sector. The state retains an extensive role in managing the enterprise sector. Most privatized enterprises are small and many of the larger privatized enterprises are joint-stock companies. Government support, including soft budget provisions, is widespread. The privatization program of recent years has reduced the size of the state sector significantly in terms of share of output and employment.

53. The privatization and enterprise reform process can be divided into the following phases: (1) 1991–92 (preparatory phase): Passage of Legislation and a Decree in 1992; (2) 1992–93 (Phase I): Focus on small SOEs and further improvement in laws and regulations; (3) 1994–95 (Phase II): Focus on 1300 medium and large SOEs; (4) 1996–97 (Phase III): Attention toward 13 large monopolies and 4000 additional SOEs; and 5) 1997–99 (Phase IV): Implementation of Corporate Governance and Enterprise Reform Program. The basic approach followed was massive privatization of small SOEs, gradual privatization of medium and large SOEs, followed by the unbundling and corporatization of state monopolies, such as utilities.

54. Some key problems that emerged in post-privatization years have been: (i) no real changes in the management of the SOEs who are not necessarily loyal to new owners (shareholders); (ii) shareholders were not fully aware of their rights; (iii) insider-dominated management grew; (iv) efficiency of privatized SOEs did not improve; (v) further privatization progressed slowly; (vi) subsidies to SOEs continued to drain government resources; and (vii) the Company Law was not adequate enough to ensure corporate governance since legislative changes were excessively time-consuming.

55. Against this background, the corporate governance and enterprise reform program (1997–99) (CGERP) was formulated. The overall goal of the CGERP was to achieve economic growth through efficiency improvement in the enterprise sector. Specifically, this was expected to be achieved by: (i) improvement in corporate governance (including the establishment of the Corporate Development Center); (ii) imposition of financial discipline on enterprises, such as phasing out financial subsidy and budget loans, and introducing market-based financing mechanisms; and (iii) the promotion of domestic and international competition (strengthening liberal trade and investment regimes, and liberalizing prices).

56. Lessons from the Kyrgyz Republic experience:

- changes in ownership or control are important but they may not be sufficient to enhance efficiency when corporate governance is weak and government involvement and insider controls are prevalent
- competitive market conditions are a precondition for increasing enterprise efficiency
- corporate governance should be improved together with changes in ownership or control
- legal and regulatory framework and their enforcement should be strengthened
- reform measures should include development of banking and capital markets
- public education is critically important to make people aware of the reform measures and expectations from them

F. The Case of the Philippines: Privatization of the Water Supply and Sewerage

57. Dr. Reynaldo Vea of the Manila Water and Sewerage System (MWSS) presented a case study on a metropolitan water supply and sewerage company that covered 6 cities and 31 municipalities, served 11 million people and covered some 1,274 square km. Dr. Vea explained that the reasons for privatization included a slow procurement system, downsizing difficulties (politically), uncompetitive salaries and financing difficulties. The objectives of privatization included: (i) transferring the financial burden to the private sector for providing water to Metro Manila; (ii) improving service standards while rehabilitating and expanding the system; (iii) increasing operating efficiency; and (iv) minimizing the tariff impact on consumers.

58. According to the program the MWSS would retain ownership of fixed assets, but transfer operational and investment responsibility to winning bidders. Concessionaires would share responsibility for the operation and maintenance of the infrastructure common to the East and West zones. Originally MWSS had 7,400 employees, with 2,000 workers availing themselves of an early retirement scheme prior to privatization and 200 contractual workers not qualifying for regular positions. About 100 employees opted for reappointment with a trimmed-down MWSS. Thus about 5,100 were absorbed by the concessionaires.

59. The regulatory office monitors performance, relating to compliance with the concession agreement, asset conditions and customer service. The benefits of privatization, resulted in a lower tariff, an increase in government revenues, in reduction of debt service obligations, and in elimination of government subsidy to MWSS. The case of MWSS is a success story, whereby the envisaged benefits were chiefly realized through the privatization program.

G. *Privatization of Malaysian Electricity Supply: Key Lessons Learned*

60. **Ms. Sudzi Zainuddin, an Assistant Director, Energy Section of the Economic Planning Agency of the Government of Malaysia** presented a case study on the privatization of the Malaysian electricity supply and the lessons learned. She started her presentation by giving some background information. Privatization initiatives started in 1983 followed by the structural master plan (1991) for privatization seven years later. The motivation for privatization was to: (i) reduce the financial burdens of the government (for debt service level to reach the normal level); (ii) reduce the size and presence of the public sector in the economy; (iii) improve efficiency and productivity growth; (iv) facilitate economic growth; (v) and to meet restructuring objectives of the national development policy.

61. First, the National Electricity Board (NEB) was corporatized to Tenaga Nasional Berhard (TNB) under the Electricity Supply Act of 1990, and then partial privatization started in 1992 through the floatation of 25 percent of its shares, and IPPs were introduced in 1993/94. The timing of IPP's introduction coincided with low growth of electricity supply and lacked adequate investment capital for TNB (since it was only corporatized not privatized). Growth of electricity consumption was stable even under negative GDP growth. IPPs now contributed 35 per cent of generation (they are restricted to generation only, the distribution is still operating as monopoly).

62. What were the key lessons learned in Malaysia?

- in order to have a strong privatization process, strong macroeconomic fundamentals are required
- a strong capital market is required otherwise selling and financing will be a problem
- it is hard to proceed with privatization (without a responsive private sector)
- clear and consistent policy objectives are needed. If there are many contradictory policy objectives, it may confuse the private sector
- clear privatization administration is desired
- there is a need for a flexible framework and continuous changes to suit the changing environment

63. As for the future, Malaysia is trying to develop the private sector electricity market for generation, transmission and distribution and to restructure and divest the TNB assets. Ms. Zainuddin concluded her presentation by indicating that privatization in Malaysia was done in a very pragmatic way. A gradual, step-by-step approach was adopted. Now the monopoly of TNB is broken at least in the generation sector. IPPs are competitive and they are making substantial profits. Privatization has contributed to increases of electricity supply and to economic growth.

H. *The Case of the United Kingdom: Privatization Experience in Europe*

64. **Dr. Paul Cook** observed that whereas privatization was a political process, the outcome was not always what the government might have wanted. It can also be a long process. In the United Kingdom, the process to commercialization and corporatization took about twenty years. For privatization to succeed, it requires both political commitment and gains to consumers. Such gains started to emerge only when regulators started to look at competition issues. The problems with the public enterprises (established through nationalization in 1945–51) included lack of clear objectives and under-performance. The rationale for privatization was, in fact, invented after the process began in 1979 (U.K. did not have an official policy initially).

65. He went on to explain the key phases of the broad privatization process in the United Kingdom: (i) council houses and competitive markets; (ii) easy utilities (telecommunications, gas and electricity); (iii) competitive tendering; (iv) difficult utilities such as coal and public transportation; (v) and finance. Sales revenues amounted to $60 billion between 1979–80, 4 million were sold, and over 11 years of privatization represented nearly 12 per cent of one year's GDP. The motivation for privatization included efficiency, freedom of choice, people's capitalism, budgetary pressure, public pay determination, and employee share-ownership. The main methods of privatization were share floatation, direct sale, management buy-out, contracting-out and franchising.

66. The British Telecommunication (BT) model involved no major restructuring, a separate regulatory office, use of a price-control formula, and a regulatory review period. Competitive entry, where feasible, was to be preferred to regulation. British Gas (BG) was privatized as a complete monopoly covering generation, transmission and distribution.

Privatization Experiences from Latin America, Eastern and Central Europe: Lessons for Developing Countries

67. **Dr. Frank Lysy, Lead Economist of the IFC**, said that privatization has been a powerful tool for providing key goods and services to the populace cheaply, but it could do better. Ownership *per se* might not be so critical to achieve economic efficiency, particularly when firms were exposed to competition with no barriers to entry and exit, and when managers followed market signals and were rewarded for performance. But, practically, there could be many other reasons for efficiency losses. For example, firms may have some non-market objectives such as employment of poor people (through tax incentives or subsidies), building plants in targeted regions, using enterprises for social services, lowering prices for targeted groups, providing jobs for political supporters, and obtaining kick-backs.

68. Theoretically, it is possible that SOEs can be efficient, but private ones are more efficient on average according to substantial evidence. What the studies do not identify are the conditions under which privatization would lead to positive results: there are also cases of well-performing state enterprises and examples of privatization disasters. These include the loans-for-shares scheme in Russia that became hopelessly corrupt, with transfer of assets to the well-connected few. Voucher privatization in the Czech Republic was more controversial as a consequence of a lack of adequate regulatory regime to protect minority shareholders, plus a failure to privatize banks, and incentives for asset stripping.

69. **Diverse regional experiences** suggest the following lessons so far:

- privatization to a capable strategic investor generally works best, rather than to insiders or dispersed ownership.
- the more open and transparent the process (including openness to foreign investors), the better.
- permit markets to be competitive by not restricting entry or imports. If this is impossible by nature, regulatory capacity needs to be developed.
- it is important to ensure minority shareholder rights.
- finally, it is important to draw on world-class expertise in the design of regulatory regimes and of the privatization process.

Practicality is better than perfection.

People's Republic of China: Changes in the Pattern of Enterprise Ownership and Governance

70. **Dr. S. Athar Hussain, Senior Research Fellow, Asia Research Center of London School of Economics, United Kingdom**, stated that the PRC has a privatization process, but it is not a central part of the program. The problems of reforming a large state sector are different from other developing countries. When reform started the state sector accounted for 80 per cent of the labor force in the urban areas. The basic problem is what authorities should do with politically sensitive surplus labor. Unemployment problems in PRC are already serious, but yet there is a limit on the speed of state sector reform.

71. Dr. Hussain then went on to focus on three key aspects in his presentation: reallocation of control rights from government agencies, organizational restructuring of state enterprise, and ownership transformation. In fact, enterprise reform started when overall reform began, and has been going on for twenty years. The change over the years has been in the emphasis. Beginning in the 1990s, there was a transfer of rights. From 1994, there has been a shift of emphasis from reallocation of control rights to restructuring to ownership transformation. Out of a total of eight million enterprises, only around 500,000 are sizeable industrial enterprises and 80,000 are state-owned industrial enterprises. In terms of output, the SOEs then account for a quarter of gross output. In terms of ownership, there are five main types: state-owned, collectively owned, shareholding, foreign funded and others. This, therefore, implies that the ownership structure is very diversified. A change in the form of state ownership makes a great deal of difference.

72. Reform of the SOEs is not a simple issue since state ownership is not a uniform jurisdiction: there are central, province, municipality and county-level owned enterprises. Intergovernmental competition is also important, such as in the car and television industries. But this can also lead to protection of SOEs by all levels of government, a lack of exploitation of economies-of-scale and over-investment. A related point is that PRC's SOEs are quite small in terms of their size.

73. On the prospect of the state sector in PRC, Dr. Hussain said that the state sector, as it is today, cannot be sustained. A gradual process of privatization including management buy-out, and introduction of employee shareholding is desirable; in a kind of 'grab the large and let go of the small' *de facto* policy. However, there are real difficulties. For the PRC they include: (i) not enough strategic investors; (ii) not enough investment bankers as advisors; (iii) many enterprises in a centrally-planned economy are different compared with enterprises in a market economy, as they do not make the same types of decisions.

74. The government has to perform two functions, namely, the regulatory and ownership role. These should be separated because they are often in conflict with each other. In most industries, the current structure is not sustainable. Policy favors mergers, which always existed in PRC. But mergers were difficult because local governments were very resistant. Since the early 1990s, this has changed. First, in the 1980s, enterprises could still continue (even if losses were incurred) since there were adequate subsidies. What has changed in the 1990s is that competition has increased and budget constraints have been substantially hardened. Second, local governments have been faced with the options of either no enterprises or enterprises taken over by the others. Third, in most industries, they have leaders and laggers. This differentiation makes non-sustainability in the long run very clear. Alternative options without mergers are limited. In many of the new industries, the State Council established large corporations to compete in the international market.

Country Specific Issues and Experiences: What Core Lessons Can Be Drawn?

75. The seminar participants discussed their country specific issues and experiences and prepared a consolidated report for each group, which was presented in the plenary sessions for discussion. The following is the summary of the **key messages that emerged from the group exercises**.

76. South East Asia and the Pacific country participants reported that their countries have political will; a framework plan; appropriate institutions; appropriate employment policies; and are open to foreign investment usually up to 49 percent ownership. However, they noted two major problems in the privatization process. First, there is a need to increase public awareness of the privatization program. Second, if the privatized enterprises ran into difficulties, what should governments do? Should they bail them out? Moreover, while governments should follow contracts to the letter, they must also consider the wider political picture and broader social implications.

77. Representatives of the South Asian countries listed the following as ten major issues in privatization for them: (i) resistance from stakeholders; (ii) lack of proper preparatory groundwork such as policy, legal and regulatory frameworks, pre-privatization restructuring, and management capacity building; (iii) transparency of process such as the 'hold-up' problem; (iv) lack of institutional reform in capital markets and the financial sector; (v) lack of political will, commitment, courage and clarity; (vi) inadequate valuation of assets/liabilities of SOEs; (vii) proper utilization of proceeds; (viii) social impact; (ix) absorption capacity of the market; and (x) long-term strategy, sequencing and post-privatization monitoring. What also comes out of this listing is that politics tend to dominate the process in South Asia. In fact, selling the 'concept' politically requires great effort. There are several groups who have roles to play in this process and privatization will be very difficult unless a consensus is reached.

78. Participants from transition economies of Central Asia, East Asia and South East Asia indeed differ from each other concerning privatization in terms of commitments, approaches, speed and achievements. But one common problem faced by these economies, which is perhaps different from the other developing economies, is that market institutions are substantially underdeveloped. There is a broader question about precisely how to privatize and there is a need for high quality technical assistance. The group reported that the main motivating factors for privatization were *efficiency considerations*, *economic growth*, and *technological progress*. They identified change of the political and economic system and increasing burdens of the state sector as triggering factors.

79. They reported that the achievements of privatization so far have been reduced burdens on the fiscal and financial system, and improved economic efficiency, high economic growth and economic freedom for enterprises. Lastly, the group noted major difficulties such as: (i) low personal income; (ii) lack of strategic investors; (iii) employees' welfare; (iv) lack of market infrastructure; (v) corruption and lack of transparency; (vi) political factors; and (vii) the lack of high quality technical capacity.

Closing Remark

80. **Mr. S. B. Chua, Director for Capacity Building at the ADB Institute**, gave the closing remarks at the seminar. He thanked all the participants and resource persons for their participation and contribution. He stressed that the ultimate success will depend on how meaningfully the participants make use of the knowledge and skills that the seminar has imparted to the participants. He suggested that networking among participants and between participants and resource persons would also be useful to keep abreast of recent developments in privatization and enterprise reforms.