Privatising State-owned Enterprises

AN OVERVIEW OF POLICIES AND PRACTICES IN OECD COUNTRIES

OECD

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FOREWORD

Over the past two decades, close to one trillion US dollars worth of state-owned enterprises have been privatised in more than 100 countries. In OECD countries, which account for nearly 80 percent of the total amount, privatisation has had major implications for public finances, corporate performance, employment and equity markets. Governments have sought to ensure that privatisation initiatives not only contribute to efficient and competitive markets but also reinforce broader government strategies and reform efforts.

This report provides insights from OECD country experiences to support governments in shaping future privatisation efforts. It identifies the key drivers and objectives of privatisation programmes over the past two decades, as well as their scale, structure and impacts. But the report's primary focus is on the methods, techniques, implementation and management issues related to privatisation in OECD countries. Given the diversity of countries' political, economic and historical contexts, as well as differing policy objectives and relationships among stakeholders, there is no single "right" approach to privatisation. However, the report clarifies the possible implications and trade-offs entailed in different choices, and draws key lessons from OECD privatisation experience.

Experience shows that strong political commitment to privatisation at the highest level is required to overcome bureaucratic inertia, to resolve inter-institutional rivalries and to move the process forward. Objectives should be clearly identified and prioritised up front, while competition and regulatory issues should be addressed prior to sales. The sequencing of sales is important too and specific sales should be based on commercial considerations. The privatisation process should be transparent to enhance its integrity, gain credibility with potential investors and ensure public support. An effective communications campaign is needed to explain the policy objectives of privatisation and how they are to be achieved. Governments should draw upon external advice and make sure that they allocate adequate resources including human and financial resources. Foreign ownership restrictions should be limited and post-privatisation control devices used judiciously.

By sharing OECD experience with privatisation, this report aims to help governments in designing sound privatisation programmes, management and implementation processes. A well-structured and successful privatisation process will in turn contribute to the overall positive achievements of broader structural reforms. The report is published under the authority of the OECD Working Group on Privatisation and Governance of State-Owned Assets. [1]

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1. The report takes stock of developments through June 2002, drawing upon data through the end of 2001 and the experience of the Working Group's precursor - the OECD Network on Privatisation and its non-member-focused Advisory Group on Privatisation (*c.f.* Annexes 1 & 2).

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EXECUTIVE SUMMARY

Privatisation is often part of a broader process of structural reform. Privatisation transactions are complex and require careful consideration of a host of issues. Well-designed and implemented privatisation policies are essential to ensure credibility of reforms, to help governments achieve their objectives and to create efficient and competitive markets for good and services.

Over the last two decades close to one trillion dollars worth of state-owned enterprises have been privatised in more than 100 countries. More than three-quarters of the global amounts raised has been in the OECD area. The privatisation experience of OECD countries encompasses a wide range of approaches that reflect each country's unique economic and political context, making their collective experience a valuable source of information on methods and practices.

The purpose of this report is to contribute to dissemination of information on OECD privatisation methods and techniques. It does not seek to discuss the policy rationale for privatisation, nor does it intend to assess the empirical evidence on the impact of privatisation on various variables. These important aspects have been discussed in much depth elsewhere. In this report the policy rationale underlying privatisation is taken as a given. Its focus is on the implementation aspects and the OECD experience in this regard.

The report has three parts. Part 1 provides a brief overview of the scale, structure and the key drivers and objectives of privatisation programmes over the past two decades, along with a brief summary of what empirical studies and country information say about the impacts of privatisation on key variables such as corporate efficiency, performance, employment and equity market development. Part 2 constitutes the main body of the report and focuses on the experience with various methods, techniques and implementation issues. Part 3 highlights the key lessons.

This report has been drafted under the guidance of the OECD Working Group on Privatisation and Governance of State-owned Assets. It is based on case examples, discussion of the practical policy issues and information accumulated

over the life of the OECD Privatisation Network[1] and its outreach activity, the Advisory Group on Privatisation[2]. It is supplemented by the information from the relevant literature on the subject and a survey of member countries. The quantitative information about OECD privatisation activities and their structure is based on the OECD privatisation database.

An Overview of Privatisation Policies in OECD Countries

Over the last two decades privatisation proceeds in OECD countries has raised in excess of three-quarters of a trillion dollars. The privatisation drive during this period has been fuelled by the following factors: (a) the emergence of a tight fiscal environment and the need to control government spending and debt; (b) disillusionment with the generally poor performance of state-owned enterprises; (c) technological changes in sectors such as telecommunications and electricity generation that have rendered monopoly provision of certain goods and services obsolete, and market liberalisation, particularly among the European Union members of the OECD; (d) globalisation of financial markets and the need to free up companies from the constraints of state ownership in order to effectively access these markets; (e) ideological shifts regarding the appropriate role of the state in the economy; and in the case of the former transition economies, the massive overhaul of the economic system.

The policy rationale for public ownership and government provision of certain goods and services has been based on the presence of some form of market failure, and the government desire to address these through public ownership. Post-war years witnessed a greater degree of state ownership and increased regulation, but by the 1970s the poor performance of state-owned companies was acknowledged and various efforts were made to improve performance. However, over time effectiveness of such efforts and the sustainability of the results achieved were questioned and, as a consequence, by the middle of the 1980s and particularly in the 1990s the policy debate focussed on the issue of state-ownership itself, and whether it mattered. By the 1990s privatisation had become a key component of economic reform throughout the OECD area.

Privatisation objectives are multiple, and at times conflicting, and their relative importance has varied across countries, and even within the same country they have changed over time. Within the OECD, privatisation objectives have included fiscal objectives, attracting investment, improving corporate efficiency and performance, introduction of competition into hitherto monopolistic markets, capital market development, as well as political objectives. These policy objectives are at times conflicting, thus making it necessary to make trade-offs.

The bulk of OECD privatisation activity took place during the 1990s. Prior to this only a handful of countries undertook large-scale privatisation programmes. With the exception of the UK, Germany and France in Europe and countries such as New Zealand, Mexico and Canada outside of Europe the programmes were rudimentary and rather narrow in their scope. However, by the middle of the 1990s, privatisation had gained momentum in most OECD member countries. In Europe, activity accelerated, especially among those who had joined the Economic and Monetary Union (EMU), as they embarked on an ambitious economic reform programme in order to meet the requirements of the convergence criteria of the Maastricht Treaty.

OECD privatisation activities as measured by the value of proceeds generated in each year has the following characteristics:

- share offerings have been the predominant method of sale
- OECD privatisations have typically begun with smaller assets in competitive sectors
- Telecoms have dominated OECD privatisations
- Domestic retail investors have been a significant source of proceeds from public offerings
- Foreign investors have played an important role in OECD privatisations

During the past two decades the effects of privatisation have been the subject of intense scrutiny, with the vast majority of studies focusing on the impact of privatisation on profitability, real output, investment, productivity, and employment. In contrast, macroeconomic and fiscal impacts have been the focus of less intense scrutiny, and the distributional effects of privatisation are only beginning to be studied. This report briefly looks at the findings from selected studies and individual country information in relation to the key policy objectives of privatisation.

One of the most important policy objectives of privatisation is to improve the efficiency and performance of companies. Despite the difficulties with data and methodology there is overwhelming support for the notion that privatisation brings about a significant increase in the profitability, real output and efficiency of privatised companies. The results on improved efficiency are particularly robust when the firm operates in a competitive market, and that deregulation speeds up convergence to private sector levels.

For many OECD countries capital market development, in particular deepening and widening of equity markets, has been an explicit or implicit privatisation objective. Privatisation through public share offerings has had an important impact on capital market development in OECD Member countries.

Meeting fiscal objectives has been one of the core issues in the privatisation drive of the OECD countries, where governments have sought to reduce deficits and debt, to generate tax revenues from the privatised corporations and to realise windfall gains. Empirical studies have noted a positive link to improvement in the macro environment. However, the results need to be interpreted cautiously as there is not enough evidence to establish causality.

Restructuring and privatisation have generally been accompanied by job losses, the degree of which has been related to the dynamics of the sector in which the company operates. Employment losses tend to be largest where the industry faces excess capacity, and technology shifts increase competition without increases in demand. In contrast, in sectors such as telecommunications where market liberalisation and growing demand for new services create new employment opportunities the net losses tend to be smaller. However, regardless of these factors and the general macro environment, restructuring and privatisation may lead to some degree of job losses and dislocation, at least in the short-term.

In addition to the above, privatisation has important distributional effects which have recently begun to be better studied. The distributional effects of privatisation arise from the effects of privatisation on income from employment, prices and changes in the access to goods and services that were formerly provided by the privatised state-owned companies.

Implementation Methods and Techniques

The purpose of this section is to highlight the key issues and to provide examples of the approaches adopted by different countries. In each country the approach to implementation and management has been shaped by the balance of power among different stakeholders, existing economic structures and policy objectives of the government. As throughout the report, it is emphasized there are no correct or wrong approaches. The purpose of this part of the report is to identify and highlight the key issues that have required consideration and the possible implications and trade-offs that the choices entail.

While there is no right or wrong approach, effective privatisations have the following features in common:

- Strong political commitment to privatisation at the highest level in order to overcome bureaucratic inertia and to resolve inter-institution rivalries in order to move the process forward.
- Clearly identified and prioritised objectives in order to provide the policy with focus and a sense of trade-offs that may be required.
- A transparent process to enhance the integrity of the privatisation process, gain credibility with potential investors and political support from the public.
- An effective communication campaign directed at the stakeholders in particular, to explain the policy objectives of privatisation and the means by which they are to be achieved in order to respond to public concerns and to gain support for the policy.
- Allocation of adequate resources (this includes human and financial resources) in order to meet the demands of the policy for the skills and resources that are required to accomplish the many tasks involved in privatisation.

Key components of the privatisation process

Articulating objectives and trade-offs

Privatisation objectives are inter-related and at times conflicting (e.g. maximising revenue versus creating competitive market structures). Clear identification of policy priorities early in the process helps governments identify potential conflicts and trade-offs, and provides them with a better sense of direction. It also helps guide the choice of privatisation methods and focus communication of the policy. Therefore, it is critically important to set out the objectives and prioritise them as much as possible in order to ensure that the potential trade-offs are fully understood at the outset. In OECD countries, privatisation objectives have varied among countries and the relative weight of different objectives have also changed over time.

A privatisation programme or an ad hoc approach?

The decision on whether to set up a privatisation programme versus adoption of an *ad hoc* approach, depends on the relative size of the enterprise and the scale and scope of activity envisaged. Typically, in countries where privatisation candidates have been very few and far in between, and relatively small, an *ad hoc* approach to privatisation has been adopted. However, the most critical

aspect of any privatisation appears to be the existence of a clear political commitment to privatisation, coupled with a pragmatic and flexible approach with the capacity to respond to fast changing market conditions irrespective of whether privatisation is being pursued on an *ad hoc* basis or as part of a pre-established schedule.

Establishing the institutional framework

Privatisation transactions are complex, requiring a great deal of planning and preparation. Depending on the type of assets that are being sold, privatisation of SOEs can pose a host of policy questions and decisions that need to be addressed prior to sale. These include decisions such as when and how to restructure the SOEs that are slated for sale, hiring of advisors, timing, the decision as to who should lead the process, the approach to labour issues, the size of stake for sale, and how fast the asset should be sold. For this reason, the institutional framework for decision-making and management of privatisation policy and development of a clear road map is critically important for the smooth execution of privatisation policies and in ensuring the programme's success.

The multiplicity of different players, each with their own vested interests means that the process should be organised in a manner that can identify relevant policy questions, develop appropriate responses and essentially ensure that all the relevant issues have been addressed prior to going to the market. Otherwise, transactions can be delayed and the absence of a clear policy on matters such as the regulatory regime can create investor uncertainty and undermine the credibility of the programme. For this reason the institutional framework to privatisation makes an important contribution to the smooth and efficient progress and in ensuring desired outcomes.

In OECD countries, the approach to the institutional framework for management and implementation of privatisation policies has been shaped by the following factors: Existing government arrangements and structures in place for managing the various government activities and assets; the distribution of responsibility for various state-owned enterprises; the balance of power among various stakeholders; the scale and objectives of privatisation.

Despite wide variations within OECD countries the management and implementation of privatisations can be grouped into three broad categories as described below. It is important to note that these classifications highlight only the main features of the approach adopted. Often the distinctions are quite blurred and centralisation is only a matter of degree.

The **centralised model** is when all the decision-making and implementation powers are highly centralised and vested in a single body. The centralised approach has been adopted in countries where a large privatisation agenda has been in place, and/or the size and complexity of transactions can benefit from the centralisation of experience and executive decision-making. In those OECD countries where a centralised approach to management and implementation of privatisation has been adopted, the institutional arrangements have taken the following forms: (a) a unit within a financial ministry or a central agency of the government; (b) a dedicated privatisation body; (c) a holding company of the government.

The **decentralised model** is a fragmented approach whereby the sectoral ministry responsible for the enterprise often leads and executes the process of privatisation. Within the OECD area, generally those countries with *ad hoc* privatisations have adopted this approach. The decentralised approach is more appropriate when there are few candidates to privatise, the assets pose few cross-cutting public policy issues, or when the stage in the privatisation programme's lifecycle warrants this approach, i.e. when the institutional framework has been disbanded and the scope of activity does not warrant establishment of a new programme.

Under the **mixed approach** different elements of the two above models are combined in varying degrees. Its adoption is often the result of the country's existing arrangements for ownership and management of state-owned assets, for example where holding company structures have been in place. Another reason for this approach arises from the large number and diversity of the assets involved.

Regardless of the institutional approach it is very important to ensure that a central financial/economic ministry plays a key coordinating role in privatisation. This will help ensure that the policies adopted and outcomes are consistent with the government objectives. In this regard, the financial/economic ministry is often best placed to play that role due to its overall economic and financial policy mandate, and its interest in ensuring that the reforms are undertaken.

SOEs have an important role in both initiating and implementing their own privatisation. This has been particularly true where the SOEs have enjoyed a large degree of *de facto* autonomy. The government often relies on the cooperation of the company in order to ensure that the company is successfully prepared for sale and transition to the private sector, especially when the sale is to be preceded by major restructuring. However, while the SOEs have an important role to play, their control or undue influence over the privatisation

process can create a conflict with the policy objectives of privatisation and that of the process.

Privatisation of state-owned enterprises requires skills and expertise that often are not available in the public sector. As experience from the OECD countries shows most privatisation transactions have entailed some degree of involvement by private sector advisors, and the quality and experience of advisors have been critical in ensuring the success of sales. In this regard it is equally important to ensure that the public sector develops an "intelligent customer" capability in order to fully understand and evaluate the advice that it is getting from the experts. One of the benefits of a centralised approach to management of privatisation is that it allows for the centralisation of such expertise.

Privatisation transactions change the status quo, and by their nature they are contentious. Often the selling price is a source of criticism and perceptions of conflict of interest. Corruption charges can severely undermine the credibility of the privatisation process with potential investors and erode public acceptance of the policy, jeopardise the programme and setback reform efforts. For this reason gaining credibility and public acceptance for the policy critically depends on the ability of the government to inspire confidence in the process by ensuring that it meets the highest standards of probity. The integrity of the privatisation process depends on the degree to which the process is transparent, its provisions for ensuring that the decisions are made free from real or perceived conflicts of interest, that selling methods rely on open competitive approaches as much as possible, and finally on whether there are mechanisms in place to ensure accountability. The OECD experience shows that open, transparent and competitive processes generate better outcomes in terms of price and quality of buyers and can help privatisation to obtain its objectives. The gains in terms of better outcomes and programme credibility generally outweigh the costs of running competitive processes.

Policy Choices

The approach to privatisation legislation is largely a reflection of the existing legal framework, the way the SOEs are organised and the size and scope of the privatisation activity foreseen. In general, two broad approaches to privatisation-specific legislation can be distinguished.(a) framework legislation and (b) case-by-case legislation. Both approaches to legislation have been used in the OECD area. The decision on the approach to legislation is a function of each country's existing legislative structures and traditions, constitutional provisions and the scope and scale of planned privatisation activity.

Pre-privatisation restructuring is one of the key steps in the privatisation process and has important implications for achieving the desired outcomes. This report discusses the issue of company specific restructuring. It argues that pre-privatisation restructuring is not a pre-requisite for all transactions, and is best handled on a case-by-case basis. The degree and need for company-specific restructuring is shaped by factors such as: the size of the enterprise; planned method of sale; the structure of the market in which it operates and government objectives with respect to the envisaged market structure post-privatisation.

One of the important policy decisions for the government is the issue of the order by which assets are privatised. The question is whether privatisation of certain assets should precede that of others, and if so, according to what criteria. For example should criteria such as company performance and readiness, the sector to which the SOE belongs, or the market structure in terms of being competitive versus non-competitive be the key determining factors. The reasons underlying the sequencing of sales include the need to: (a) support and enhance the outcome of subsequent privatisations; (b) build credibility and gain support for the programme; (c) address transactional and market requirements. The experience with privatisation programmes in the OECD countries shows that successful programmes have usually begun with the sale of assets that operate in the competitive sectors of the economy and required less preparation. This has helped build momentum and gain credibility among investors and the public, facilitating subsequent sales.

One of the key decisions facing privatisation officials is related to the staging of sales, in other words how much and how fast the company should be sold. The decision as to whether the enterprise is to be sold in stages, or all at once, and how quickly is influenced by the interplay of the following factors: (a) Sale strategy; (b) transaction-related factors such as the size of the asset, and the absorptive capacity of the market; (c) market structure and the existence of an adequate regulatory capacity. In the case of the latter, the partial sale is intended to serve as an interim step where more time is needed for an effective regulatory capacity to develop. The success of this approach in terms of realising privatisation objectives and exposing the companies to market discipline has largely been based on the government's credibility and its ability to refrain from political interference.

The policy on foreign ownership of privatised state-owned enterprises can be a sensitive issue, particularly in the context of industries that are considered to be of national and strategic importance. The rationale for opening up privatisation transactions to participation by foreign investors is that they can be an important source of capital, especially where the domestic pool of capital is too small to absorb the offerings. This is particularly relevant to emerging market economies

and former transition economies where domestic financial resources are insufficient, resulting in transactions involving sale of assets to other publicly-owned bodies or other levels of government, with detrimental effects on corporate governance and performance of these companies. Participation of foreign investors in privatisation will likely open up the market to buyers with capital and expertise, which can increase the revenues and provide the company with access to management skills and technology that are most needed to help improve corporate efficiency and performance, and develop links to export markets. The experience from OECD countries with large privatisation programmes suggests that removal of all restrictions against foreign ownership and addressing concerns over issues of national security and strategic interest through the use of case-by-case and more flexible mechanisms offer a more efficient solution to such concerns.

One of the key stakeholders in the process of privatisation are the employees of the state-owned enterprises, who are often the strongest source of opposition to the policy. The main sources of opposition to privatisation are concerns over loss of jobs, and possible changes in working terms and conditions. The extent of job losses and the overall net effect of privatisation on employment is linked to the dynamics of the sector in which the company operates. However, in the short-term, at least, restructuring and privatisation result in job losses even in cases where the sector is growing and the economy is creating new employment opportunities. In this regard, experience from a variety of countries underlines the importance of consultation and negotiation with the labour groups at the earliest possible stage. Identification of the issues at the outset, establishment of a framework for mitigating against possible adverse effects, communication of the benefits of privatisation and explanation of government plans for mitigating the negative effects of privatisation helps to dispel employee concerns, gain labour support, and ultimately leads to better privatisation outcomes.

Privatisation proceeds can be used to reduce the government debt, or can be re-invested to meet other policy priorities such as funding of social security and other public services (e.g., health and education, worker retraining) and/or funding deficits. Depending on how the proceeds are utilised privatisation revenues can contribute to enhancing of the macro environment, and help ensure that the stakeholders and public at large share in the benefits of the reform, and thus secure broader public support for privatisation. The provisions governing the use and treatment of privatisation proceeds can also serve as a vehicle for enhancing the transparency, accountability and the achievement of the overall balance between the fiscal and efficiency drivers of privatisation. The use of privatisation proceeds has varied across OECD countries. This report provides examples of the approach in different countries.

Privatisation Methods

The sale of state-owned enterprises can take place through a variety of methods. The choice of privatisation method depends on the government's policy objectives, the domestic market environment and the characteristics and size of the company that is being sold. Privatisation objectives are inter-related and often conflicting. This is nowhere more apparent than in the context of selecting privatisation methods. In this section the key features of the main methods used in the OECD countries, along with their implications for realising different policy objectives, are discussed. The methods discussed in this section are: (a) public share offerings on the stock market (b) trade sales; (c) employee and management buyouts; (d) mixed sales (combination of the above). These four methods represent the most widely adopted approaches by the OECD countries (Table 2.4: Methods and objectives).

Post-Privatisation Control Devices

One of the main objectives of privatisation is to increase corporate efficiency and performance. For this reason it is necessary to ensure that privatisation is accompanied by changes in corporate governance. Therefore, schemes that aim to raise capital for the budget and leave the governance incentives and structures of the companies unchanged, or create arrangements that are not conducive to effective governance are unlikely to produce the desired outcomes.

In many OECD countries governments have created arrangements and mechanisms that allow them to retain some degree of control over the companies' post-privatisation. The intent of such post-privatisation control devices has been to protect the newly privatised companies from the rigours of the competition for corporate control. These mechanisms have been typically adopted where the government has sought to prevent foreign take-over of companies in sectors that are deemed to be of national interest, such as defence, or on the grounds of protection of public interest. In this section three such approaches to post-privatisation control and their features are discussed. These are: (a) golden shares; (b) stable core of shareholders; and (c) retention of a controlling interest in the company (Table 2.5: Instruments for Post-Privatisation Control). The main conclusion is that arrangements that are not conducive to effective governance are likely to undermine the realisation of privatisation objectives, and should therefore be adopted judiciously.

Lessons of Experience

Privatisation policies are complex, in that they seek to meet multiple and at times conflicting objectives. They also involve many participants, are often contentious in that they change the status quo, affect vested interests and act as a catalyst for change. Therefore, sound design of management and implementation processes are needed to ensure that privatisation succeeds. In each country, the approach to implementation has been shaped by domestic political considerations, the existing legal tradition and policy objectives of the government. Despite great variation in practice and the fact that there is no single right or wrong approach, this report has sought to provide an overview of the issues that privatisation practitioners have had to consider and found effective. The following are some of the key lessons learned based on OECD experience.

1. Ensure that privatisation has political support at the highest level.
2. Identify and articulate policy objectives up front
3. Ensure transparency and integrity of the process
4. Draw upon external advice and dedicate resources
5. Address competition and regulatory issues prior to sale
6. Ensure that an effective communication of the policy is in place to explain the policy, and to address stakeholder concerns
7. Limit restrictions on foreign ownership
8. Sequencing of sales can affect the programmes' success
9. Staging of a sale should be driven by commercial considerations
10. Post- privatisation control devices should be used judiciously

Privatisation is often part of a broader programme of structural reform, and never takes place in isolation. For this reason its success is critically linked to the adequacy of complementary institutions (such as regulatory bodies, a competition authority and the court system); legislation (for example, property rights, bankruptcy and competition law); and complementary policies (these include policies such as financial market reforms, labour market reforms, and trade liberalisation) that help support the proper functioning of the privatised assets.

1. AN OVERVIEW OF PRIVATISATION POLICIES IN OECD COUNTRIES

Abstract

The privatisation process in the 1980's and 1990's was fuelled by many different factors. Therefore privatisation programmes had multiple and often inter-related objectives, including the need to reduce budget deficits and debts, attract investment and develop capital markets, or to improve efficiency and performance of state owned enterprises by introducing competition in monopolistic sectors. The scale of privatisation transactions varied from country to country over the years. Public offerings and trade sales were the most common privatisation methods, representing respectively 62% and 20% of the transactions. Privatisation typically begun with smaller assets in competitive sectors and was globally dominated by the telecom sector. Domestic retail investors have been a significant source of proceeds from public offerings, while foreign investors also played an important role.

Empirical studies and country information show that privatisation had a positive impact on corporate efficiency and performance, especially when it concerned competitive sectors, and a significant impact on capital market development. While there is mixed evidence regarding it's effect on employment and income distribution, privatisation has contributed substantially to government financing.

1.1. Policy Context and Privatisation Objectives

The policy rationale for public ownership and government provision of certain goods and services has typically been based on the presence of some form of market failure, and the government's desire to address these through public ownership. In some cases public ownership has been driven by the goal of ensuring universal access to certain goods and services at reasonable prices. While the pattern and rationale underlying public ownership has varied across countries and over time, the post-war years were accompanied by a greater degree of state-ownership and increased regulation.

Over time, state-owned enterprises (SOEs), came to be regarded as inefficient and overstaffed. By the late 1970s, problems with inefficiency and poor performance of these companies had come to be widely acknowledged, and in response to these shortcomings many governments in the OECD countries initiated reforms to address them. These included measures such as the creation of holding companies, adoption of management contracts and the imposition of stiff budget constraints as a means of providing the SOEs with clear goals in order to deal with the "agency problem" and the exposure of the companies to the risk of failure, respectively. However, the effectiveness of such approaches and the sustainability of the results achieved were questioned and as a consequence, by the middle of 1980s and particularly in the 1990s, the policy debate focussed on the issue of state-ownership itself. The view that state ownership in itself leads to inefficiency and poor performance has typically rested on the following arguments.

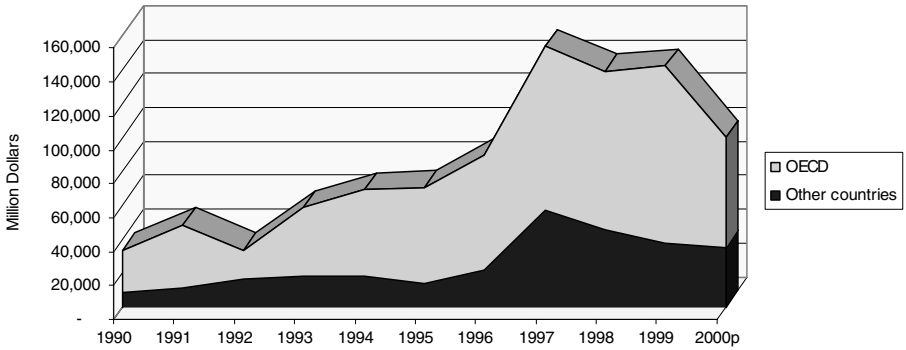
(i) Under state-ownership the companies are faced with multiple and often conflicting objectives, and are thus subject to the vagaries of politics and interference by politicians;

(ii) even where SOEs pursue the objective of shareholder wealth maximisation, it is very difficult to directly link managers' performance with incentives to achieving those goals;

(iii) in almost every case firms will not be allowed to fail, and therefore budget constraints are weak, with no consequence of poor performance in the form of bankruptcy or exposure to the risk of a hostile takeover.

Over the past two decades privatisation has established itself as a main component of the economic reform package throughout the world, alongside other reforms such as trade and market liberalisation. More than 100 countries have adopted privatisation policies, albeit in various degrees. During this period close to one trillion dollars worth of state-owned assets have been privatised throughout the world, more than three-quarters of which has been in the OECD member countries.

Figure 1.1 **Global amounts raised from privatisation**



Source: OECD Privatisation database and World Bank

The main factors fuelling the privatisation drive in OECD countries were the following:

1. The emergence of a tight fiscal environment and the need to control government spending and debt.
2. Disillusionment with the generally poor performance of state-owned enterprises and the desire to improve efficiency of bloated and often failing companies.
3. Technological changes in sectors such as telecommunications and electricity generation that rendered monopoly provision of certain goods and services obsolete, and market liberalisation, particularly among the European Union members of the OECD, provided further impetus for privatisation in such infrastructure sectors.
4. Globalisation of financial markets opened up new opportunities for financing projects, but in order to effectively access these markets, state-owned enterprises needed to be free from the constraints of state-ownership in order to raise equity capital.
5. In some countries, there was an ideological shift regarding the role of the state in the economy, and there was a desire to shed activities that were not deemed to be core government functions.
6. The massive overhaul of the economic systems in the former transition economy member countries of the OECD, fuelled large-scale privatisation activity in these countries.

In pursuing privatisation governments have sought to meet multiple and often inter-related objectives. The relative weight of the objectives has varied from one country to another and even within the same country over time. The main policy objectives of privatisation in the OECD member countries can be summed up as follows:

1.1.1. Fiscal Objectives

The need to reduce budget deficits and debt has provided a strong impetus for governments to shed non-core activities in order to reduce expenditures arising from subsidies to failing state-owned enterprises (SOEs), to generate windfall gains, to pay down debt, and to realise potential future tax revenues arising from improvements in corporate efficiency and performance of former SOEs.

The significance of attaining fiscal objectives can be seen by the scale and scope of privatisation activity among members of the EMU in preparation for the new monetary system, as they sought to meet the convergence criteria of the Maastricht Treaty[3]. In some other member countries such as Mexico and more recently Turkey, the need to bring government finances under control through the reform of the poorly performing SOE sector has been part of an agreement with international organisations and among the conditions for offering loans and assistance.

1.1.2. Attracting investment

Fiscal constraints have meant that state-owned enterprises were often starved of capital. The need to attract investment for the SOEs, in particular for the maintenance and improvement of infrastructure services, and to meet the demand for new and growing services such as telecommunications has been an important privatisation objective in the OECD. Even more important than providing access to investment capital has been the desire to free up enterprises from the constraints of year-to-year fiscal budget planning and to provide them with the ability to establish long term investment plans that do not become subordinate to annual budgetary conditions.

1.1.3. Improving corporate efficiency and performance of state-owned enterprises

Improving the efficiency and performance of state-owned enterprises has been one of the key objectives of privatisation in the OECD countries. Through change in ownership governments have sought to provide companies with

clearer goals, better incentive structures for management and staff, and exposure to market forces and freedom to fail.

1.1.4. Introducing competition into the hitherto monopolistic sectors of the economy

One of the important objectives of privatisation is to introduce competition into sectors dominated by state-owned monopolies. Privatisation has served as a vehicle to enhance competition by providing an opportunity for sector restructuring, where governments replace state-owned monopolies with several competing firms and, in the case of network industries, establish third-party access and competition rules.

1.1.5. Capital market development

Privatisation has served as a vehicle for promoting capital market objectives such as broader share ownership, and increasing the depth and liquidity of equity markets. For many OECD countries the need for well-developed equity markets as a means of channelling investments to corporations and the desire to strengthen the institutional investor presence in the domestic equity market underscores the importance of capital market development as an explicit objective of privatisation. In some countries, the sheer size of privatisation share issues has provided a real opportunity to start up an equity culture. In others such as the UK, with already well-developed capital markets, privatisation has sought to augment what was already there. In some countries privatisation has sought to bring in foreign investors, in some cases for the first time, and thus help put the country on the international capital map.

1.1.6. Political objectives

In some countries, privatisation has been pursued as a means of achieving political objectives such as strengthening the constituency in favour of a market-oriented approach to the economy, through rolling back the frontiers of the state participation in the economy. In the special case of the former transition economy members, the transformation from a planned to a market economy with limited state participation has in itself been the primary objective.

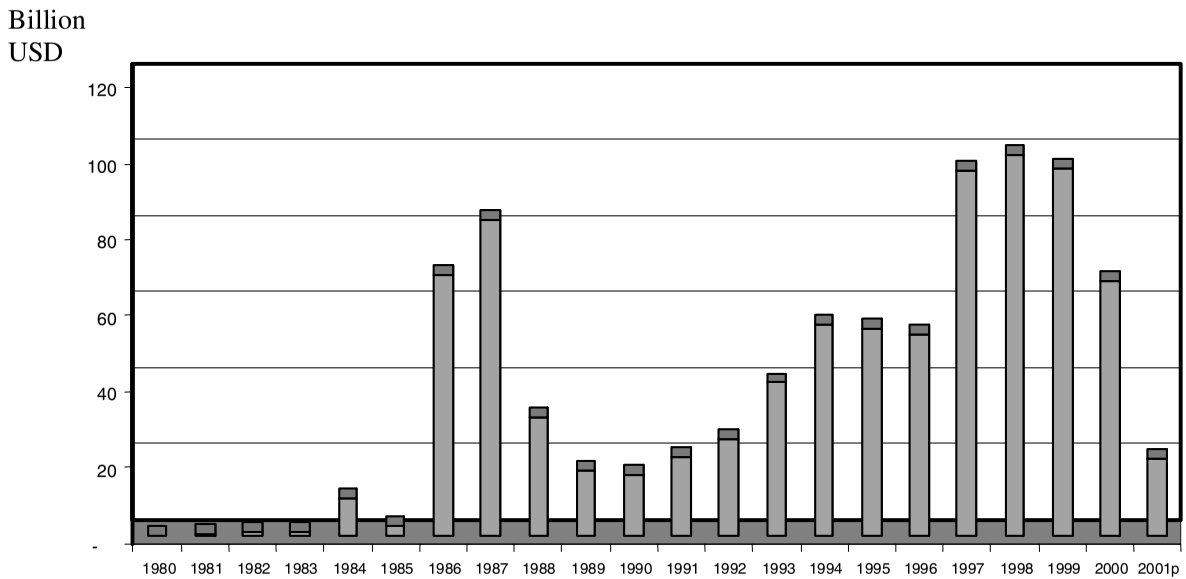
The above (individually or in combination) have formed the core of the OECD policy objectives for privatisation. The inter-related and at times conflicting nature of privatisation objectives has meant that important policy choices and

trade-offs have needed to be made. For example, maximising privatisation proceeds through the sale of monopolies would come at the expense of abandoning the objective of introducing competition. The reason is that often the sale of an asset with monopoly rights attached claims a premium. Also, where the policy objective of efficiency improvement is concerned, empirical evidence suggests that efficiency improvements are greater when firms are divested into a competitive sector. Therefore, revenue maximisation could end up being in conflict with efficiency improvement. Similarly the policy objective of broader share ownership may conflict with revenue maximisation, given the need to forgo revenues through share under pricing and providing incentives. These trade-offs are discussed in more detail in the context of choice of privatisation methods.

1.2. Scale and Key Features of Privatisation in the OECD Area

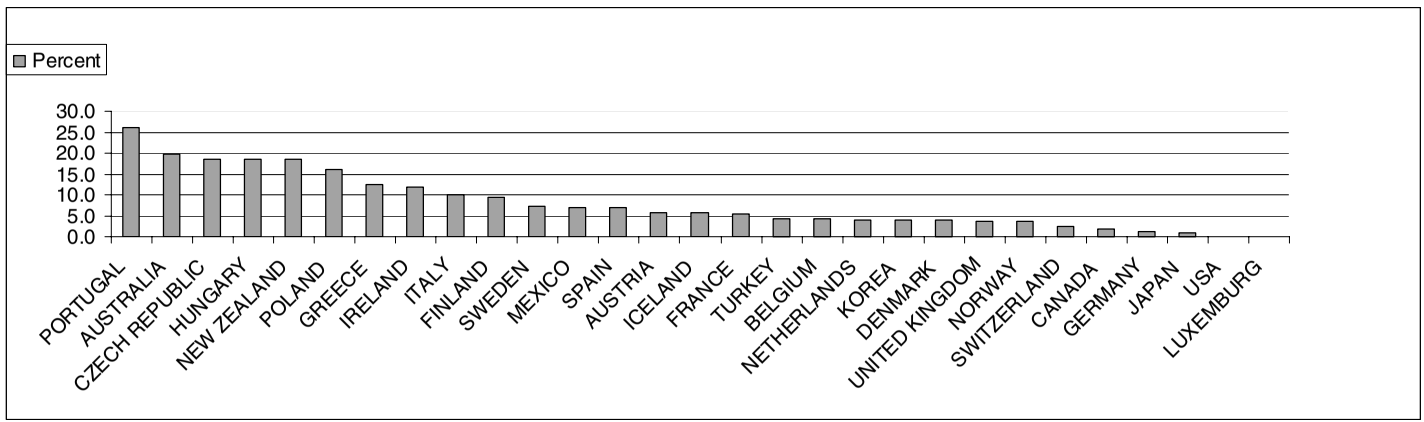
Prior to the 1990s only a few OECD countries undertook large scale privatisation programmes. Except for the UK, Germany and France in Europe and countries such as New Zealand, Mexico and Canada outside of Europe the programmes were rudimentary and rather narrow in scope. In the UK, prior to the sale of British Telecom, a number of transactions were carried out. However, the sale of British Telecom in 1984 is considered the harbinger of the launch of large-scale privatisations that continued throughout the 1980s and well into the mid-1990s. In France, a large privatisation programme began in 1986, but due to political reasons came to a halt in 1988 and remained dormant until 1993. Germany started its first privatisation programme in the 1950s and 1960s. After a hiatus, privatisations were resumed in the 1980s, leading to full privatisation of government stakes in industrial holdings and some companies in the banking and transport sectors. The 1990s were characterised by the opening up of monopolistic markets, particularly in the postal and telecommunication services, and the sale of significant stakes in companies such as Deutsche Telekom AG and Deutsche Post AG. Outside of Europe countries such as New Zealand and Mexico embarked upon massive privatisation programmes, but while these were large relative to the size of their respective economies and had a broad scope spanning a wide range of industries and activities, they were quite small relative to the scale and scope of privatisation that took place during the 1990s. Finally, while Japan's early privatisation activities were large in terms of the proceeds raised, they remained very limited in scope and were largely concentrated in a few sectors, namely, the railways and telecommunications sectors.

Figure 1.2 **Privatisation Proceeds in OECD Countries, 1980-2001p**



Source: OECD Privatisation database

Figure 1.3 **Privatisation proceeds raised relative to the size of economy 1990-2001p**



Source: OECD estimates

However, by the middle of 1990s, privatisation had gained momentum in most OECD Member countries. In Europe activity accelerated, especially among those who had joined the Economic and Monetary Union (EMU), as they embarked on an ambitious economic reform programme in order to meet the requirements of the convergence criteria of the Maastricht Treaty.

In Australia, the Common wealth and state governments embarked on large scale privatisation programmes which emphasised competition and pre-privatisation restructuring. OECD privatisations were also boosted by the massive economic and institutional overhaul of countries such as Poland, the Czech Republic, Hungary and Slovak Republic, as well as that of the former East Germany. During this period OECD privatisation proceeds in each year averaged around 0.3 percent of the GDP.

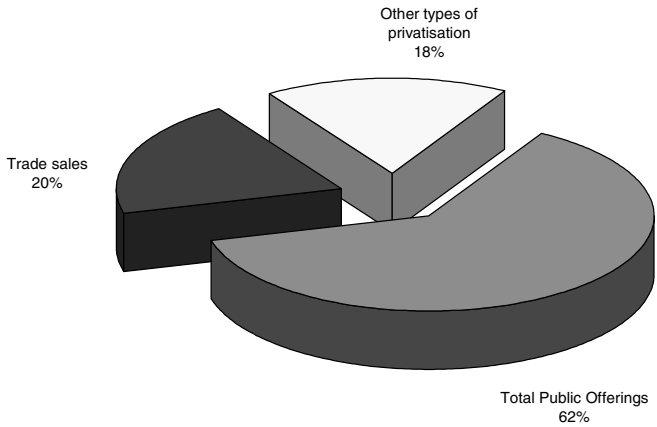
OECD privatisation activities as measured by the value of proceeds generated in each year has the following characteristics:

1.2.1. Public share offerings have been the predominant method of sale

Typically, the vast majority of privatisation proceeds in each year have been raised through public offering of shares on the stock market. This has particularly been the case in the larger OECD economies such as the UK, Italy, France and Germany, reflecting the size of assets sold and the explicit or implicit policy objective of deepening and widening equity markets. For example, public share offerings have accounted for close to 90%[4] of Italian privatisation proceeds raised since 1992. The next most important method of sale has been trade sale which has often been used in smaller OECD countries such as Australia, Mexico and in the former transition economy members such as Poland, Hungary and the Czech Republic. The use of trade sales in these countries is due to a number of factors. In some countries, the relatively small size of the assets involved has meant that the costs associated with initial public offerings (IPO) render this method of sale inefficient. In some cases trade sales have been the preferred approach, partly due to the absence of a well-developed financial and legal infrastructure, and partly as a consequence of the policy objective of improving efficiency by means of providing companies with strong management and access to technology. Finally, in some cases the urgency of completing privatisation for transition to a market economy has contributed to the adoption of this approach, given the relative speed of conducting trade sales compared with IPOs. For example, in Poland trade sales have been exercised very frequently, where by the end of 2001 some 86% of companies privatised through an indirect (capital) method[5] used a trade sale, either through negotiations based on public invitation (77%), or through a public tender (23%).

In Poland, the government has used trade sales in order to gain access to new technologies and know-how, to benefit from the flexibility that this method of sale offers, in that it enables the government to include social packages for the employees (guarantee of employment), and to obtain commitments for investments in the environment and development of the enterprise as part of the sale.

Figure 1.4 **Main Privatisation Methods in OECD 1980-2001p**

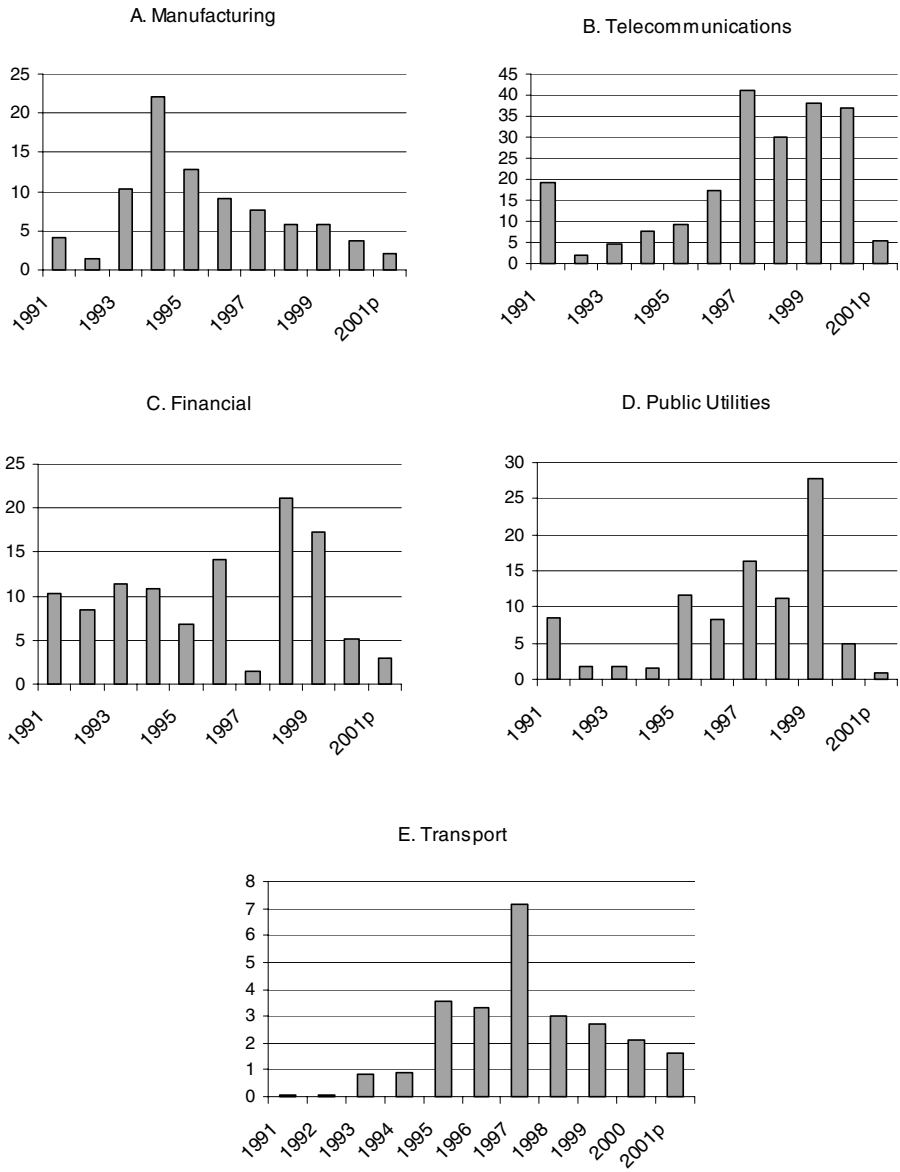


Source: OECD estimates

1.2.2. OECD privatisations have typically begun with smaller assets in competitive sectors

Typically, the life cycle of the OECD privatisation programmes has begun with the sale of firms in the competitive and purely commercial sectors of the economy such as manufacturing and banking[6]. The later stages of the privatisation programme has seen the sale of network infrastructure assets such as telecommunications, power, water and sewage. The reason is that sale of assets in the latter sectors embodies public policy considerations such as consumer protection from abuse of monopoly pricing, addressing issues of universal access and cross subsidies, and therefore poses more complex regulatory and competition issues. Through this approach governments have sought to build credibility for the programme, and to establish the market and regulatory frameworks that are essential to the success of the transaction.

Figure 1.5 **Privatisations in OECD countries by main sector**
(US$ billion)

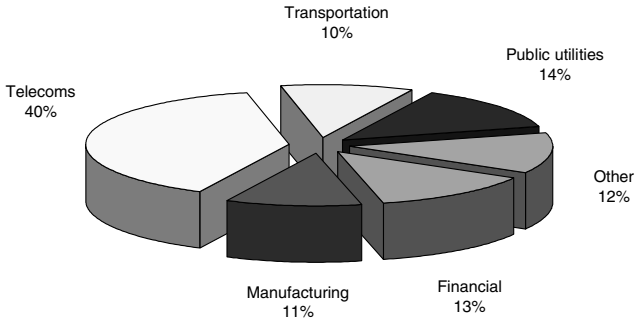


Source: OECD Privatisation database

1.2.3. Telecoms have dominated OECD privatisations

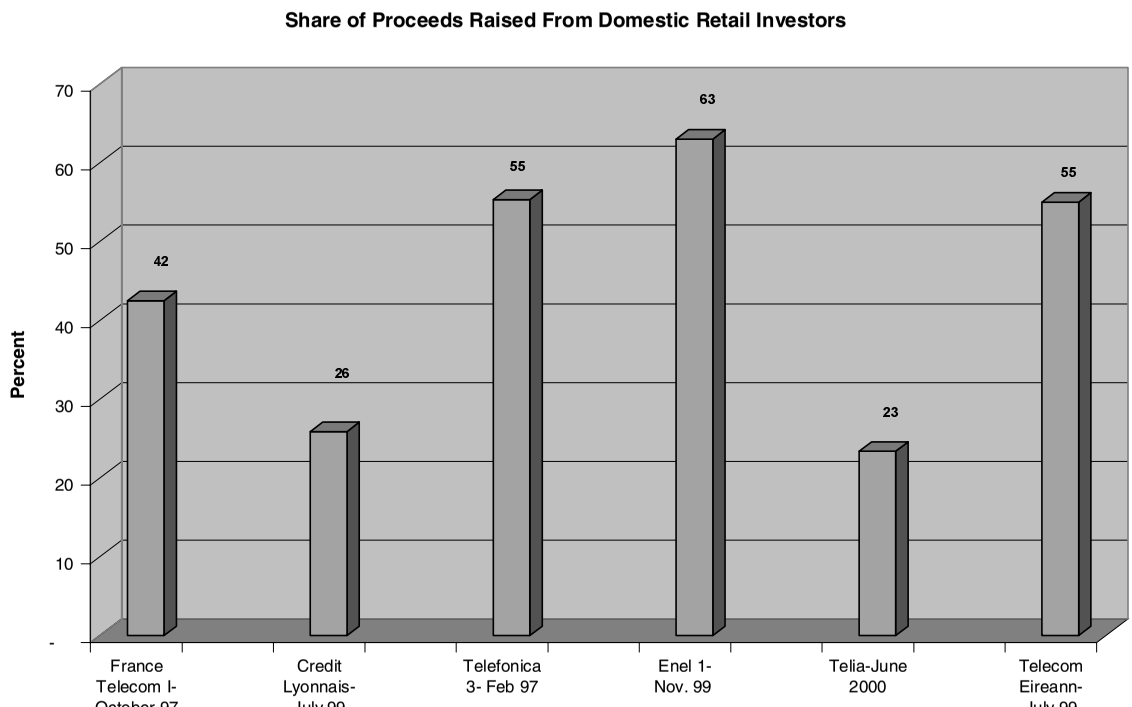
Over the past two decades a very broad range of assets have been privatised in the OECD countries. These have included assets in both the competitive sectors of the economy such as manufacturing, banking and finance, as well as infrastructure assets such as transportation, and energy. However telecommunications has dominated OECD privatisations. The relative importance of telecom sales is explained by (1) the sheer size of these assets, and (2) by the fact that telecom assets are usually the first to be sold, serving as a flagship sale of public utility assets. Furthermore, technological developments, including arrival of mobile telecommunications and their interaction with the early liberalisation of telecommunications (in the EU driven by common EU directives) has made privatisation an obvious first step. This is in marked contrast to privatisation of assets in the energy and certain transport services that is only now taking place in many OECD countries. As a result, in most OECD countries telecom companies have been partially or fully privatised. These have often been among the largest share offerings of a country, hence they act as bellwether stocks on the stock exchange, often accounting for 30% or more of total capitalisation and an even larger portion of total trading volume[7.] Furthermore, technological progress that set in motion market entry and liberalisation for telecommunication services and infrastructure lead to a substantial amount of market activity in this sector and made these highly attractive to buyers.

Figure 1.6 **OECD Privatisation By Sector, 1980-2001p**



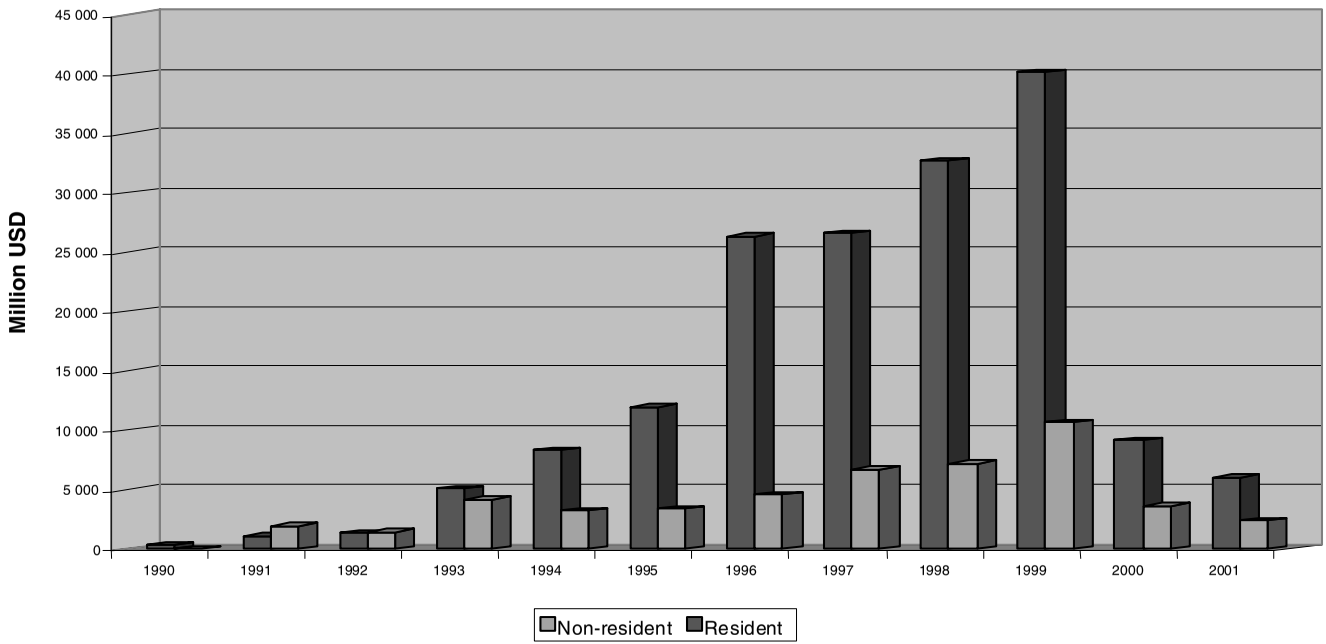
Note: *Due to reporting methodology the data does not include proceeds from indirect sales.*
Source: Estimated based on OECD Privatisation data

Figure 1.7 **Selected Privatisation Offerings and Retail Participation**



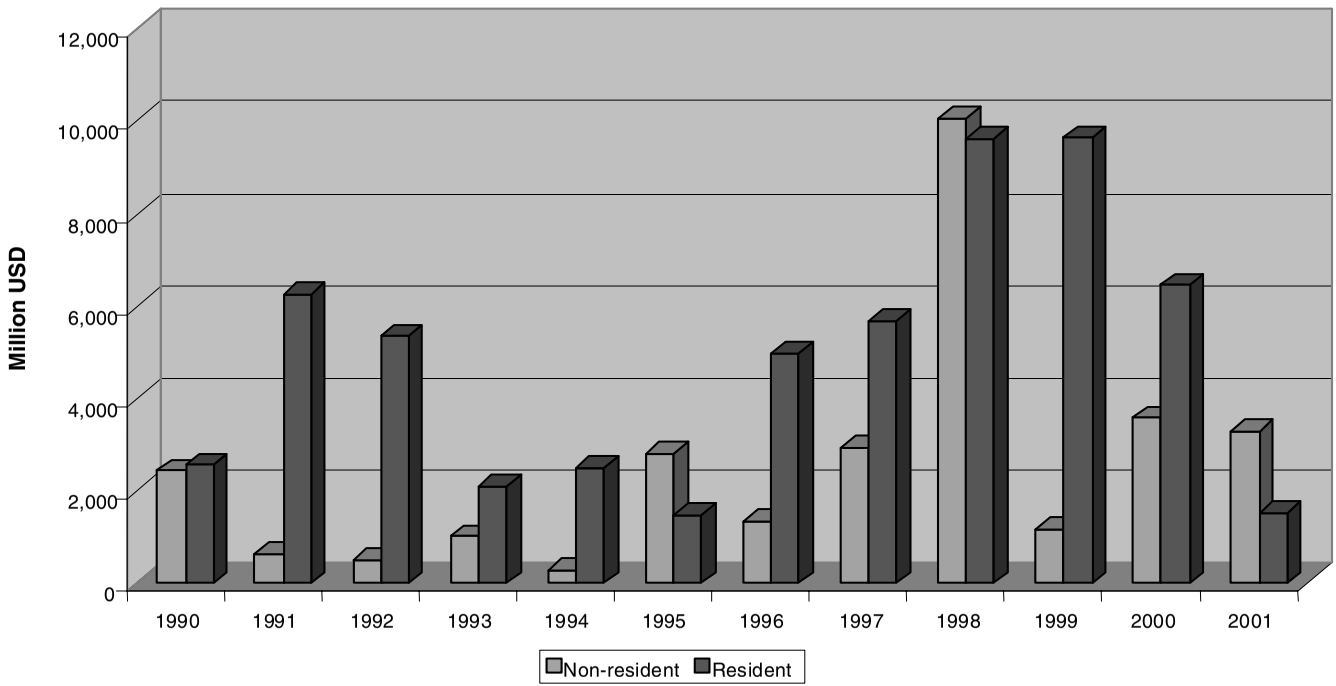
Source: Estimated based on data from OECD privatisation database

Figure 1.8A **Proceeds raised from resident and non-resident buyers in OECD Privatisation Public Offerings**



Note: This figure only takes into account of those transactions where a breakdown of information on resident and non-resident has been reported and therefore should be treated with caution.
Source: OECD Privatisation database

Figure 1.8B **Proceeds raised from residents and non-residents in trade sales in OECD countries, 1990-2001**



Note: For the same reasons as in figure 8A, the findings from this figure should be treated with caution.
Source: OECD Privatisation database

1.2.4. Domestic retail investors have been a significant source of proceeds from public offerings

Retail domestic investors have had a strong participation in privatisation share offerings. Their strong presence owes much to the deliberate government policy of targeting this class of investors. By offering incentives, many OECD governments have sought to widen share ownership and to realise larger proceeds. The latter has been accomplished through the creation of a sense of scarcity, and thus price competition from institutional investors who need to buy shares where large privatisation offerings are involved, in order to meet their index targets

1.2.5. Foreign investors played an important role in OECD privatisations

During the early 1990s foreign investors accounted for over one-half of OECD privatisation proceeds raised through public share offerings. However, the share of non-resident buyers has dropped significantly in recent years, due in part to the increased absorptive capacity of the domestic capital markets.

By contrast, foreign investors accounted for a relatively small portion of proceeds generated through trade sales during the same period. However, foreign buyers in trade sales have made an important contribution to the privatisation efforts of countries with a limited pool of domestic capital and with a need for the infusion of management and technology. For example, foreign direct investment (FDI) has played a central role in Hungary's privatisation programme where close to 70% of proceeds has been raised from sale to foreign investors. In the Czech Republic, FDI has been extremely important as it has accounted for some 89% to 96% of total privatisation proceeds for the last three years. In Poland too, FDI has played a very important role in the privatisation process, where revenues from transactions concluded with foreign investors accounting for over 75% of the total value of capital privatisation revenues[8].

1.3. Empirical Evidence on the Effects of Privatisation

During the past two decades the effects of privatisation have been the subject of intense scrutiny, with the vast majority of studies focusing on the impact of privatisation on profitability, real output, investment, productivity and employment. Despite the data and methodological difficulties[9] there is a large body of literature on privatisation effects, covering a range of time periods, industries and countries looking at the impact on key firm-specific variables. By

contrast macroeconomic and fiscal impacts have been the focus of less intense scrutiny, and the distributional effects of privatisation are only beginning to be studied.

In this report a brief summary of the findings from selected studies are reported in relation to the key policy objectives of privatisation. Most of the studies referenced below include a substantial portion of OECD countries in their sample, and where they are purely based on OECD experience this has been noted.

1.3.1. Impact of privatisation on corporate efficiency and performance

One of the most important policy objectives of privatisation is to improve the efficiency and performance of the companies. Despite the data and methodological difficulties noted above there is overwhelming support for the notion that privatisation brings about a significant increase in the profitability, real output and efficiency of privatised companies. The results on improved efficiency are particularly robust when the firm operates in a competitive market, and that deregulation speeds up convergence to private sector levels. The studies also report that:

- Profitability increases more and productivity increases less in regulated or less competitive sectors.

- Fully privatised firms perform better than partially privatised ones. Cross-country studies report smaller profitability gains and productivity changes as compared to fully privatised ones.

The following provides a brief overview of the empirical studies of the impact of privatisation on corporate efficiency and performance.

Galal et al (1994) looked at 12 large companies (mainly airlines and regulated public utilities) in four countries two of which (the UK and Mexico) are in the OECD area, and measured the net welfare change against the counterfactual. They report that in all but one case privatisation led to a net welfare improvement. Using the same approach, Newbery and Pollitt (1997) looked at privatisation of the Central Electricity Generating Board (CEGB) in the UK and reported that privatisation increased efficiency. However, benefits of the improvements flowed to the shareholders in the form of increased profitability, but due to insufficient competition consumers did not share in these gains[10].

La Porta and Lopez De-Silanes (1998) study of Mexican privatised companies involved a comparison of the performance of 218 enterprises from 26 sectors in Mexico that were privatised between 1983 and 1991 with industry matched private companies and reported that the performance of the privatised companies quickly converged to that of the private sector. This convergence was faster where the market was competitive. They reported increased output and a large decline in employment. However, the profitability increases were not realised at the expense of consumers and workers, in the form of higher prices and unemployment, respectively. The main source of increased profitability is reported to have been improved efficiency rather than higher prices and exceptional labour shedding.

Holder (1998) survey of several studies of the performance of the UK privatised companies (public utilities included) concludes that privatisation has increased labour productivity at a faster rate than before privatisation, leading to lower prices in real terms and improved service quality in particular, in the telecom sector. Only in case of water and sewage companies, where privatised firms were required to make significant investments for the maintenance of the network (and to bring up the quality to standards required by EU), did prices significantly increase in the aftermath of privatisation.

Laurin and Bozec (2000) looked at the productivity and profitability of two Canadian rail companies, Canadian National (CN) and Canadian Pacific (CP) rail, before and after privatisation of the CN in 1995. They found that CN's relatively poor performance during its fully state-owned period of 1981-91 rapidly converges with that of Canadian Pacific's performance levels during the pre-privatisation but post-announcement period (1992-95), and surpasses it thereafter.

However, in a study focusing on telecom companies from 23 OECD countries over the period 1991-1997, Boylaud and Nicoletti (2000) investigated the impact of privatisation and market liberalisation on efficiency, reporting lower prices, improved productivity and higher service levels. They reported that prospective and actual competition had a clear impact on bringing about lower prices and better service quality in the telecom sector, but it found no clear evidence on the impact of privatisation.

A number of studies have compared the pre- and post-privatisation performance of a large number of privatised companies from multiple industries and countries that were privatised through a public offering of shares. For example, Megginson, Nash, Van Randerborgh (1994), looked at 61 companies from 18 countries and 32 industries that were privatised between 1961-1990 through public share offering on the stock market and report significant increases in

profitability, output and efficiency. D'Souza and Megginson (1999) compare 85 companies from 28 countries that were privatised between 1990 and 1996 and similarly document significant improvements in profitability, output and efficiency, and a decrease in employment.

Megginson and Netter (2001) surveyed empirical studies from non-transition economies over different periods of time, countries and industries and concluded that there was almost unanimous support for the view that privatisation is associated with increased output, efficiency, profitability and capital investment.

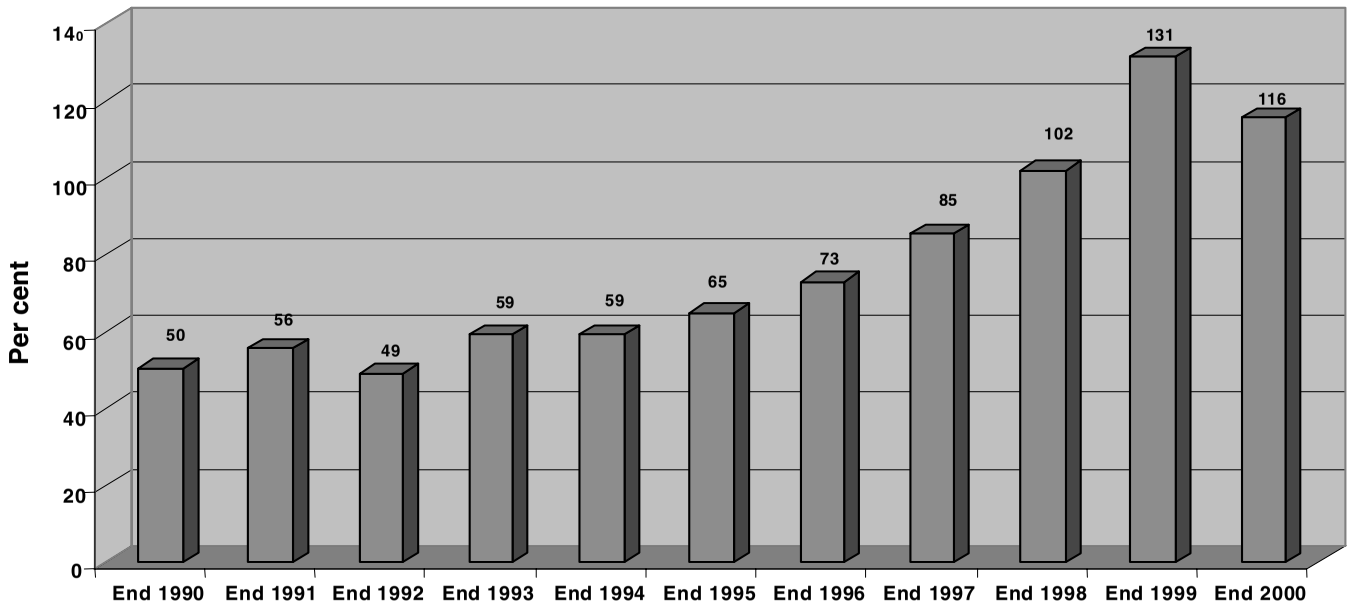
While providing support for the notion that privatisation improves firm-specific efficiency and performance, the studies underscore the importance of competitive markets as a means of enhancing the efficiency improvements and ensuring that the improved profitability is not achieved at the expense of consumers (i.e. through higher prices). In this regard improved corporate efficiency and increased competition are complementary privatisation policy objectives.

1.3.2. Impact of privatisation on capital market development

For many OECD countries capital market development, in particular the deepening and widening of equity markets, has been an explicit or implicit privatisation objective. The link between capital market development and privatisation is well-documented. For example, Boutchkova and Megginson (2000) report that in countries with large public offerings of privatised companies, market capitalisation as a proportion of GDP and trading volume has grown rapidly. They also show that privatised companies are among the largest listed companies by market capitalisation (in non-US countries) and that of the 35 largest common stock issues in history, 30 have been privatisation issues. In countries such as Portugal, Japan, the UK, Germany, France and Italy, privatised and partially privatised companies are the most highly valued companies, accounting for a sizeable share of total market capitalisation. Sheshinski and Calva (1999) note that for countries in all income groups privatisation increases market capitalisation as a proportion of GDP.

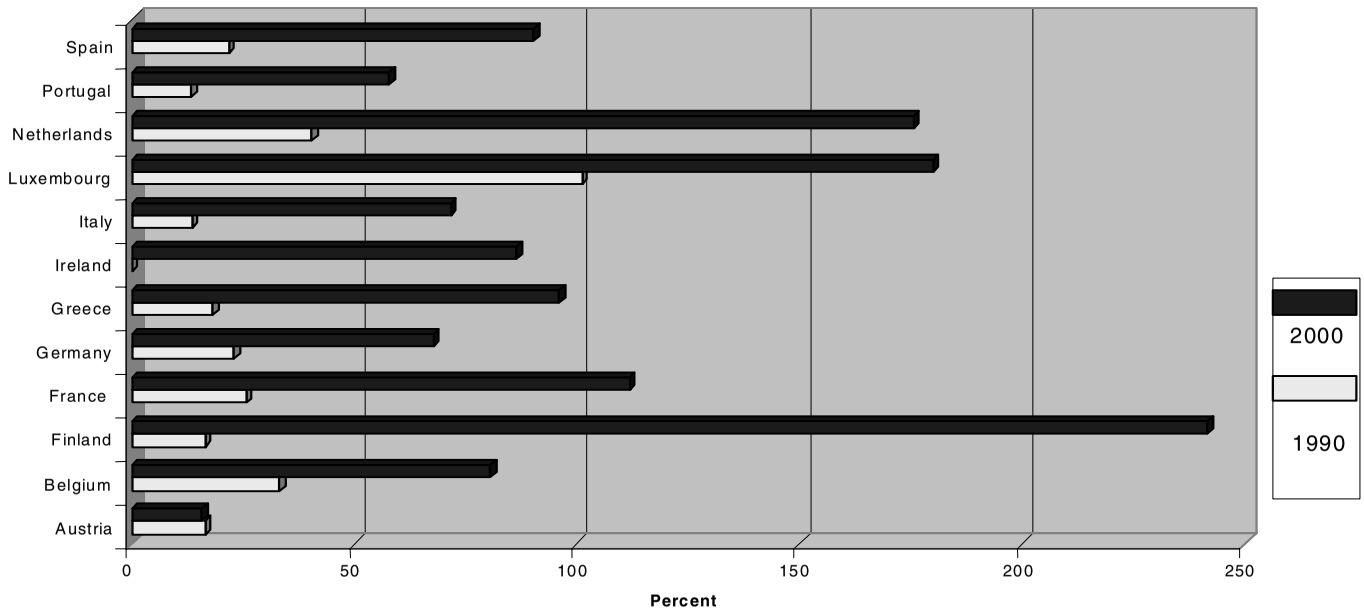
During the 1990s the OECD market capitalisation as a proportion of GDP more than doubled (from about 50% in 1990 to 116% by the end of 2000), with the most drastic changes taking place in the non-UK continental European countries. Privatisation share offerings have been linked to the development of the equity markets in the OECD. For instance, by the end of the 1990s, more than half of the Lisbon stock market capitalisation was made up of privatised or partially privatised companies.

Figure 1.9 **OECD Area Market Capitalisation Relative To GDP**



Source: OECD and FIBV data

Figure 1.10 **Market Capitalisation Relative to The Size of Economy in EMU12**



Source: OECD and FIBV data

Since the early 1990s, privatisation in Poland has been instrumental in the creation and development of the basic capital market institutions: the stock exchange; securities deposit; and brokerage houses. Privatisation has also provided the stock exchange with sufficient trading volume, which in turn supported trust in that institution. The significance of the privatised companies for the stock exchange was reflected in their share of market capitalisation. While the number of listed companies has increased significantly, privatised companies accounted for around 80% of market capitalisation during the 1990s.

1.3.3. Privatisation and fiscal objectives

Fiscal objectives have been one of the core policy objectives of privatisation in the OECD countries. Typically, governments have sought to reduce deficits and debt, to generate tax revenues from privatised corporations and realise windfall gains. However, the impact of privatisation on fiscal and macro-economic variables has not received the same degree of scrutiny as the impact of privatisation on performance.

Barnett (2000) reports that privatisation proceeds tend to be transferred to the budget and saved, and that privatisation proceeds have a positive link to improvement in the macro environment. However he cautions that the results need to be interpreted cautiously as there is not enough evidence to establish causality.

National Economic Research Associates (NERA) 1996 examined the relationship between privatisation and public sector finances for a sample of some 31 privatised infrastructure companies. They report that the revenues from sale of shares, corporate tax receipts, interest and debt repayments, and dividends received from the government's residual share holdings made a very substantial contribution to government finances.

One of the main objectives of the Italian privatisation programme has been to alleviate the burden of public debt. Privatisation proceeds have made a significant contribution to the realisation of this objective where proceeds have been earmarked for debt reduction rather than financing deficits. Since 1994, Italy's privatisation programme has generated over $110 billion in proceeds, which along with other measures has made a significant contribution to Italy's improved finances. For example, between 1995 to 2001 the Treasury bought back government bonds worth some 54 billion USD, and the debt/GDP ratio was reduced substantially.

1.3.4. Impact of privatisation on employment and employees

Labour groups are one of the most important sources of opposition to the privatisation of SOEs, especially those operating in infrastructure sectors. Employees of state-owned companies often benefit from working terms and conditions that are more favourable than those of private sector, and are generally among the most organised sectors of the economy. Their opposition to privatisation is largely based on the view that privatisation leads to loss of employment, that workers lose job security and that their working terms and conditions tend to deteriorate and converge to those of private sector contracts. In countries where state-owned companies account for a significant portion of employment, opportunities for employment are limited, and the social safety nets are not well-developed the impact of privatisation on employment and employees assumes greater significance.

State-owned companies are often overstaffed[11] and restructuring in an effort towards greater efficiency, whether in advance of privatisation or sometimes instead of privatisation, is often accompanied by substantial declines in the number of employees. The extent to which companies are restructured in advance of their sale is linked to factors that include their size, the nature and dynamics of the sector in which they operate, as well as the planned method of sale[12.] Typically, privatisation of larger companies and those operating in monopoly sectors of the economy are preceded by company-specific restructuring which may or may not be part of broader changes as markets are liberalised and competition is introduced. It is often during this phase of reform that the bulk of employment losses take place. For example, in the Netherlands the employment and employee effects such as loss of civil servant status and job security, along with reductions in the number of employees and changes in their job content and benefits have taken place during the restructuring phase. However, privatisation may also involve further employment reductions beyond those achieved during the pre-sale job losses[13].

Among OECD countries the telecommunications sector has undergone the most drastic changes in terms of market liberalisation and technological change and has been fully or partially privatised in most countries. In its comparative review of privatisation on industrial relations, the European Industrial Relations Observatory (EIRO)[14] survey focuses on the case of telecommunications in the EU. It reports that "***The net effect on employment of privatisation varies between countries and both increases and decreases in total sectoral employment can be found, depending on the post-liberalisation structure of the industry and on the components of the sector which are taken into account."***

The empirical evidence on the impact of privatisation on efficiency and corporate performance are vast. By comparison, the issue of the effects on employment and, in particular, the impact on employees in terms of the quality of post-privatisation employment, such as working terms and conditions, are relatively less explored. They tend to provide less clearcut conclusions than has been the case with studies of corporate efficiency and performance, and mixed outcomes have been reported. Furthermore, the data and methodological difficulties in isolating the effects of privatisation from other reform measures and the selection bias noted in the earlier section also apply to the empirical studies of employment levels.

D'Souza and Megginson (1999) compare the pre- and post-privatisation performance of 85 companies from 28 countries and report an insignificant decline in employment, while reporting significant improvements in output profitability, capital spending, operating efficiency and average salary per employee. Bartolotti, D'Souza, Fantini and Megginson (2001) compared pre- and post-privatisation financial and operating performance of 31 national telecommunications companies in 25 countries that were fully or partially privatised through public share offerings between October 1981 and November 1998 and have reported a significant drop in employment. Similarly La Porta and De-Silanes (1999) report a significant decline in the number of employees.

The experience of transition economies with privatisation suggests that restructuring and privatisation have been accompanied by large reductions in the number of employees. For example, in a survey of empirical studies Megginson and Netter (2001) report that in all firms in transition economies employment fell after the reforms were initiated[15].

A small number of empirical studies have reported increases in employment levels. For example, Megginson, Nash, van Randenborgh (1994) and Boubakri and Cosset (1998) have reported increased employment in their sample firms that include both OECD and non-OECD countries. However, their findings could be explained by the fact that their sample was based on companies sold through public share offerings on the stock market, and therefore may reflect the situation with better performing companies that could be sold through a stock market offering.

Also Galal et al (1994), found in their study of 12 companies in four industries (discussed in the earlier sections) that, contrary to expectations, workers were either no worse off, or were in fact reported to have been better off in three cases, where their net welfare improved significantly. However, in this study labour is treated as a group which can mask the fact that at the firm level the worker's net welfare can be adversely affected.

Nellis (2002) notes that over the past decade studies by the ILO[16], along with single country and single firm case studies from a variety of regions and sectors suggest that while a surprising number of privatisations retain workers or in some cases increased employment, and while most privatising governments have sought to promote job retention in their privatisation methods, post-privatisation losses tended to be larger than the gains.

The change in the level of employment is only one aspect of the effects. The question of distribution of job losses among different groups of workers and the quality of post-privatisation employment (in terms of benefits, working conditions and security of tenure) for both the retained workers and for those who find alternative employment is another significant aspect. With respect to the former, employees of privatised companies are reported to often have longer hours, decreased job security and union power, but they receive generous salaries and terms.

Birdsall and Nellis (2002) note the lack of sufficient exploration of the issue of the quality of employment, where they observe that the labour issue has received very little rigorous analysis despite its significance. They also note that in the majority of the cases restructuring before privatisation has led to job losses which have generally continued after privatisation. In a minority of cases there have been improved employment numbers post sale. Furthermore, the important question of the quality of jobs that were found after being laid off has not yet been fully explored[17].

To summarise, studies and data that have explored the impact of privatisation on employment, along with anecdotal information, suggest that the overall effect of privatisation on employment varies across countries and sectors. The potential for employment losses tend to be largest where the industry faces excess capacity, and shifts in technology increase competition without increases in demand. In contrast, in sectors such as telecommunications where market liberalisation and growing demand for new services create new employment opportunities the net losses tend to be smaller. However, regardless of the general macro environment, and the market dynamics of the sector, restructuring and privatisation tend to be accompanied by some degree of dislocation and job loss, at least in the short-term. Furthermore, while governments have often sought to tackle the employment effects as part of restructuring ahead of sale, in many instances employment reductions have continued after privatisation.

1.3.5. Other effects

In addition to the above, the distributional effects of privatisation are important and have only recently being studied. In a recent paper dealing with the distributional effects of privatisation, Birdsall and Nellis (2002), review the growing but uneven literature on the distributional effects of privatisation. The distributional impacts of privatisation can arise from changes in distribution of assets and the returns to them or from prices and access to goods and services formerly provided by the state. This study states that “the distributional impacts of privatisation cannot be simply predicted. But the effects on equity depend on at least three factors: initial conditions in each case, the sale event, and the post-privatisation political and economic environment”.

They note that "privatisation appears to have worsened the distribution of assets and income at least in the short run" and that this has been observed more in the case of transition economies than in Latin America. This effect seems to be less clear for utilities such as electricity and telecommunications where privatisation may have increased access by the poor than in the case of banks and natural resource companies[18].

2. IMPLEMENTATION METHODS AND TECHNIQUES

Abstract

Part 2 underlines the key components of the privatisation process, showing why it is necessary to articulate objectives and trade-offs, to choose between an ad-hoc approach or a privatisation programme, and then to establish an institutional framework. This institutional framework should determine whether a centralised, decentralised or mixed model should be adopted, establish the role of SOEs and private sector advisors in the process, and designate ways to ensure the integrity of this process. Then key policy choices will have to be made with regards the following: *(i)* privatisation legislation; *(ii)* pre-privatisation restructuring; *(iii)* sequencing and staging of decisions; *(iv)* foreign ownership; *(v)* labour issues and *(vi)* treatment of privatisation proceeds.

Part 2 also presents the key characteristics of the different privatisation methods. It shows their impact on corporate governance and transparency, and discusses which methods are more appropriate in which circumstances. Finally, Part 2 discusses the different post-privatisation control devices that may be applied, with their rationale, advantages and disadvantages.

2.1. Key Components of the Privatisation Process

In some countries adoption of privatisation policies has its roots in ideology and the attitude towards the role and scope of government participation in economic activity. In others the policy is driven by pragmatic considerations such as the need to realise fiscal objectives or to improve the economy's competitiveness. Regardless of its policy roots, implementing privatisation policies is often complex and requires an effective and well coordinated approach in order to produce the desired outcomes. This is due to the presence of the following factors.

- Privatisation policies seek to meet multiple and at times conflicting objectives, and their implementation gives rise to a large number of cross cutting policy issues that need to be identified and adequately addressed, prior to sale, particularly where privatisation of assets in the non-competitive sector is involved.

- Privatisation is a contentious policy in that it brings about changes that erode the influence of bureaucrats and SOE managers, involves restructuring and the potential for loss of jobs, and has an impact on consumers for whom price and access to goods and services is likely to be altered. Therefore, it often faces opposition from various stakeholders. Furthermore, the policy is vulnerable to potential abuse by the participants in the process. This can severely undermine government credibility and set back reform efforts.

- Privatisation is a highly resource intensive activity, often demanding skills and expertise that are not typically available in the public sector. Therefore, its planning and implementation involve a significant amount of interaction with private sector advisors. It also requires a great deal of planning and effective coordination of a large number of critical and interdependent policy and transactional tasks in order for transactions to be carried out under favourable market conditions.

In each country the approach to implementation and management has been shaped by the balance of power among different stakeholders, existing economic structures and policy objectives of the government. While there is no right or wrong approach, effective privatisations have the following features in common.

- Strong political commitment to privatisation at the highest level in order to overcome bureaucratic inertia, to resolve inter-institution rivalries in order to move the process forward.

- Clearly identified and prioritised objectives in order to provide the policy with focus and a sense of trade-offs that may be required

- A transparent process to enhance the integrity of the privatisation process, gain credibility with potential investors, and political support from the public.

- An effective communication campaign directed at the stakeholders in particular, to explain the policy objectives of privatisation and the means by which they will be achieved in order to respond to public concerns and to gain support for the policy.

- Allocation of adequate resources (this includes human and financial resources) in order to meet the demands of the policy for the skills and resources that are required to accomplish the many tasks involved in privatisation.

In the OECD countries, the decision to privatise the SOE rests with the government, and /or parliament. Regardless of how institutional management and implementation is being handled, the critical decisions on principle, methods, and price (some range or floor price) has often rested with politicians. The exact form of political decision-making ranges from a council of Ministers, the legislature, or the relevant Minister depending on each country's decision-making processes, the significance of the privatisation candidate, and where the authority for decision-making is delegated. For example, in Germany the responsibility for privatisation rests predominantly with the administration[19]. In some contexts the local governments have also played a significant role. An example is Poland where since 1990 municipal governments have been responsible for carrying out privatisation of assets transferred by the Treasury to "gminas" (communes which are the smallest administrative unit in Poland). A federal division of powers may also give sub-national governments ownership and control over key activities such as electric utilities and transportation which can affect privatisation processes and decisions (for example in Canada).

This section discusses the key elements of the privatisation process and some of the policy choices that need to be addressed in implementing such a process.

2.1.1. Articulating Objectives and Trade-Offs

Privatisation objectives are inter-related and at times conflicting (e.g. maximising revenue versus creating competitive market structures). Clear identification of policy priorities early in the process helps government identify

potential conflicts and trade-offs, and provides the government with a better sense of direction. It also helps guide the choice of privatisation methods and focus communication of the policy. Therefore, it is critically important to set out the objectives and prioritise them as much as possible in order to ensure that the potential trade-offs are fully understood at the outset.

In OECD countries, privatisation objectives have varied among countries and the relative weight of different objectives have also changed over time. As noted in the earlier section for some countries a key objective has been fiscal, i.e. to raise revenues and to reduce budgetary demands. For example, the UK and Dutch privatisations during their earlier stages, and Italy and Spain during the second phase of its privatisation programme in 1989-95, are among this category. In Australia the main objective has been increased efficiency and the creation of a competitive market structure, while in Finland the emphasis has focused on strengthening the competitive position of companies in response to globalisation, greater European integration and promotion of capital market development. In Germany, while promotion of capital market development is an important objective, reducing the role of the state in the economy and securing the future of former SOEs in competitive markets, are among the main aspects of the privatisation policy.

2.1.2. Establishing the Process Framework: A Privatisation Programme or an Ad-Hoc Approach?

The decision on whether to set up a privatisation programme versus adoption of an *ad hoc* approach depends on the relative size of the firm and the scale and scope of activity envisaged. Typically, in countries where privatisation candidates have been rare and relatively small an *ad hoc* approach to privatisation has been adopted. This includes countries such as Sweden, Switzerland, Finland and Denmark where privatisation has been carried out in an *ad hoc* and case-by-case manner. In contrast, where the scope and scale of privatisation has been large, or where the firms have been sufficiently large so as to potentially impact the market, a medium-term multi-year programme has been put in place to ensure an orderly, well coordinated and executed privatisation schedule. For example, Italy, France, Spain, and Portugal, have all adopted this approach. In former transition economy members such as Hungary, the Czech Republic and Poland the large number and scope of privatisation candidates over a relatively short period of time has led to the establishment of elaborate privatisation programmes.

Privatisation transactions in general and those involving public share offerings in particular require a great deal of pre-privatisation preparation and planning.

Having a multi-year programme in place has certain advantages in that it enables the government to plan, develop a strategy, and ensure that the market is ready, so that the sales can proceed under favourable conditions and in an orderly manner. It can also serve to assure potential investors of the government's commitment to privatisation and that policy debates have already taken place and been resolved. Finally, having a programme in place enables the government to negotiate better terms with its advisors and realise cost savings which can be quite significant. Therefore, where the size and scope of the privatisation agenda is relatively large, a privatisation programme could prove efficient and offer greater predictability for the market.

However, the efficiency of a multi-year programme depends on the number and size of expected sales, and the targets that the government seeks to meet. In some cases the scale and scope of the envisaged activities do not warrant the establishment of a programme, and instead the government can benefit from a pragmatic and flexible approach to privatisation. In particular by not committing to a pre-set privatisation programme and targets, sales may be executed when the right offers come along and when market conditions are perceived to be optimal. In this regard rigid adherence to a fixed programme, rather than a pragmatic approach may actually make the policy harder to implement as the process would have less flexibility to adapt to changing market conditions and to address issues that can contribute to securing better privatisation outcomes.

As noted above the most critical aspect of any privatisation plan is a clear political commitment to privatisation, regardless of whether the policy is being pursued within the framework of a programme, or through an *ad hoc* and flexible approach. Without political commitment execution of privatisation transactions will be difficult, irrespective of the institutional framework in place.

The experience from member countries underscores the importance of a pragmatic approach to privatisation that allows the government to respond to changes in market conditions, irrespective of whether privatisation is being pursued *ad hoc* or as part of a pre-established schedule. Even where a programme is in place along with the necessary approvals, often it is the market conditions that ultimately determine the implementation of the policy. This is evident in the sharp drop in the level of OECD privatisation activities in 2001.

2.1 3. Establishing the Institutional Framework

Privatisation transactions are complex, requiring a great deal of planning and preparation. Depending on the type of assets that are being sold, privatisation of SOEs can pose a host of policy questions and decisions that need to be

addressed prior to sale. These include decisions such as when and how to restructure the SOEs that are slated for sale, hiring of advisors, timing, the decision as to who should lead the process, the approach to labour issues, the size of the stake and how fast the asset should be sold. For this reason, the institutional framework for decision-making and management of privatisation policy, and development of a clear road map is critically important for the smooth execution of privatisation policies and ensuring the programme's success.

Typically privatisation of state-owned enterprises involves participation by various players inside and outside of the government. Internally the line Ministries in charge of the company, the state-owned asset, and the central and financial ministries all have an interest in the process. Furthermore, given the many dimensions and aspects of privatisation other stakeholders such as labour and consumer protection agencies could also be involved in the process.

The multiplicity of different players, each with their own vested interests, means that the process should be organised in a manner that can identify relevant policy issues, develop appropriate responses and ensure that all relevant angles have been addressed prior to going to the market. Otherwise, transactions can be delayed and the absence of a clear policy on matters such as the regulatory regime will create investor uncertainty and undermine the credibility of the programme. For this reason the institutional framework to privatisation makes an important contribution to the smooth and efficient progress with the tasks and ensuring desired outcomes.

Management and implementation

In OECD countries, the approach to the institutional framework for management and implementation of privatisation policies has been shaped by the following factors.

- Existing government arrangements and structures in place for managing the various government activities and assets;
- the distribution of responsibility for various state-owned enterprises;
- the balance of power among various stakeholders; and
- the scale and objectives of privatisation.

Box 1 **Holding Companies - Some Examples**

Institute for Industrial Reconstruction (Istituto per la Ricostruzione Industriale), IRI - Italy

IRI was a wholly owned holding company of the Italian Treasury. Established in 1933, it was one of the main bodies through which the government intervened in the economy. IRI provides an example of an existing body whose mandate was changed to carry out privatisation of the assets under its ownership. IRI's assets spanned a wide range of activities that included defense, transportation, manufacturing and banking, compromising some 500 companies. By 1992, IRI had been in a loss making position for seven consecutive years, and had accumulated large debts.

One of the first and most important steps in the Italian privatisation programme was to put in place Law 359/1992 which converted IRI, along with the other three other main state holdings: ENEL (electricity), ENI (petrochemical), INA (insurance) into public limited companies, with the government as the sole shareholder. This was done in order to create, wherever possible, the conditions "to go public" and to make them subject to the provisions of civil law.

IRI had a mandate to privatise the assets under its ownership, and pursued a policy of active management and strategic repositioning as a means of maximising the value of its assets. As a result, by 1996 the situation had been turned around and IRI was paying dividends to Treasury. Between 1992 and its closure in June of 2000, over 30% of the proceeds raised by the Italian privatisation programme were generated from the sale of assets that were held by IRI .

IRI was responsible for transactions such as the sale of Autostrade (highway operator), stakes in Alitalia, and Finmeccanica (defence and manufacturing conglomerate) in 2000 . In preparing the assets for sale IRI often undertook restructuring of the assets and pursued a strategy of maximising value. The sales were carried out through a mix of methods and with a strong emphasis on ensuring the transparency of each transaction. The policy was to retain minority stakes only for a limited time period, where the asset was to be sold in tranches.

Apvrt - Hungary

The Hungarian Asset Management and Privatisation (Apvrt) is a wholly state-owned company founded by the government in 1995. Unlike IRI, the Apvrt does not represent an existing company, but rather a new holding company, with a privatisation related mandate from the outset.

Apvrt is governed by the Hungarian Business Associations Act and by the Privatisation Act (1990), and it exercises ownership and management rights over state-owned asset. It is charged with the task of market based management and sale of these assets in accordance with privatisation law. In its earlier years Apvrt had a government- …/

…/ appointed board of directors and a supervisory board which was made up of government appointees at the advice of the political parties, and reported to a Minister without portfolio. Its budget and use of privatisation revenues is subject to Parliamentary decisions within the framework of the annual budget law.

In 1999, with the drastic decline in the number of assets under state-ownership (175 state-owned enterprises, or about 1/10 of that of 1990) the asset management and privatisation activities were separated. Apvrt was reorganised, a new decision-making structure was put in place, and two successor companies were created in July 2001: the National Holding Company (NHC) and the Debt Management Company (DMC). The NHC is to serve as the asset manager and to sell assets that are slated for privatisation. These changes reflect the change in government priorities whereby the government is now seeking to maximise the value of the assets in companies that are to remain wholly or partially under state-ownership, and to sell assets according to a timing and pace which ensures the best commercial value.

Austrian Industries Holding Company (OIAG) - Austria

The Austrian holding company approach provides an example where a former holding company was transformed into a privatisation body. The Austrian Industries Holding Company (OIAG) was initially a federal government Chancellery. OIAG's mandate initially focused on steel and aluminum industries. During the 1970s the company had a supervisory board that was made up of political appointees. However, after 1986 it had an independent supervisory board and was under the Ministry of Transport and Public Economy. Between 1985 and 1987 the management of OIAG was changed and large enterprises were split into legally and independent market-oriented companies.

As a result of recession and low steel prices the Austrian steel and aluminium industry found itself in debt, and as its parent company, the OIAG sought state assistance in order to meet the companies' debt obligations. The parliament agreed to provide a large capital injection but also required it to be the last, and that further new capital come only through privatisation.

In 1993, legislation was put in place that changed the mandate of the company, charging it with the task of privatising the majority stake of its companies. The new holding (OIAG), was not allowed to intervene in the business of the subsidiaries, except for the sole purpose of privatising a majority stake in them, and was to remain the minority shareholder in Austria's most important industries. At the same time, the company was provided with incentives for accomplishing this goal. In some cases, the law established specific timetables for privatization, along with the size of the stake to be sold, while in others the method of sale was specified. The law also established a number of criteria on the basis of which OIAG was to develop the privatisation concept and obtain government approval for its implementation. …/

/… The Austrian government's programme of February 2000 provides for ÖIAG's current obligations to be discharged through privatisation revenues raised during the coming legislative period. As a result, ÖIAG management has been given the task of developing a concept for privatisation over the next few years, with participation in the following companies being transferred entirely to new owners, strategic partners, or by going public: Österreichische Staatsdruckerei GmbH, Dorotheum GmbH, Print Media AG, Flughafen Wien AG, Österreichische Postsparkasse AG, Telekom Austria AG and Austria Tabak AG. Furthermore, as a privatisation agency, ÖIAG will continue to make its expertise available to companies that are not directly part of the ÖIAG portfolio.

In accordance with the ÖIAG Act which came into effect in May 2000, ÖIAG has been entrusted with the complete or partial privatisation of its companies, and in this task it is required to comply with the Austrian government's privatisation mandate. In carrying out this mandate, ÖIAG must achieve the best possible price in the interests of the Austrian people, taking the company's interests into account while at the same time acting in the best interests of Austria. The new ÖIAG Act also provides for the de-politicisation of the supervisory board by means of a new appointment system under which, after the initial appointments suggested by the federal government, future appointments will be made by the supervisory board itself. Apart from the five supervisory board members proposed by the Federal Chamber of Labour, in accordance with the ÖIAG Act, ten members should be prominent businessmen, executive officers of commercial companies or individuals with many years of experience in business. This new supervisory board was appointed in May 2000.

As of June 2002, ÖIAG had already privatised the following companies or parts of the companies in compliance with the privatisation mandate of the Federal Government: Österreichische Staatsdruckerei GmbH, Dorotheum GmbH, Flughafen Wien AG, Österreichische Postsparkasse AG, Austria Tabak AG, Print Media Austria AG and 22.4% of Telekom Austria via an initial public offering.

Despite wide variations within the OECD countries the management and implementation of privatisations can be grouped into three broad categories as described below. It is important to note that the classifications provided below highlight only the main features of the approach adopted, as in many cases the distinctions are often quite blurred and centralisation is only a matter of degree.

1. The centralised model

Under the centralised approach all the decision-making and implementation powers are highly centralised and vested in a single body. The centralised approach has been adopted in countries where a large privatisation agenda has been in place, and/or the size and complexity of transactions can benefit from the centralisation of experience and executive decision-making. Finally, where

presence of cross-cutting issues require a clear focus and a well co-ordinated approach to ensure that all relevant policy issues are dealt with. A key attraction of the centralised approach is that it tends to restrict the number of participants and thus tends to be more transparent and less prone to conflicts of interest.

In the OECD countries where a centralised approach to management and implementation of privatisation has been adopted, the institutional arrangements have taken the following forms.

a) unit within a financial ministry or a central agency of the government

Under this arrangement a unit within an existing financial or economic ministry is charged with the responsibility for the overall management and implementation of the privatisation agenda. This approach provides the government with direct access and control over the process, and often can be put in place faster and more flexibly than establishing a new dedicated agency or holding company where new legislation or approvals may be required. A potential risk is that the process can become politicised and fall prey to bureaucratic inertia. However, much depends on each country's institutions and the balance of power within the government, i.e. the affected government departments. A major disadvantage of this approach is that inflexible government human resource policies make it very difficult to deploy and retain staff with the right kind of expertise.

Examples of OECD countries where the responsibility is vested within a central financial or economic ministry include France and New Zealand (Ministry of Treasury), Portugal (Ministry of Finance), Mexico (Ministry of Finance during its earlier privatisations). In general, central ministries (such as Treasury or Finance) have a strong incentive to ensure that the privatisation agenda gets implemented and, therefore, they are better placed to lead the privatisation programme. This is due in part to the budgetary and economy-wide implications of the privatisation programmes and partly because these are often the ministries who are responsible for carrying out other economic reform initiatives of the government.

b) a dedicated privatisation body

Under this arrangement a single dedicated agency is responsible for all aspects of management and implementation of privatisation. The establishment of such an agency, its mandate and scope of authority, would likely require legislation and is

thus slower and more complex than the use of a unit within a central ministry. Examples of this arrangement include Turkey's Privatisation Administration.

The main advantage of this approach is that the agency has a very precise and strong mandate. It can therefore rise above inter-departmental rivalries, de-politicise the process, and move the agenda forward. It also enjoys greater flexibility in its human resource deployment and compensation and is thus better able to attract and hire staff with the type of skills required. However, one of the disadvantages of this approach is that the agency may have little clout with the SOEs and fail to draw upon the sector-specific knowledge of the relevant ministries and address public policy issues. Establishing strong links and an appropriate reporting relationship to the political decision makers at the highest level can help raise the profile of the agency and its effectiveness in pursuing its mandate. Furthermore, through policy consultation and coordination with the sectoral ministries, the dedicated agency can benefit from the sectoral expertise that is available in the public sector.

c) holding company of the government

Under this approach the assets are already owned or contributed (by the government) to a holding company who acts as the owner and is responsible for their management and sale. In a number of OECD countries, holding companies have evolved over time and have come to serve as dedicated privatisation agencies as in the case of Austria. Often the holding companies are based on existing organisational arrangements that had been put in place for the management of state-owned enterprises. Thus their privatisation mandate reflects the recent evolution of their mandate into an agent of privatisation.

The use of a holding company structure clarifies the management/ownership decision-making roles and the incentive structure, and can serve as an intermediate step towards privatisation. This is especially true where the enterprises slated for privatisation are in too poor a shape to be sold and are in need of a great deal of restructuring and preparation in advance of their sale, as in the case of Hungary's Apvrt.

The use of holding companies has a number of advantages. This approach enjoys greater flexibility in accessing skills and financial resources[20] that are required for privatisation. In countries such as Hungary, where there is a large privatisation programme and where assets have been in poor shape, the holding company approach has been used to help with fundamental restructuring and preparation. A disadvantage of the holding companies is that they can themselves become politicized and create an additional layer of bureaucracy with its own vested interests that can be inconsistent with the government's

policy objectives and reform agenda. However, in the case of existing holding companies where their mandate has evolved to include privatisation, the risks of bureaucratic resistance can be mitigated through appointment of a new senior management team charged with a clear mandate to prepare the company for privatisation (as was the case in Italy).

In the OECD countries existing administrative structures have influenced the exact form of the central body in charge of privatisation. For example, in Spain, Italy and Austria the holding companies in charge of privatisation are the products of earlier industrial policies and restructured conglomerates. However, as part of the preparations in advance of privatisation their mandates were changed drastically and they came under close the supervision of their countries' treasuries.

2. The decentralised model

This is a fragmented approach whereby the sectoral ministry responsible for the enterprise often leads and executes the process of privatisation. Within the OECD, often those countries with *ad hoc* privatisations have adopted this approach. For example, privatisations Germany, Denmark and Switzerland share this institutional characteristic. Another example is Japan, where despite the size of its privatisation activity, the scope has been confined to a few large companies (namely NTT the Japanese telecom company, Tobacco and East Japan Railway Company). However, while the approach is basically decentralised, the central economic/financial ministry always plays a very significant and pro-active role. For example, in Denmark no major privatisations have been carried out without a strong pro-active participation by the Ministry of Finance, which has also played an important role in the privatisation processes themselves, and has in fact been a main driver of privatisation. In Germany the Ministry of Finance gets involved in every privatisation, and acts as the driver of privatisation, in that every two years it initiates a review of the need for continued state ownership of the state-owned enterprises. This review results in a government resolution by which companies for which the rationale for state ownership has disappeared are earmarked for privatisation.

Similarly, in the UK the Treasury played an important part in coordinating the privatisation programme and was actually involved in all significant deals, although the sectoral ministry for state-owned enterprises was responsible for accountability and ultimately in charge. In the UK, sectoral ministries were responsible for introducing legislation, restructuring and for carrying out the transactions, while Treasury played a central co-ordinating role, it was not responsible for the execution of the actual transactions except in the case of secondary sales where the shares were transferred to it for sale.

The decentralised approach is more appropriate when there are few candidates to privatise, the assets pose few cross-cutting public policy issues, or when the stage in the privatisation programme's lifecycle warrants this approach, as in the case when the institutional framework has been disbanded and the scope of activity does not warrant establishment of a new programme. In Canada, for example, after adopting a centralised approach in the late 1980s to early 1990s, sectoral ministries are now back in charge of privatisation. Similarly, in Mexico the current practice is largely decentralised.

Relatively few OECD countries have adopted this approach. One of the main drawbacks of the decentralised model is that it does not build on experience nor does it create a focal point for investors to deal with the government. Furthermore, where the process is managed and implemented by the SOEs and the structures they report to in line ministries, there can be inconsistencies with the government's policy objectives (e.g. where introducing competition is an important policy objective). Furthermore, where SOEs essentially control themselves privatisation may encounter several bottlenecks. For example, investors may try to by-pass the institutional framework, open the process to lobbying, undermine government control and create inconsistencies between the approaches of different parts of the government.

For this reason the decentralised approach requires a very strong Ministry of Finance or Treasury presence to guide the process, and it is assisted where there is the capability to move civil servants between departments. The latter allows the government to transfer the expertise gained from one privatisation to the other, which can be drawn upon in the course of another transaction. In the UK this approach to staff mobility was adopted to some degree.

3. The mixed model

Under the mixed approach different elements of the centralised and decentralised model are combined in varying degrees. The adoption of the mixed approach is often the result of the country's existing arrangements for ownership and management of state-owned assets, such as where holding company structures have been in place. For example, in Italy the Ministry of Treasury, along with its holding companies, was responsible for managing and implementing the OECD's largest privatisation programme in the 1990s. IRI, the wholly Treasury-owned holding company with assets in a wide range of industries accounted for approximately one-third of privatisation proceeds raised in Italy's privatisation programme between 1992 and 2000[21], when it was finally liquidated and its residual assets transferred to the Treasury.

Another reason for this approach arises from the large number and diversity of the assets involved. Hence, in Poland privatisations involving large enterprises with cross cutting aspects are carried out centrally by the Ministry of Treasury, while privatisation of smaller entities has been delegated to heads of provinces (voivods)[22].

A key disadvantage of this approach is that the multiplicity of the institutions can create confusion among potential investors. It can also give rise to inter-institution rivalries. A clear definition of the mandates and roles and responsibilities of those involved can ensure that activities are well integrated and coordinated. Also, a clearly defined source of authority with final responsibility for decision-making, and, ideally, placed at the highest level possible is required to demonstrate the political will and power to arbitrate between different players and thus move the process forward.

Regardless of the institutional approach it is very important to ensure that a central financial/economic ministry plays a key coordinating role in privatisation. This will help ensure that the policies adopted and outcomes are consistent with government objectives. In this regard, the financial/economic ministry is often best placed to play that role due to its overall economic and financial policy mandate, and its interest in ensuring that the reforms are undertaken.

Given that privatisation is a very resource intensive activity that requires flexibility and often skill and expertise that is not widely available in the government, it is necessary to ensure that the organisation responsible for managing and implementing privatisation is provided with the internal flexibility to handle the tasks. Furthermore a degree of independence in managing resources (including human) and the possibility of their rapid deployment in response to changing requirements would help the organisation fulfil its mandate.

Role of SOEs and private sector advisors

1. Role of the SOEs

SOEs have an important role in their own privatisation, both in terms if initiation and implementation. This has been particularly true where the SOEs have enjoyed a large degree of *de facto* autonomy. The government often relies on the cooperation of the company in order to ensure that the company is successfully prepared for sale and transition to the private sector, especially when the sale is to be preceded by major restructuring. Given the important role

of the SOEs in privatisation, often new leadership with private sector skills and a strong commitment to privatisation has been put in place to bring about the necessary changes and to lead the company during its transition to the private sector. In this respect, governments need to give consideration to the issue of remuneration and use of options in compensating the company leadership. Often these give rise to significant political issues that bedevil privatisation.

While the SOEs have an important role to play, their control or undue influence over the privatisation process can create a conflict with the policy objectives of privatisation and that of the process itself:

1. SOEs have their own vested interests and the SOE control of the process could potentially lead to a situation where the SOE and government objectives are inconsistent with each other. An obvious example is where the government is seeking to create a competitive market environment while the company management often favours less competition rather than more. For this reason it is important to ensure that the company management is committed to seeing privatisation through and that the SOE does not control the process.

2. SOE involvement could give rise to potential charges of insider influence over the sale, create uncertainty for potential investors, and result in a situation where the potential investors try to by-pass the established rules. These will undermine the credibility and integrity of the process.

2. Role of Advisors

Privatisation of state-owned enterprises requires skills and expertise that is not available in the public sector. As experience from the OECD countries shows, most privatisation transactions have entailed some degree of involvement by private sector advisors. Typically, the hiring of advisors is one of the tasks carried out during the very early stages of the programme, and developing the expertise in selecting and monitoring the performance of advisors has proven to be an important consideration in preparing for privatisation. Given that privatisation often entails a large degree of interface with private sector advisors, it is important to ensure that the public sector develops an "intelligent customer" capability in order to fully understand and evaluate the advice that it is getting from the experts. This also underscores the benefit of a centralised approach to managing privatisation in that this approach tends to lower costs and improves the chances of developing such capability.

During the early stages of the sale where the asset is valued and method of sale is being discussed, financial advisors, accounting firms and lawyers are hired. They advise on the value of the firm using different valuation methodologies[23], feasibility of the sale and the most appropriate method of the sale and the possible markets. Often based on this type of advice and depending on their approach to selling the governments make a decision in principle regarding the key parameters of the transaction and the process moves on to the implementation aspects of the sale.

The kind of advisory services acquired has typically depended on:

1. ***Relative size and complexity of the transactions***

   - One of the first steps in privatisation of the SOEs is corporatisation whereby the SOE is typically converted to a joint stock company whose shares are held by the government. Legal and financial advisors are hired to advise on corporatisation and on preparation of enabling legislation where this is required.

   - Financial advisors are hired to review the SOE's business and finances, its accounting practices and to advise on matters such as preparation of the company books, valuation and financial restructuring. While most transactions require the services of financial advisors, the range and the sophistication of advisory services required is determined by the size and complexity of the transaction.

   - Sale of larger assets and especially those operating in non-competitive sectors of the economy generally involves company-specific restructuring, and in the case of the latter, sector-restructuring as well. In this context, management consultants and industry experts are hired to advise on restructuring.

2. ***Privatisation objectives and method of sale***

The choice of the sale method determines the kind of advisory services that are required.

a. *Where public offering of the shares is the preferred method two types of advice can be distinguished.*

Strategic advisors who advise on the privatisation programme in general and the privatisation strategy, i.e. preparation and positioning of company for sale.

Sale advisors (investment bankers) whose advice is transaction specific and deals with matters such as preparation of the offer and general management and execution of the sale. They help establish the structure and organisation of a sale, and advise on issues such as pricing, preparation of prospectus and execution of the actual transaction. Other sale related advisors hired for public share offerings include advertising and public relations consultants.

- The implementation of successful public offerings is critically dependent on the quality of the advisors in terms of their experience and their access to international markets so that they can generate interest in the offering and distribute shares both domestically and internationally. For example, in the UK privatisations, external advisors worked closely with the government.

- Typically, the compensation structure has been linked to the size of transaction. In recent years, thanks to increased competition the size of the transaction fees charged by the investment bankers has declined, and the transactions have been handled by syndicates involving fewer banks. In some cases, such as in the UK, fees have increasingly been structured so as to place a greater emphasis on their performance (in share allocation).

b. The sale of SOEs through trade sale to a strategic buyer

Often entails far less preparation and restructuring, especially where the assets in competitive sectors of the economy have been involved. These transactions have required legal and financial advisors to advise on corporatisation, and to carry out valuation, and financial restructuring. The transaction specific advice in this context includes soliciting interest from potential buyers, preparing the transaction documents and helping market the company to the potential investors.

The experience of the OECD shows that in hiring advisors the following considerations deserve attention.

1. Separation of strategic from transaction-specific advisory mandates

While using the same advisor for strategy and transaction-specific advice can help speed up the privatisation process and reduce costs, it has a real potential for giving rise to conflicts of interest. Combining of the two mandates (strategy and sale) can potentially compromise the independence of the advice received, as it provides the advisor with an incentive to under-value the assets as a means of facilitating the sale. It can also lead to a conflict with the government's policy objectives. For example, where the government is seeking to restructure the industry and introduce competition, the advisors may advise on the sale of an asset with monopoly rights attached as a means of maximising revenue and ,in turn, higher commissions for the advisors.

OECD member countries have approached this issue in different manners. For example, in the UK, valuation and sale mandates were separated during the primary offering of the shares where the sale is preceded by a significant amount of restructuring, or when the timetable for the offering was indeterminate. In such cases, there could be a real or perceived conflict of interest, for example in the case of partial sales where the government is deciding on how much to sell[24]. In such cases obtaining a second opinion, or a separation of the sale from advisory mandates, can help protect against such conflicts of interest. However, in the case of secondary offerings where the company shares are already in the market this can be a lesser concern. In the Netherlands the government has used a separate advisor and lead underwriter in order to ensure the objectivity of advice received. This approach has been used by Germany as well. In Italy, government separates the two mandates and the strategic advisor can only act as a junior partner in the sale syndicate.

While the separation of the advisory and sale mandates helps reduce the likelihood of conflicts of interest, in practice achievement of such a separation could be severely constrained. In recent years, with the consolidation and integration trends in investment banking, the market for strategic advice as distinct from that which leads to transactions has become smaller than was the case in the past. This has meant that many investment banks may only be interested in the strategic advisory role if it leads to (or at least does not result in preclusion from) subsequent transactions.

In this respect, Italy's approach to hiring advisors as noted above, and also the more recent UK privatisation transactions where the government has sought to appoint a separate advisor who can offer a second opinion, have helped address the potential for such conflicts-of-interest.

2. *Should the government and the SOE share the same advisors?*

This is another area for potential conflict of interest. When the government and the SOEs have the same company advising them on legal or financial issues the likelihood of the advice being compromised is increased. In such cases it is best if the company and the government have separate advisors. However, common advice in areas such as presentational or marketing strategy might be beneficial.

3. *Open and transparent competitive processes should be used for hiring advisors*

In order to ensure best value and to protect the transparency of the privatisation process governments should hire advisors through a competitive bidding process. But in light of the importance of technical specialised skills, it is important to ensure that competitive processes assign sufficient weight to the quality, competence, and experience of advisors as the key criteria in the selection. In this regard it would be useful to develop a list of qualified bidders instead of focusing exclusively on cost.

4. *Ensure that the advisor is only representing the government or its selling agent's interests*

The government needs to ensure that the advisor is not working for (or is not indirectly related to) potential bidders who may be working with the subsidiary, and that the information obtained by the advisor does not make its way to potential bidders.

5. *Ensure that the pay structure does not create incentives for working against the government interests*

For example, ensure that the commissions do not skew the advice in favour of options that are against government objectives, e.g. granting monopoly rights in order to generate bigger commissions from the sale.

As noted above, acquiring the best advice plays a very important part in ensuring the success of privatisation. At the same time, developing an "intelligent customer" capability as discussed in the earlier section is also critically important for acquiring the appropriate advisory services and for ensuring that the officials involved in the process can make effective use of the advice received.

Table 2.1 **An Example of the type of advisors required by different players in the privatisation process** [25]

i. Government Advisors

Legal advisors	Investment Bankers	Accounting Consultants	Stockbrokers	Advertising /PR & Opinion Research Advisors
Government lawyers • Preparing, enabling legislation. • Setting up of an agency for selling SOEs • Legislative changes needed to sell specific entities External Legal Advisors • Overseeing and advising on all commercial and transactional aspects.	• Advising on strategy and structuring the sale • Advising on stock issue versus strategic sale, pricing, underwriting, marketing and preparation of prospectuses for public share offerings The same advisor may in practice be the provider of both strategic and transaction advice.	• Advise on corporatisation, SOE accounting policies, financial statements valuation and prospectus preparation	• Advise on public issues, stock exchange requirements and regulations and admission of new companies to listing	• Advise on marketing campaigns and communications • Research public opinion and views of investors and monitor the impact of PR campaigns

ii. SOE Advisors

Financial Advisors	Management Consultants
• Advise SOE management on valuation of assets, cash flow future, capital adequacy and preparation of accounts in a form that could be used in preparing of the prospectus.	• Advise SOE on corporatisation and preparing them to perform in a private sector environment and in the absence of subsidies. • In case of strategic sales and joint ventures the experts agree that it is best to minimise operational restructuring .

Integrity of the process

Privatisation transactions change the status quo, and by their nature are contentious. Often the selling price is a source of criticism and perceptions of conflict of interest and corruption charges can severely undermine the credibility of the privatisation process with potential investors and erode public acceptance of the policy, both of which can jeopardise the programme, and setback reform efforts. For this reason gaining credibility and public acceptance for the policy critically depends on the ability of the government to inspire confidence in the process by ensuring that it meets the highest standards of probity.

The integrity of the privatisation process depends on the degree to which the process is transparent, its provisions for ensuring that the decisions are made free from real or perceived conflicts of interest, that selling methods rely on open competitive approaches as much as possible, and finally on whether there are mechanisms in place to ensure accountability[26].

Transparency: Transparency of the process helps ensure that decisions are not arbitrary and have been based according to certain rules and criteria, and are applied in a fair and open manner. For this reason, a precise and clear set of rules and procedures are defined and followed, and information on the transaction are made public ex-post. Finally transactions should be subject to some form of scrutiny and oversight by public bodies as appropriate.

- Establishment of clear rules and processes for auctions, specific criteria for the evaluation process in the context of competitive bidding, use of open procedures in the selection of private sector advisors, and rigorous publicity requirements contribute to the acceptability of the process by making sure that the choices have not been driven by vested interests and that they have been arrived at in the context of a level playing field.

Conflict of interest: Conflict of interest provisions for government officials, SOE insiders, and private agents, are measures that can help ensure that the rules are applied uniformly and thus enhance transparency. This can assure investors and the public that the decisions are based on the established criteria, and through maximum disclosure the government can contribute to the process integrity and stem public criticism of the process.

- Often the potential for conflicts of interest is very real and therefore measures aimed at mitigating against them are needed to ensure the integrity of the process. In this respect, the rules should focus on intra- corporate relationships, especially regarding SOEs, activities of government officials and the behaviour of sub-contractors.

Accountability: *A*ccountability of privatisation institutions would help enhance the integrity of the privatisation process. The mechanism for ensuring accountability is largely shaped by the existing arrangements and institutions that are in place in each country, and whether they are deemed to be adequate for addressing privatisation transactions, and the need to balance accountability requirements (to the executive branch and/or legislature) against the potential for rendering the process excessively vulnerable to short-term political consideration.

Often the selling price is one of the main sources of criticism. The approach to ensuring proper pricing has varied among different OECD countries. For example, France and Spain have an *ex ante* review of the planned transaction in place. In France the Privatisation Committee, composed of independent experts[27], sets a floor price which is binding for the Minister of Economy (which has the responsibility for setting the final price). The establishment of this Committee (under the 1993 privatisation legislation) was in response to the criticisms of the discretionary powers of the Minister of Economy in selecting the investors in earlier privatisation transactions. In Spain, an expert committee of up to eight individuals, most of whom are academics and privatisation experts review prices. Italy has benefited from the establishment of a special Advisory Committee which is composed of bureaucrats and independent experts and has the explicit mandate to provide oversight of the transparency and fairness of the privatisation process.

In a number of OECD countries, privatisation-specific rules have been put in place to protect against conflicts of interest. These include the Czech Republic, the Slovak Republic, Poland, Mexico, and Turkey.

In most countries, the usual audit processes apply *ex post* to privatisation transactions. For example, in the UK, the National Audit Office (NAO) examines each privatisation transaction and prepares a report. In a few countries such as Denmark, Sweden, and Finland there are no privatisation-specific rules in place for protection against conflicts of interest. This is largely a reflection of the relatively small scale of privatisation activity that is taking place and the adequacy of the existing processes and structures in accommodating oversight of privatisation-related activities in these countries.

OECD experience shows that open, transparent and competitive processes generate better outcomes in terms of price and quality of buyers and can help privatisation attain its objectives. The gains in terms of better outcomes and programme credibility generally outweigh the costs of running competitive processes.

2.1.4. Policy Choices

The approach to privatisation legislation

There are two aspects to privatisation legislation. First, is the privatisation specific legal framework, i.e. legislation that establishes the framework for decision-making and change in the status of state-owned enterprises and their transfer to the private sector. The second aspect relates to the state and characteristics of the legal and institutional infrastructure in each country. This includes the laws governing property rights, company law, competition law and the regulatory framework. A well-developed legal framework is an essential requirement for ensuring that the privatised companies can function and perform effectively in the private sector. In most OECD countries the institutions of a market economy are already in place, with the exception of the former transition economies where the challenge of large privatisation programmes has been compounded by the need for the creation and enhancement of the market economy institutions and legal frameworks. While the general legal infrastructure of the countries is critical to the success of the privatisation, their discussion is beyond the scope of this report.

Instead, the report focuses on privatisation-specific legislation within which such transfers can take place. The approach to legislation is largely a reflection of the existing legal framework, the way the SOEs are organised and the size and scope of the privatisation activity foreseen. In general, two broad approaches to privatisation-specific legislation can be distinguished.

Framework legislation: Under this approach a comprehensive framework is put in place to address all aspects of the privatisation process, from the institutional and decision-making organisation to the disposal of the asset. The purpose of such legislation is to state the objectives of privatisation, the principles governing it, and specifies the institutional structure. It also provides framework rules for conditions of sale and provides for powers to sell and create special provisions for the employees. In some cases the legislation has also sought to provide for modalities of privatisation and to create special rights for the state post-sale. Finally, a framework law usually contains a broad delegation to the administration to deal with privatisation particularities.

Typically, countries where the scale and scope of the privatisation activity has been large have adopted this approach because it provides the government with greater flexibility and predictability to formulate and implement privatisation policies. The countries that have enacted general privatisation legislation include Austria (1993), France (1986 and modified in 1993, and 1996), Italy (1992/1994/1999), Poland (1990 and 1996), Portugal (1990) and Turkey (1984, 1986).

Case-by-case legislation: In this case, the approach to legislation generally focuses on specific assets and parts of the privatisation process, rather than establishment of an overall legislative framework.

A number of OECD countries have approached privatisation on a case-by-case basis and the introduction of a general legal framework has not been necessary, reflecting the country's existing legislative system, constitutional requirements, and institutions in place. In some the legislative requirements have been accomplished in the framework of their budget laws (Spain and New Zealand), while in others company-specific legislation has been introduced to enable the privatisation of the company (UK). In Germany general legislative requirements already exist in the framework of the budget law, while in other areas (mostly former monopolies like Post and Telecommunications) additional company-specific legislation (e.g. to introduce competition and to transform the former monopolies into stock companies) were introduced, to enable their privatisation

The decision on the approach to legislation is a function of each country's existing legislative structures and traditions, constitutional provisions and the scope and scale of planned privatisation activity. For example both France and the UK have implemented some of the OECD's largest privatisation programmes, yet their approach to privatisation legislation has been very different.

Pre-privatisation restructuring

Pre-privatisation restructuring is one of the key steps in the privatisation process and has important implications for achieving the desired outcomes. There are two types of restructuring.

i. Company-specific restructuring: Often, SOEs are a division or a branch of the government with no corporate identity, and their finances and performance are often in a poor shape. In this context company-specific restructuring refers to the various changes that pertain to the company directly and are related to its legal identity, financial, operational, and strategic features.

ii. Industry-wide restructuring: This refers to changes that are designed to affect the structure of the whole industry/sector and are based on the government's envisaged market structure post-privatisation. This type of restructuring affects both the structure of the industry as a whole, and its implementation typically entails a significant amount of company-specific restructuring as a means of supporting the envisaged market structure.

Box 2 **Restructuring: Deutsche Telekom AG**

Deutsche Telekom AG is Europe's largest provider of telecommunications services. Until 1989 the company was the monopoly provider of infrastructure, services and terminal equipment. In Germany, as in many other countries, public telecommunications services and infrastructure were provided as an integral part of Deutsche Bundespost; the state postal, telephone and telegraph monopoly as provided by the constitution.

The restructuring and preparations for privatisation began in 1989 with the enactment of the first postal reform law: " Postreform I ". As a first step, the government separated the regulatory (public policy) from the commercial functions, and thus began to transform the services administered by the Deutsche Bundespost into market-oriented businesses. The activities of the Deutsche Bundespost were divided into three business areas: telecommunications; postal services; and banking. At this time, a process of market liberalisation of the telecom sector was also initiated.

The second postal reform law, "Postreform II" of 1994 converted Deutsche Bundespost into three distinct joint stock companies in the business areas noted above, and, effective 1995, Deutsche Telekom AG began operations. Postreform II, also provided the framework for privatisation of Deutsche Telekom. The sale of the company took place through a series of stock market offerings, beginning with an initial public offering in November of 1996 that reduced the government stake to 74%.

In accordance with the requirements of the European Commission directive on liberalisation of telecommunications market, the sector was fully liberalised on 1 January 1998. The operation of networks (including cable networks) for all telecommunications services other than public fixed-network voice telephony had been previously fully opened to competition starting on 1 August 1996.

The company-specific restructuring of Deutsche Telekom included the following steps:

Early in the process, a new senior management team drawn from the private sector was appointed and the executive and supervisory boards were established.

Company operations were restructured in order to increase efficiency, and its activities were refocused in order to ensure that products and services were consistent with the market demand. As part of its restructuring efforts the company had to reduce staff from 230,000 (in 1995) to around 167,000 in 2000. The company negotiated collective agreements with its three unions, with provisions for voluntary and early retirement to facilitate the transition. The company also undertook a great deal of retraining to allow for redeployment of employees into new activities. Another key element of this transaction was the provision of substantial discounts (as much as 40% in the IPO) to employees who wished to purchase shares and as a result over 60% of the employees eligible for purchase participated in the IPO. …/

/…
In 1998, the regulatory authority for telecoms and postal services were established to promote fair competition and adequate service.

The restructuring of Deutsche Telekom provides an example of where the size of the asset, the nature of its activities, along with the requirements of market liberalisation and the method of sale all necessitated drastic restructuring of the company, both at the company and industry level. It is also worth noting that the changes were taking place against the backdrop of re-unification, and the demands of absorbing, upgrading and expansion of the network in eastern Germany, which meant that by the time the company was privatised in 1996, it had the world's largest corporate debt at around $70 billion[28]. Furthermore, company-specific restructuring and any resulting reductions in the workforce had to be carried out within a context that provided limited room for labour shedding.

The focus of this section is on the former. The latter, particularly where privatisation of network infrastructure assets are critical in shaping the privatisation outcomes and realisation of its objectives, such as introducing competition, has been discussed extensively elsewhere[29].

There are different types of company specific restructuring. These include the following.

i. Legal restructuring whereby the company's regulatory and commercial functions are separated, as in the case of network infrastructure companies;

ii. Corporatisation of the SOEs and financial restructuring whereby the company is converted into a joint stock company whose shares are initially owned by the government or a holding company of the government, and its finances are restructured so as to put it on a viable footing;

iii. Operational restructuring, which affects the management and employment levels of the company; and

iv. Strategic restructuring which deals with the business focus and strategy of the company.

In its broadest form, company-specific restructuring will include all of the above, where its identity is defined, finances are put in order, and its strategy and operations are focused, in order to make it profitable and well-positioned so that it remains viable in the private sector. Firm-specific restructuring in this context typically begins with the change in the management team with an

explicit mandate to prepare the company for transfer to the private sector. The new management will have a mandate to restructure operations and this can involve lay-offs and the addressing of labour issues such as negotiations with unions and establishment of a framework for implementing changes. The company also undergoes financial restructuring. This phase often involves decisions on the optimal capital structure of the company, treatment of its liabilities (for example, employee pension liabilities) and the general cleaning up the company balance sheet in order to make it marketable and to increase its potential value.

In this regard, certain tasks with uncertain outcomes are involved, the government may be better placed to carry them out than the private sector. Firms in the private sector might discount the value of the assets to accommodate such uncertainties. For example, where privatisation of large companies is involved, and restructuring would involve a large number of lay-offs, where labour relations are difficult, and/or where an adequate social safety net for the unemployed is not in place negotiation with unions may require government involvement.

Pre-privatisation restructuring is not a pre-requisite for all transactions, and is best handled on a case-by-case basis. The degree and need for company-specific restructuring is shaped by factors such as: the size of the enterprise; planned method of sale; the structure of the market in which it operates and government objectives with respect to the envisaged market structure post-privatisation.

i. Small- and medium-sized enterprises are often privatised without any significant restructuring. In most OECD countries privatisation of such assets has been carried out with only minor legal and financial restructuring. This has been due to the observed inefficiency of further restructuring, in that the costs are not recovered in the sale price. New owners tend to restructure the company in accordance with their business strategy and are therefore unlikely to offer a premium for a restructured company. For example, the experience of Mexico's privatisation programme suggests that direct costs of restructuring can be substantial and financial and operational restructuring does not increase the value of the sale proceeds. In Mexico labour cutting prior to sale tended to increase the value of the company, while investing in the company had a negative effect[30].

ii. By contrast, where privatisation of larger entities is concerned, a significant amount of restructuring is often a pre-requisite. In this case, in addition to the legal restructuring, the company is broken up into smaller pieces, decisions on matters such as its optimal capital

structure and treatment of its liabilities are made, its balance sheet is cleaned up, and its operations and strategy refocused.

iii. The decision on the need for pre-privatisation restructuring is also a function of the method of sale. For companies slated for flotation on the stock exchange restructuring has often been a lengthy process and of paramount importance. For these companies, significant gains in corporate efficiency are generally attained during pre-privatisation restructuring. In contrast, where the company is to be sold to a strategic investor through a trade sale it is best to limit restructuring a minimum, leaving other changes to the new owners.

iv. Market structure and the government objectives concerning introduction of competition is another significant determinant of pre-privatisation restructuring. Where privatisation involves assets operating in network infrastructure sectors and/or where the state-owned enterprise has been a monopoly provider of goods and services, restructuring at the company and industry level become closely intertwined. As a first step the regulatory and commercial functions are separated, and these are then followed by the breaking up of the company into successor companies along vertical (functional) and/or horizontal (geographic) lines, in order to identify and separate competitive from natural monopoly segments, and to establish the necessary regulatory framework where competition is absent. Industry restructuring and the introduction of competition are very difficult and costly to implement *ex post*, and tend to undermine government credibility with investors. In the OECD these difficulties were amply demonstrated in cases such as the privatisation of British Telecom and British Gas. However, the degree of difficulty will depend on the extent to which improved competition depends on restructuring of existing companies either through regulatory or legislative action. For example, in the context of British Gas the task was far more difficult because the focus was on breaking up the existing company, compared with that of British Telecom where the main task was to introduce more competition to go beyond the initial duopoly created at privatisation.

Box 3 **OECD Recommendation on Restructuring Public Utilities**

Until about a decade and half ago, in most countries, public utilities (i.e. industries operating in sectors such as electricity, telecommunications, water, gas and rail) were considered natural monopolies operating as privately owned regulated industries, or most commonly as state-owned monopoly providers of services.

Given the nature of these industries, governments have been expected to guarantee adequate provision of these essential services at a reasonable cost to the entire population. This means that governments maintain an ongoing interest in these industries, even after they have been fully sold-off, distinguishing them from sale of assets in the purely commercial and competitive sectors of the economy. For this reason privatisation of public utilities is complex and often takes place during the later stages of a privatisation programme.

One of the main objectives of privatisation is to increase corporate efficiency. However, the change in ownership alone is not enough, and its only when privatisation is accompanied by introduction of competition that the momentum for improved efficiency is maintained and the benefits flow to the consumers in the form of lower prices and greater allocative efficiency in the economy.

While public utilities have typically been regarded as natural monopolies, changes in technology and markets have meant that these industries are not monolithic natural monopolies but rather consist of many parts, some of which can sustain competition. For example, in telecommunications and electricity generation industries the capital intensity and lead times involved in the provision of services has dropped substantially, thus expanding the potential for competition in these segments.

In this regard, privatisation provides a unique opportunity to introduce competition into the market. One of the key steps in the process of privatising utilities is identifying competitive segments, and carrying out industry-wide restructuring as a means of narrowing the focus of regulation to those areas where competition is not feasible.

The OECD has recently adopted a recommendation that encourages member governments to consider structural separation of activities as a means of enhancing competition in the public utility sectors, in the context of privatisation and market liberalisation of such industries. This recommendation recognises the existence of potential costs and benefits, and notes that costs and benefits should be balanced and recognised by the relevant agencies, including the competition authority.

The recommendation specifically calls for the careful balancing of the benefits and costs associated with structural measures (such as vertical ownership separation) against behavioural measures (such as regulation of access to an integrated firm). It also notes that "the benefits and costs to be balanced include the effects on competition, effects on the quality and cost of regulation , the transition costs of structural modifications and the economic and public benefits" and that these should be "based on the economic characteristics of the industry in the country under review".

Sequencing decisions

One of the important policy decisions for the government is the order by which assets are privatised. The question is whether privatisation of certain assets should precede that of others, and if so, according to what criteria. For example, should criteria such as company performance and readiness, the sector to which the SoE belongs, or the market structure, in terms of being competitive versus non-competitive, be the key determining factors. The main reasons underlying the sequencing of sales are the following.

1. **Supporting and enhancing the outcome of subsequent privatisations**. In some cases privatisation of certain assets has preceded that of others as a means of supporting and enhancing the outcome of the subsequent transactions. An example of this is the privatisation of banks (see Box 4).

2. **Building credibility and gaining support for the programme.** Successful privatisations in terms of outcomes and sale objectives can help government build credibility for the programme, both with potential investors and with the public. They help demonstrate government commitment to the policy, its ability to address policy issues and to execute sales efficiently. In order to meet this objective the sequencing decision has been based on the quality of the assets (poor versus good performers), and on the complexity of the assets in terms of their market structure and the need for a regulatory framework (assets in competitive versus non-competitive markets).

   For this reason governments have often focused on "easier" and less risky transactions before taking on more complex and problematic ones, in order to gain credibility, to build experience and to buy time to prepare for the more complex transactions.

   In contrast, the sale of public utilities has typically been carried out later in the programme to allow time for company and sector restructuring and to develop an effective regulatory framework when competition cannot be introduced.

   However, in some cases fiscal pressures and the need to demonstrate government commitment to reform has meant that privatisation has focussed on more difficult cases during the early stages of the programme.

   During the past two decades OECD privatisation activities as a whole focused initially on manufacturing and financial sectors, and later on moved to assets in the network infrastructure sectors such as

telecommunications, gas and electricity. As noted earlier in most countries sale of infrastructure assets has typically begun with the sale of telecom companies.

3. **Address transactional and market requirements.** In some cases the decision on sequencing is driven by transactional considerations. For example, the need to comply with the requirements of an envisaged market structure. This is the case where a vertically integrated monopoly is broken up into several successor companies prior to its privatisation and a competitive market structure is envisaged. In such cases the successor companies to the broken up monopoly must be put in place in a timely manner to ensure effective competition can take place. In these situations sale of these companies has to take place within a predetermined and co-ordinated time frame as large lags between these sales can undermine the planned market structure. Also, in some cases the transactional considerations may dictate the timing and approach. For example, the offering of the UK's National power and Power Gen were done through a joint offering, as their separate offering could have had a detrimental effect on the price (of the offerings).

The experience with privatisation programmes in the OECD shows that typically successful programmes have begun with the sale of assets that operate in the competitive sectors of the economy and have required less preparation. This has helped build momentum and gain credibility among investors and the public, facilitating subsequent sales.

Box 4 **Complementary Role of Bank Privatisation**

The complementary role of bank privatisation is particularly pronounced where institutional investors are absent and the capital markets are not well-developed. This was particularly underscored in the context of the privatisation programme of the former transition economy members of the OECD. This has been due to the following reasons.

1. Banks can serve as a resource for financial and management advisory services.

2. Help enforce hard budget constraints on SOEs and partially privatised SOEs, and in turn contribute to the improved performance of these companies.

Staging decisions

One of the key decisions facing privatisation officials is related to staging of sales, in other words how much and how fast the company should be sold. The decision as to whether the company is to be sold in stages, or all at once, and how quickly is influenced by the interplay of the following factors.

i. Sale strategy, where the government is seeking to maximise the proceeds raised by sharing in the benefits of improved corporate efficiency and performance, and by taking advantage of favourable changes in the market. For this reason, many OECD governments have approached privatisation by starting with partial privatisation in order to increase total privatisation proceeds. Under this approach the state-owned enterprise is allowed to improve its performance, build a track record in the market, and overcome the price discounting arising from information asymmetries, and fetch a higher price for the subsequent tranches. Furthermore, by retaining a stake in the company, the government can signal its confidence in the future of the company and its interest in maximising the value of its shareholding. However, the success of this strategy is closely linked to government credibility in the market.

ii. Transaction-related factors such as the size of the asset, and the absorptive capacity of the market. In some cases the gradual approach to privatisation is dictated by the sheer size of the entity (too big to be sold in its entirety), and the limited absorptive capacity of the market, requiring that the sale be carried out in instalments.

iii. Market structure and the existence of an adequate regulatory capacity where there are concerns over excessive market power and partial privatisation is used as an interim step. In such a case, the gradual approach to a sale can provide the sufficient time required for the development of the desired market structure along with the institutions that are necessary for the successful operation of the company; for example, where an effective regulatory capacity is not in place and needs time to develop in order to protect against exercise of excessive market power, with the longer-term intention being full divestiture.

While a gradual approach to privatisation can help address public interest concerns in the absence of well-developed markets and institutions, and help increase proceeds, it does not sever the link to the government, and may give rise to the following drawbacks.

i. The partially privatised asset is vulnerable to government interference. This creates uncertainty for investors with adverse effects on the value of shares. It also means that full benefits of privatisation in terms of improved efficiency may not be realised.

ii. Does not result in full risk transfer to the private sector, and could expose the government to moral hazard where the company is considered to be too big or important to fail[31].

In light of the above, the success of a gradual approach to privatisation is critically dependent on the government's ability to establish credibility with the investor community, and to mitigate against the risk of moral hazard. In this regard the government would be required to demonstrate the following.

- It does not intend to interfere in commercial decisions, and that it will act as a shareholder committed to increasing the value of its holding;

- It is committed to full privatisation and that it will eventually follow through with this commitment; and

- That subsequent sales will be undertaken in a manner that is not detrimental to the existing shareholders

With respect to mitigating against risks, the government would need to ensure that:

- It does not engage in policy and regulatory change ex post,

- It conducts due diligence to ensure the quality of the owners, in that the buyers/management possess the financial and technical capacity to run the business successfully.

- Normal and contingent liabilities and risks are identified at the outset and provisions are put in place to mitigate against them at the time of privatisation

- Appropriate restructuring has been carried out prior to sale to ensure that the asset can viably function as a going business concern in the private sector.

Table 2.2 **Examples of Partial Offering of Shares- Case of ENI**

Tranches	Gross proceeds Millions of Euros	Percent Stake Sold	Share Price in Euros	Type of offer
December 1995	3,253	15.05	Retail, Employee, institutional: 2.7	IPO- global offer
November 1996	4,582	16.19	Retail: 3.57 Employee: 3.55 Institutional: 3.7	Global offer
July 1997	6,833	18.21	Retail: 4.8 Employee: 4.7 Institutional: 4.9	Global offer
June 1998	6,711	15.20	Retail, employee, institutional: 5.9	Global offer
February 2001	2,721	5	institutional: 6.8	Institutional
Total	24,100	69.65		

ENI was sold through five tranches offered between December 1995 through February 2001, reducing the government stake in the company to just over 30%.
Through partial offering of stakes the company has obtained larger price per share
Source: Italian Treasury, Presentation to APEC Privatisation Forum, 2001

In the UK, the general policy has been to sell 100% of the company to the private sector either through one sale or through sale of stakes over time. In some exceptional cases the government maintained its large residual shareholding over a longer period. This was done in two cases: 49% and 40% residual holdings in British Telecom and Genco respectively. In the case of the former the sheer size of the company made the retention of such a large stake necessary, while in the case of the latter this was intended to maximise the proceeds through a two-stage sale. In the case of generators the market had proved itself capable of absorbing much larger offers than the two generating

companies. In both cases the government provided undertakings to assure investors regarding its intentions: namely, that the intent was to dispose of the shares over time, and that the government would not be seeking to exert any influence on management decisions.

In Italy a gradual approach to sales has played an important role in helping the government boost proceeds per share in the public offering of companies. For example, the shares of ENI, the petrochemical giant have been sold in five tranches to date, and in this manner the government has been able to obtain a larger share price in each subsequent offering. In the Netherlands, one of the key objectives of the government has been the maximisation of the proceeds per share, and for this reason partial sales have been undertaken. Similarly, the sale of Telecom Portugal, and the Portuguese national electricity company; Electricidad Di Portugal (EDP) have been effected in multiple tranches. In Germany, company size and enhancing the value of proceeds have influenced the approach to staging of sales.

The positive effects of staging privatisation transactions have been widely noted. In particular, where competition has been introduced the government has acted as a passive shareholder and a partial sale has served as a prelude to full privatisation of the company. The use of partial sales as means of obtaining better value for the taxpayer has also been recommended by the British National Audit Office (NAO) in its review of the privatisation of Railtrack which was sold in its entirety in one offering in 1996[32].

Policy on foreign ownership and restrictions

The policy on foreign ownership of privatised state-owned enterprises can be a sensitive issue, particularly in the context of industries that are considered to be of national and strategic importance. In some countries there have been constitutional restrictions on foreign ownership of assets in certain sectors (for example in Mexico and Portugal until 1990).

The rationale for opening up privatisation transactions to participation by foreign investors is that they can be an important source of capital, especially where the domestic pool of capital is too small to absorb the offerings. This is particularly relevant to emerging market economies and former transition economies where domestic financial resources are insufficient, resulting in transactions involving sale of assets to other publicly owned bodies or other levels of government, with detrimental effects on corporate governance and performance of these companies.

Box 5 **Staging of Sales**

The decision on the size of the stake that is to be sold, as well as its speed, has an important bearing on the proceeds realised.

In 1996, the Department of Transport sold the entire government stake in Railtrack; the rail infrastructure company and one of the successor companies to the former state-owned British Rail. The sale took place through a stock market share offering. The shares were priced at £3.90 each, raising equity proceeds of some £1.9 billion. During the subsequent days and months the share price went up substantially, and according to the NAO, on 30 October 1998 the share price was £16.05, giving Railtrack's equity a market value of some £8 billion."[33]. The full divestment was justified on the grounds that in light of the looming elections, a partial sale might have had an adverse impact on potential investors in that it might have exposed the company to government influence over company decisions. The government was also concerned that the sale of a smaller stake might be regarded as a sign of lack of confidence in the company.

The National Audit Office examined the sale and carried out sensitivity analyses and estimated proceeds under different scenarios and made the following statements with respect to privatisation offerings.

"In future Government flotations, the National Audit Office recommends that vendors should:

start with the presumption that better value for money will be obtained by selling shares in stages with a view to disposing of the remaining shares through a subsequent sale or series of sales; and

when deciding on the level of first year return to offer to individual investors, take into account the prevailing returns available on other investment opportunities such as deposit accounts, rather than referring back to returns offered on previous Government share sales which may in the circumstances be unnecessarily generous."

In this regard Departments are advised to seek clear, robust and well-justified advice from their advisors on the size and speed of sale and to discuss the matter with the Treasury.

Participation of foreign investors in privatisation will likely open up the market to buyers with capital and expertise, which can increase the revenues and provide the company with access to management skills and technology that are needed to improve corporate efficiency and performance, and develop links to export markets.

In the OECD the approach has been mixed. Currently, in a large number of OECD countries there are no restrictions against foreign ownership. For

example countries such as the Czech Republic, Denmark, Germany, Hungary, Poland, the Slovak Republic, and Sweden have no such restrictions in place. In Hungary and Poland in particular, foreign investment in the privatised companies has yielded significant benefits related to restructuring, improved profitability and competitiveness of privatised companies.

In the UK the policy has been one of openness to foreign investment in privatised companies, and foreign investors have helped contribute to maximising privatisation revenues. In France, prior to 1996, the initial privatisation law of 1986 set a maximum ceiling on share ownership by non-EU investors at around 20% of the total share capital of a privatised company. However, since 1996 those restrictions have been removed.

In other countries such as Australia, restrictions have been applied on a case-by-case basis while in countries such as Korea, and Mexico there are specific restrictions in place. For example, in Korea currently there is a 49% ceiling on foreign ownership in companies such as Korea Telecom[34]. Such limitations, especially in the absence of a large domestic capital market, restrict the choice for selection of potential buyers and may undermine the objectives of sale.

The experience of OECD countries with large privatisation programmes suggests that removal of all restrictions against foreign ownership and addressing concerns over issues of national security and strategic interest through the use of case-by-case and more flexible mechanisms offer a more efficient solution to such concerns.

Addressing labour issues

One of the key stakeholders in the process of privatisation are the employees of the state-owned enterprises, who are often the strongest source of opposition to the policy. This is due to the effects of privatisation on employment and working terms. Typically, state-owned enterprises have been overstaffed, offered security of tenure with terms and conditions that are more attractive than those of the private sector and generally have restrictive labour contracts limiting the potential for job reallocation and for sub-contracting.

Restructuring associated with privatisation often involves significant job loss, which may also continue post-privatisation. This is particularly the case in sectors facing declining demand, and where market and technological change have enhanced competition in the sector without any increase in demand for the core business. Even where a sector is growing, or where the economy is creating new employment opportunities, some degree of job loss and labour dislocation

takes place, at least in the short-term. Furthermore, the job impacts of restructuring and privatisation are not always evenly spread in that while they may be relatively small they could still have a disproportionate impact on certain groups (e.g. female, lower-skilled, and older workers), regions or sectors. Privatisation also alters working terms and conditions and often means the loss of civil servant status, and in many countries; the security of tenure that is associated with it, resulting in a convergence to private sector employment practices. For these reasons labour groups are often among the most vocal sources of opposition to privatisation of state-owned enterprises, particularly those of the public utilities, which also happen to be among the most organised sectors in the economy.

Given the impact of restructuring and privatisation on labour, a key issue for the government is to identify the potential problems and to develop measures to mitigate against the possible adverse effects of privatisation. In this regard a labour strategy would be an important part of the privatisation process, ensuring that issues and options are identified, pros and cons are considered and that a pragmatic approach is adopted. The key elements of a labour strategy[35]should include the following.

- The establishment of appropriate labour market policies and regulations to promote job creation by the private sector and to promote labour mobility.

- Management and implementation of the process in a manner that involves consultation and participation of labour unions at the earliest stage possible. This would also include the establishment of a communication strategy directed at employees to explain the need for reform, its broader benefits as well as the measures that would be in place to help mitigate against the possible adverse impacts.

- The timing of restructuring (labour impacting), and the consideration of options for dealing with impacts on employment along with their costs and benefits, to help develop a pragmatic approach to balance both commercial and business considerations as well as social and political issues.

- Establishment of the necessary compensation and adjustment measures, such as severance pay, worker retraining and redeployment and public works.

One of the most important tasks facing governments is addressing privatisation-induced labour adjustment issues. In order to mitigate against the possible adverse effects of privatisation, governments have adopted a variety of responses. These have varied across different countries and are shaped by: (1) the relative size and the significance of the SOE sector as a source of employment in the economy, and the general macro economic environment in terms of its capacity to absorb displaced workers; (2) availability and scope of unemployment benefits and social welfare programmes available to the unemployed; and (3) the degree to which provision of social benefits and amenities have been integrated into the state-owned enterprise activities (i.e. the case of transition economies, where the SOE is also the provider of housing, social benefits, etc.). Furthermore, in many OECD countries various schemes for employee participation in privatisation have been introduced.

The evidence from Poland suggests that the restructuring processes associated with system transformation had a more significant impact on employment than privatisation, and that the reduction in employment levels took place as part of restructuring before the change in ownership. The use of social packages[36] has been credited for the absence of a direct impact of ownership change on unemployment levels. For example, between 1998 and 2001, under the government-approved " Restructuring Program for the Polish Steel Sector", the number of employees more than halved in a conflict-free manner. The reduction in the number of employees has been a result of the implementation of the "Steel Social Package" a product of a tri-partite agreement among unions, government, employers[37].

Despite its possible adverse employment impacts and implications for job security, privatisation can offer greater flexibility, and trade-offs for the employees in terms of pay and opportunities for advancement. Therefore, a shift to the private sector may not always be negatively perceived. For example, in the case of privatisation of Korea, Tobacco and Ginseng Corporation (KTGC), when given the opportunity to choose between job security through a transfer to another government authority, or the higher pay and benefits offered by the privatised KTGC, many employees opted for the latter[38].

In many OECD countries labour unions, while opposed to privatisation, are also cognizant of the need for reform and have adopted a pragmatic approach, seeking to be consulted and to participate in managing the labour adjustment. Experience from a variety of countries underlines the importance of consultation and negotiation with labour groups at the earliest possible stage. Communication of the benefits of privatisation, and explanation of government plans for mitigating the negative effects of privatisation helps dispel employee concerns, gain labour support and ultimately leads to better privatisation

outcomes. The need for the establishment of a framework agreement to deal with cross sector issues (e.g. the change in status, change in pensions), and the benefits of adopting a uniform rather than a case-by-case approach has been emphasised by labour groups and governments alike, as it allows the issues to be identified and addressed in a consistent manner from the outset.

Treatment of privatisation proceeds

One of the important considerations is the treatment of privatisation proceeds. The proceeds can be used to reduce government debt, or can be re-invested to meet other policy priorities such as funding of social security and other public services (e.g., health and education, worker retraining) and/or funding deficits. Depending on how the proceeds are utilised privatisation revenues can contribute to the enhancement of the macro environment, and help ensure that stakeholders and the public at large share in the benefits of reform, and thus secure broader public support for privatisation.

The provisions governing the use and treatment of privatisation proceeds can also serve as a vehicle for enhancing the transparency, accountability and the achievement of the overall balance between the fiscal and efficiency drivers of privatisation. For example, setting aside privatisation proceeds in a sinking fund and using them to purchase government bonds in circulation or their redemption at maturity provides an institutional arrangement that enhances transparency and accountability. It also tends to reduce the likelihood of underselling of public assets in pursuit of short-term liquidity[39] which could otherwise take place at the expense of achieving other privatisation objectives such as increased efficiency.

The use of privatisation proceeds has varied among OECD countries. In some, such as the UK, Sweden and Denmark, privatisation proceeds have not been earmarked for any specific purpose and have in effect flowed into the general revenue fund. In Germany, while privatisation proceeds basically flow into the general revenue fund of the budget the proceeds gained through the privatisation of Deutsche Telekom AG and Deutsche Post AG were earmarked for a limited time (until 2003) to reduce the public debt, provided that they were not needed for financing the pension fund of public servants working for these companies or the former monopoly Deutsche Bundespost. In others the proceeds have been earmarked for a specific use. For example in Poland privatisation proceeds have made a significant contribution to implementation of the Social Security Reform[40.] Similarly in the Czech[41] and Slovak Republic's privatisation proceeds have been earmarked for specific uses. In Greece the proceeds from privatisation have been dedicated to reducing public debt and funding adjustment policies for the affected employees, while in Italy the revenues from

privatisation are set aside in a special Fund and used to purchase government bonds in circulation or their redemption at maturity, thus contributing to the reduction of the debt/GDP ratio. In Turkey, the government has used the proceeds for capital increase, transfers to Treasury, loan repayments and credit to companies and for funding social assistance supplements. In Mexico, privatisation proceeds were largely used to pay off public debt and also to a lesser extent to fund public expenditure. Finally, in some cases the proceeds from sale of stakes, or new share issues have flowed to the state-owned enterprise to pay for its investments and acquisition of assets.

2.2. Privatisation Methods

The sale of state-owned enterprises can take place through a variety of methods. The choice of privatisation method depends on the government's policy objectives, the domestic market environment, and the characteristics and size of the company that is being sold. Privatisation objectives are inter-related and often conflicting and this becomes nowhere more apparent than in the context of selecting privatisation methods. As the discussion below shows, each method has different implications for meeting policy objectives. For example, methods that maximise proceeds may also be conducive to strong corporate governance, but they do not have a significant impact on the domestic equity market. Similarly methods that promote broad share ownership tend to generate dispersed ownership and are not likely to produce a strong governance structure. For this reason, in choosing the method of privatisation the government is in effect engaged in a balancing act.

The discussion of this section begins with a brief overview of the main features of different approaches to sale and their implications for meeting privatisation objectives.

In the OECD countries, the following privatisation methods have been employed.

1. Public share offerings in the stock market
2. Trade sales
3. Mixed Sales
4. Management and Employee buy-outs
5. Asset sales, often following the liquidation of the SOE
6. Mass privatisation

Public share offerings on the stock market have been the dominant method of sale, particularly in the larger OECD countries, accounting for the bulk of proceeds raised, followed by trade sales and employee and management buy-outs. Mixed sales (combination of public offering of shares and trade sale) have provided an increasingly common approach. These four methods represent the most widely adopted approaches by OECD countries, and therefore the following subsections focus on these only. The other two methods noted above are discussed only briefly below.

Asset sales following liquidation have been typically used for companies that are not viable as a going business concern. Mass privatisation involves the distribution of company shares to the population at large through the distribution of free vouchers or at a nominal price to eligible citizens, who can then use them to buy a stake in the privatised company. Mass privatisation has been a very important approach in transition economies, in that it has enabled the privatisation of a large number of enterprises over a short period of time. This method however, applies to only a few of the OECD Member countries (the Czech Republic, Poland and the Slovak Republic) during the earlier phase of their transition to a market economy.

The discussion in this section primarily focuses on means of realising different policy objectives and their relative merits and drawbacks. Instruments for fine-tuning and exerting post-privatisation control over the companies are discussed in the next section.

2.2.1. Public Offerings

Privatisation through public share offerings is an open competitive process whereby the shares of a company are floated on the stock market. Public offerings are the most transparent method of sale, but are also the most expensive approach. They require a great deal of preparation and planning, involve significant restructuring of the company, and draw heavily on the services of a vast array of advisors (see above). These include lawyers, accountants, investment bankers, industry consultants, public relations and marketing advisors. Given the amount of preparation and the costs involved, public share offerings have typically been used to privatise larger companies with a potential for good performance.

Privatisation through share offering often requires the existence of a relatively well-developed financial and legal infrastructure. This means stock markets that are relatively liquid and deep, and a fairly sophisticated set of laws governing property rights, company law as well as insolvency and bankruptcy. However,

privatisation has in itself served as a vehicle for promoting the development of the equity market in countries where the capital market is not well-developed.

In terms of meeting objectives of privatisation, public offerings are particularly attractive where the government is seeking to develop the equity market, and to promote a culture of equity ownership. This has been a key reason underlying the use of public share offerings as a predominant method of sale in many OECD countries which had relatively small equity markets (e.g., Italy, Spain and Portugal). In other countries such as the UK, an already well-developed market was augmented thanks to public share offerings. On the other hand, public offerings tend to produce dispersed shareholdings which in the absence of a well functioning market for corporate control can deprive the company of strong governance. Furthermore, public share offerings lack the degree of flexibility afforded by trade sales where contract negotiation and extraction of transaction specific commitments from the new owners is a priority. Finally, in terms of the revenues raised, public offerings are generally more expensive to execute, and could entail some degree of loss of revenue arising from under pricing of shares and offering incentives.

The following discusses the key steps in the implementation of privatisation through an Initial Public Offering (IPO):

- Restructuring (this may include industry-wide restructuring as well as company specific restructuring, as has been discussed earlier)

- Preparation of the prospectus in which information pertinent to potential investors is disclosed. These include explanation of policy on a range of matters, such as dividends, environmental issues, employee and management participation, government intentions regarding disposal of residual stakes, and regulation. The government will also receive advice as to the share instruments to be used (e.g. common shares, preference shares, convertible bonds, etc.). In preparing the prospectus the government needs to work closely with its legal, financial and sale advisors, as well as with the company and its financial and legal advisors.

- Ensuring that all the relevant policy issues are identified and addressed early in the process to prevent uncertainties regarding unresolved policy issues from causing delays and eroding investor confidence.

- Marketing of company shares by holding road shows in major financial markets.
- Setting of the subscription period (usually a two week period).
- Share allocation to different classes of investors such as retail, institutional, foreign and residents.
- Fixing the price.

Table 2.3 **Privatisation Methods: Overview of a Global Offering, an example from the Italian Privatisation Programme**

Weeks	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15
Appointment of Advisers	■	■	■												
Due Diligence and Prospectuses Preparation	■	■	■	■	■	■	■	■	■	■					
Draft prospectuses					■										
Iter Consob					■	■	■	■	■	■					
Analyst Presentation							■								
Research Black-out										■					
Advertising Campaign									■	■	■	■	■	■	
Pre-Marketing										■	■	■			
Prospectuses Printing											■	■			
Roadshow & Bookbuilding													■	■	
Retail Offering (OPV)														■	
Pricing															
Closing															■

Source: Italian Treasury Presentation to APEC Privatisation Forum, 2001

The initial public offering of shares on the stock market generally requires decisions on the following:

i. ***The size of the offering and staging of sales:*** From a transactional perspective the decision on the size depends on the market conditions and its absorptive capacity, and on government objectives and its intentions regarding future sales. OECD experience suggests that markets have been quite resilient in terms of their ability to absorb large issues. However, when a company is too large to be sold at one time, the government can benefit from selling the company gradually through multiple tranches over a period of time. However, the success of this approach is critically dependent on the government's ability to demonstrate a commitment to act as a shareholder and focus on maximising the value of its shares. This approach to the sale allows the government to price shares more accurately and obtain a better value in subsequent transactions[42]. In many OECD countries such as Italy, the UK, and Germany to mention a few, this approach has been utilised successfully and has allowed the government to overcome the price discounting that takes place due to the company's lack of track record during the initial public offering, and to time the sale so as to take advantage of favourable stock market conditions.

ii. ***Pricing***: One of the key objectives of privatisation is to raise revenues, and even where revenue maximisation is not the primary objective of privatisation, the share price and its performance in the aftermath of a sale is an important gauge of its success. If the offered share price proves to be too low, it leads to the charge of selling the asset too cheap as was the case of British Telecom's first offering. If over-priced, the price declines in the aftermath of the sale tend to undermine government credibility. Loss of credibility and restoration of confidence are particularly important for governments with extensive privatisation plans, given their need to return to the market for their future sales, and could prove costly to restore. For example, in the case of the Spanish telecom operator; Telefonica, the price of the shares dropped leading the government to offer price guarantees to retail buyers in subsequent Spanish transactions.

The earlier OECD privatisation share offerings were carried out through fixed price offerings to the public, where prices were fixed well in advance of the sale, and were often underwritten by the lead broker. In the absence of fuller information about the shape of demand, pricing was inaccurate and often carried a large discount. Another disadvantage was that fixed price offerings were exposed to greater risks of market uncertainty as market conditions could

change severely between the time that prices were set and the time that the actual trade took place (as was the case of BP in the UK in October 1987). There was also very little flexibility and fine-tuning of share allocation among different market segments, both to maximise opportunities for increasing proceeds and to achieve specific policy objectives, such as broadening share ownership.

The UK experience with privatisation through large share offerings has been instrumental in developing and refining a price setting technique known as book building. This approach typically puts the shares to institutional tender. Information on demand at different prices is then collected from the investors to build the demand curve and set the price. Investors are asked by sale advisors to make their indicative bid at different prices, which is then consolidated by the global sale coordinators. Better information about demand means that the prices are set more accurately, and since prices are set very close to the transaction date there is less market uncertainty. This approach affords the government greater control over share allocation among different categories, so that it can target investor classes in accordance with its policy objectives. Typically, the institutional market is priced using the book building exercise, and is followed by the public offer to the retail market at prices that are set below those established through the institutional tendering process, often accompanied by some form of incentive to promote retail participation and its retention of purchased shares. Most of the OECD share issue privatisations of the past decade have increasingly relied on the book building approach.

As noted above, one of the key considerations is that the offers should be perceived as successful, in that price development should be satisfactory in the after market and that the demand from different classes of buyers be balanced. After the sale share prices can fluctuate and stabilising them is done through the exercise of a Greenshoe option, where the government makes a supplementary offer of shares (of up to a certain maximum percentage) to the global sale coordinator.

Share allocation to different market segments and ***use of incentives***: The government has to choose among the different classes of buyers and decide as to whether any one group is to be favoured over others. Typically, the market segments consist of domestic retail investors, institutional investors (includes pension funds, investment funds and insurance companies) both foreign and resident, and the company employees. The issue of share allocation is another example of where privatisation objectives may conflict. The share allocation decision, along with the policy on incentives and the extent of under pricing impacts objectives such as revenue maximisation, ensuring strong governance, capital market development and widening of share ownership. For example, widening share ownership and/or gaining employee support for privatisation

may come at the expense of promoting stronger institutional participation and loss of benefits of a stronger governance that is often associated with this class of investors. Also, wide share ownership can negatively impact market liquidity of the shares that are to be floated, because retail investors are less likely to trade on a day-to-day basis and in this manner can suppress the offer price.

For many OECD countries development of the equity market and the widening of share ownership have been explicit goals of privatisation and public share offerings have been used as a means of achieving this policy objective. In countries such as Portugal, Spain and Italy privatised and partially privatised companies account for a significant proportion of market capitalisation, and have helped promote an equity culture. However, unless accompanied by a strategy for share allocation to different market segments, public share offerings may produce a diffuse ownership structure for the company. In the absence of a well-functioning market for corporate control (i.e. where restrictions are placed on corporate takeovers), such diffuse ownership structures can hinder the development of a strong governance structure.

In the OECD countries, incentives for purchase and retention of shares have been used to support the government's share allocation decisions. In most OECD public share offerings, there has been a strong emphasis on retail participation for the following reasons:

i. To broaden share ownership, create a strong equity culture and, in the process, increase public support for privatisation.

ii. To help create a sense of scarcity and competition among institutional investors who need to buy shares in large issues in order to meet a certain index, and in this manner to help generate larger proceeds for the government.

Typically, the incentives have been offered to domestic retail investors, many of whom have been first time shareholders. For example, the UK, Spain, Portugal, Italy, Germany and France have all included various forms of incentives in order to generate a strong retail demand for shares and for their retention. These incentives have included share price discounts, payment by instalment options and loyalty shares. In some Spanish privatisations there have been offers of price guarantees to protect against significant price drops (of over 10% during the first year). However, in countries such as the Netherlands and Switzerland the decision has been in favour of maximising proceeds rather than spreading share ownership and as a result no discounts were offered.

i. Under pricing of shares and the use of incentives entail costs in the form of revenues foregone, and therefore their use would need to balance these costs against the benefits and effectiveness of the policy. These approaches are, in effect, a transfer from all taxpayers to a select group of saving classes (i.e. the retail investors that participate and receive shares). For this reason it could be seen as a regressive tax. Furthermore, the effectiveness of these approaches as a means of creating an equity holding culture has been questioned[43].

ii. In offering retail incentives, it is also important to note that once the practice has been established in the initial privatisation offerings, it tends to set a precedent that would be difficult to change in subsequent privatisations.

As privatisation programmes mature secondary offerings and the sale of residual stakes become more important. Organisation and implementation of secondary offerings are generally less complex than IPOs, given that the company shares are already traded on the market. However, decisions on issues such as share allocation, timing and pricing would still be required.

2.2.2. Trade Sales

Trade sales refer to direct sale of an asset to a buyer through negotiations or a process based on competitive bidding.

Trade sales are typically used for the sale of small- and medium-sized companies and have been a preferred method of sale for countries in need of strong management and infusion of technology, such as the former transition economy members of the OECD. Unlike public share offerings trade sales are typically carried out with minimal legal restructuring, require less planning and are thus cheaper and faster to execute. In terms of prerequisites, trade sales also have the advantage of being feasible in the absence of a well-developed and sophisticated market environment, and for this reason they have often been used in the smaller OECD member countries.

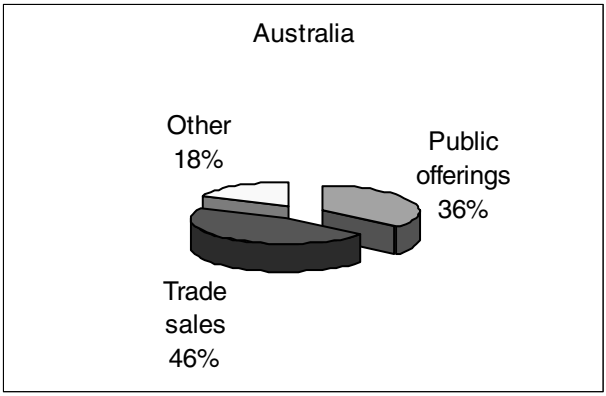
Trade sales are likely to generate better outcomes in terms of proceeds, as they include a price premium for providing control. However, they are often designed to serve objectives other than revenue maximisation. Trade sales are typically more conducive to the development of a strong governance structure for the company than is the case with share offerings, particularly those that create diffuse shareholders. But they do not contribute to capital market development. One of the key advantages of trade sales is that they can provide

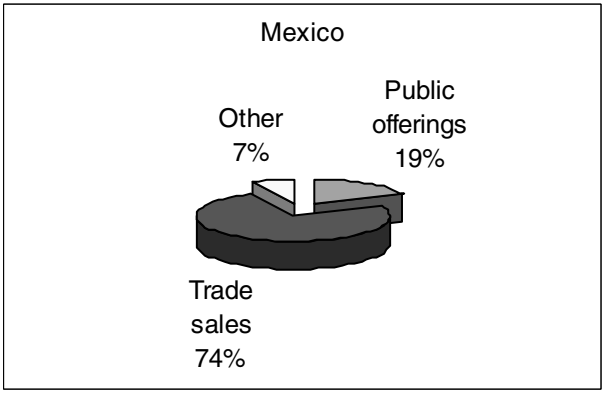
an avenue for promoting foreign direct investment in a way that can have long-term economic benefits that go beyond the immediately affected sectors. This is particularly the case for transition economies. In terms of process integrity their main drawback is that they do not provide the same degree of transparency as public offerings and therefore they may potentially be prone to corruption, in particular when they are conducted through non-competitive processes. In this context a fully transparent process and establishment of clear and detailed procedures for conducting negotiations and selection of buyers can go a long way in alleviating such concerns and help protect the integrity of the process. For example, in Poland the establishment of a set of clear, detailed and transparent processes has allowed trade sales to be used as a successful and effective approach.

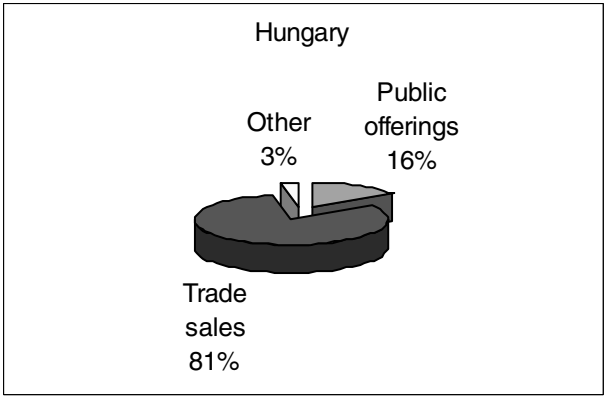
Once trade sale is selected as the preferred privatisation method, the key decision for the government is the choice of the approach. There are two broad approaches to conducting the sale.

Negotiated sales: These are less transparent than public share offerings. They have been used in countries with relatively small equity markets, and where the number of potential buyers for an asset is limited. Under this approach the government has the flexibility to negotiate with buyers individually and to present a different set of conditions to each. Also, in terms of complexity this type of transaction is cheaper and easier to organise than is the case with a competitive bidding process. This is an attractive feature where the size of the asset and the limited number of potential buyers render the more competitive sale processes uneconomic. The main drawback however is the possible lack of transparency and the potential vulnerability of the process to corruption charges. For this reason a transparent selection process coupled with clear rules needs to be established in order to mitigate against the potential risk and perception of abuse. This process would likely generate smaller proceeds than competitive bidding (due to limited competition among the buyers) and may not always result in the highest quality buyer.

Figure 2.1 **Predominance of trade sales in selected countries**
Privatisation Methods (1980-2001p)







Source: OECD Privatisation database

Box 6 **Process of a Trade Sale in Poland**

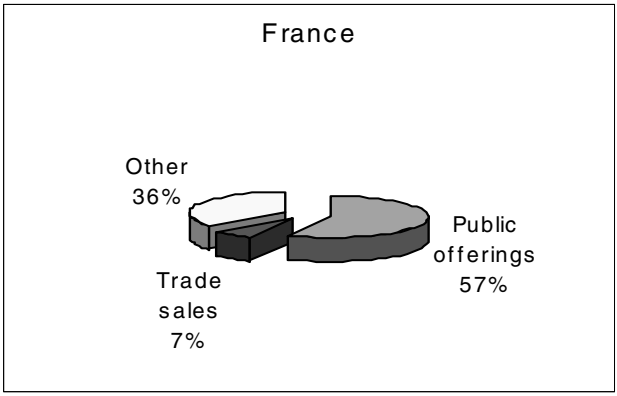
The following briefly highlights the trade sales process in Poland, where such sales have provided an effective and successful method of privatisation.

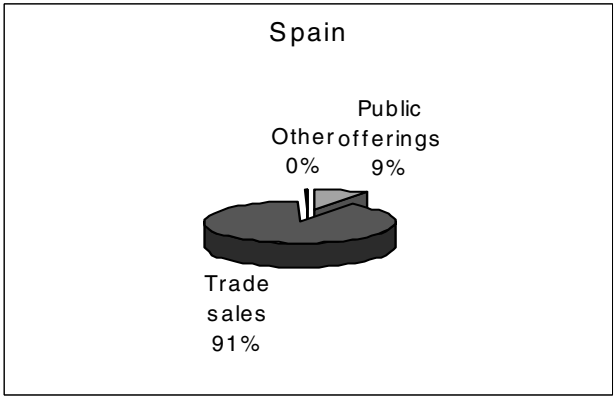
Within the scope of indirect (capital) privatisation, trade sales have been the preferred privatisation method in Poland. Of the total of some 315 companies privatised by the end of December 2001, 44 were sold through public share offering and some 271 companies were sold through trade sales based on public invitation or a competitive bidding process. Through this approach the government has sought access to new technologies and know-how, and has incorporated social and investment packages into the transaction agreements, in order to address employment impacts and to ensure that its policy objectives are in accordance with development of the company.

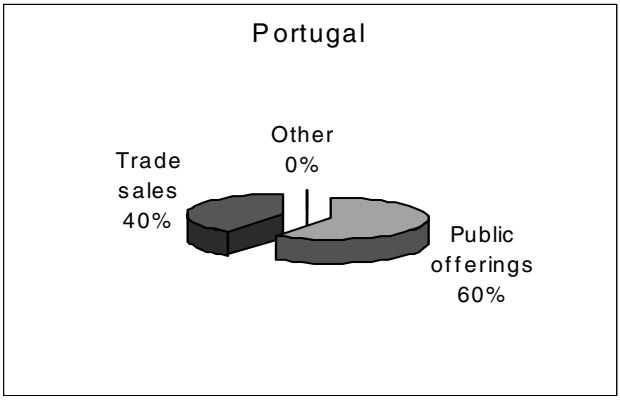
Trade sale based on public invitation has typically been applied to the privatisation of medium and large companies whose controlling portion of stock is made available to qualified strategic investors assuring equal treatment of domestic and foreign companies. This approach has been used to privatise companies in sectors such as telecommunications, banking, power, spirits, pharmaceuticals, and defence. In accordance with the procedure regulated in the 1996 Law on Commercialisation and Privatisation of State-owned Enterprises, potential investors are invited to take up negotiations through advertisements published by the Minister of the Treasury. Prior to placing the advertisement, the Minister of the Treasury (MoT) orders an analysis of the company's situation. This often provides an opportunity for carrying out an analysis of the whole sector and also of the market for a given group of products at home and abroad. The MoT also signs an agreement with an adviser, who helps the Treasury in negotiations with the interested parties. The negotiations concern the number of stocks to be sold, the price, terms of payment, investment pledges, the social package and possibly also other particulars of the deal. The MoT presents a set of minimum, equal conditions to all potential investors. If there are more prospective investors, a short list of two or three of them is prepared after preliminary negotiations, from which the winner is chosen. The details of the stock purchase agreement are then worked out with the selected investor. By the end of December 2001 this method had been used in 209 companies.

The competitive bidding process consists of issuing a public invitation for investors that have been pre-qualified by the Minister of Treasury. The pre-qualified bidders are invited to submit offers for the purchase of a substantial package of stock or shares of the corporation. In the invitation to tender, the Treasury specifies the minimum number of shares an investor must buy, the minimum bid price, and the minimum investment pledge and social undertakings required. Potential investors are required to submit information about their organisation, pay a deposit and obtain written information about the company within a pre-specified time period. They can then submit their bid in a sealed envelope as specified in the Treasury notice. Once the deadline expires, a commission appointed by the MoT shall open all envelopes, assess the conformity of the bids with the published requirements and select the bidder who submitted the best offer. The MoT may rule the tender null and void but it cannot select a different buyer than the one selected by the commission. The terms proposed by the selected buyer are binding on him for three months. During that time, the sale agreement is signed by the MoT. A buyer who withdraws from the deal shall forfeit its deposit. By the end of 2001, this method had been used in 62 cases.

Figure 2.2 **Predominance of public offerings in selected countries** 1980-2001p







Source: OECD Privatisation database

Competitive bidding process: The other approach to trade sales is through a competitive bidding process. This approach can take two forms. It can either be in the form of a simple price-based competitive bidding process where price is the sole criteria for the sale. The other approach involves a competition for a business plan design and an evaluation of the bid based on a combination of factors and not just price. The former is used for the sale of smaller assets, where the product market is competitive and where there is no public policy interest in the asset post-privatisation. The latter approach is typically used where the government retains a longer-term interest in the privatised entity, and wishes to ensure that public policy objectives are met under new ownership. For example, the trade sale of an electricity generation company would be carried out under the latter approach.

Typically, the sale process begins with an invitation for expressions of interest by potential buyers. This information is then used to establish a pre-qualified list of bidders who can then be invited to bid on a company. During this stage the buyers are required to sign confidentiality agreements and are provided with more detailed information about the company, and are invited to submit binding bids, on the basis of which a successful buyer is selected. Often, in order to ensure that the company has the capability to run the business as a going concern and that necessary investments take place, a two-stage bidding process is used to ensure that the buyers have the financial resources and technical expertise to run the business as a going concern. Under this approach the potential buyers compete for a business plan design which includes specific requirements with respect to the buyers' technical capabilities and expertise, post-privatisation investment and environmental or employment retention commitments. Only those bidders whose technical bid meets government requirements can proceed to make a financial bid. However, monitoring and enforcement of such transaction-specific commitments are often very difficult and entail costs. They are also prone to dispute and re-negotiation by the buyer. Given these difficulties an alternative approach has sought to emphasize the technical capabilities of different buyers and their ability to retain the company as a going concern. In this regard the selection process begins with an invitation for expression of interest and submission of a technical bid, which is used to evaluate the technical competence and to prepare a list of qualified bidders. The second stage involves competition based on price.

While a negotiated rather than a competitive bidding process is faster to execute, cheaper and more flexible in that the government can negotiate and allow innovation, experience with these approaches suggests that the outcomes associated with a more transparent and competitive approach tend to be politically more sustainable[44].

Post-privatisation Buyer Commitments: In OECD countries, and in particular in the former transition economy members, a variety of post-privatisation transaction specific commitments have been included in the sale agreement. These commitments have served as a means of ensuring that the new owners comply with certain government objectives; for example, meeting investment targets and provision of service levels within a given timetable, retention of employment levels in order to slow down the impact of privatisation related job losses in order to mitigate against the negative effects of privatisation and to ensure protection of environmental quality.

The policy on the use of buyer commitments has varied substantially across the OECD member countries. Typically, in the former transition economy members the use of such commitments has been a standard policy, with the exception of the Czech Republic where it has been applied on a case-by-case basis. The Czech government applies a unique policy related to environmental commitments where, also on a case-by-case basis, it assumes an obligation to finance from privatisation proceeds the removal of environmental burdens on the privatised property.

In Poland, the use of buyer commitments has been a standard policy, but individual commitment packages are negotiated with the potential buyers on a case-by-case basis. This approach has provided the government with an effective means of promoting the development of the privatised companies, and softening the employment effects of privatisation. The commitments have typically included employee retention clauses, specification of investment levels, service levels, and environmental commitments where this has been necessary.

Outside the former transition countries, Korea has included employment stabilisation requirements in the sale commitments, while in Mexico, and some transactions in Portugal and Spain buyers have been required to ensure investment levels. In Turkey, the commitments have been used on a case-by-case basis and have been of a limited duration, seeking to ensure continued operation of the company (average of three years) and protection of employee rights.

OECD experience suggests that such post-privatisation commitments could prove difficult to monitor and enforce. First, as long as detailed commitments are in place government remains involved and therefore the link between the public sector and the privatised company is not severed. In some cases this also opens the possibility of corruption. Secondly, the costs of monitoring and enforcement and the associated legal disputes can render the use of commitments as a means of meeting objectives ineffective and costly (for

example in 2000, the Hungarian Apvrt was faced with the difficult task of monitoring over 22,000 contracts and managing over 650 lawsuits with investors). Third, inclusion of the commitments in the sale agreement often result in some degree of price discounting, and thus lower proceeds.

2.2.3. Mixed Sales

Mixed sales typically combine trade sales with a public share offering and/or sale of stakes to employees. Mixed sales have been used in many of the OECD privatisation transactions. Through this approach governments are able to achieve multiple objectives. In a mixed sale, privatisation usually begins with the transfer of some degree of control (66% of voting rights, i.e. a super majority; 51% absolute majority; or some relative majority 33.5%) to a strategic buyer. With this approach the strategic buyer provides the much needed management and technology infusion to the company. This is then followed by the public offering of shares on the stock market. A third possible component is the placement of some portion of shares with the company employees, as a means of ensuring worker participation.

The public offering of shares allows the government to promote capital market development, while ensuring that the company benefits from an infusion of technology and stronger governance structures than would be the case under a more dispersed share holding structure. The order by which the different sale methods are combined varies. In the OECD area the most common order is to have a sale to a strategic investor precede the public offering of shares. The first pillar of the sale will help the government sell the assets after the new ownership structure has improved efficiency and created value in the company and thus help it reach higher share prices in subsequent tranches. Furthermore, by having the trade sale precede the public offering, the government is able to obtain a better price for the stakes sold than if it were to do it once the shares had been trading in the stock market because the buyers would be unwilling to pay more than the established share price. Recent sales using this approach include New Zealand's Contact Energy and Ireland's Telecom Eireann privatisations.

The success of this strategy is critically dependent on the government's ability to ensure that good corporate governance practices are in place to protect minority shareholders. In the absence of such practices, shareholders might be abused by the controllers and as a result public offerings will lose credibility with damaging effects on capital market development.

Box 7 **Buyer Commitments in Poland**

In Poland, commitments of strategic investors are the result of privatisation agreement provisions, which impose on the buyer the obligation to implement certain actions, necessary for further growth of the company and defined in the course of pre-privatisation analyses. Inclusion of investment commitments and social packages into the sale agreement has been an important feature of a majority of privatisation transactions.

These investment resources are mainly used to purchase new production lines, to introduce new products, to acquire new technology, and know-how, to secure environmental protection and to implement modern information technology management systems. In companies that require restructuring, investment is mostly made in modernisation of production and technological processes, creation of a distribution network, raising of capital, and for the purchase of licenses. The Ministry of the Treasury monitors implementation of commitments on a day-to-day basis, and can impose contractual indemnities when the investors fail to meet their commitments.

Social packages refer to a separate agreement and constitute an integral part of a privatisation agreement. They are very important for the protection of employees' rights, seeking to regulate labour relations in the company that is being privatised. The social package guarantees employment to a specific group of employees within the so-called guaranteed period. The termination of an employment relationship within this period may result in payment of compensation to an employee. Investors may also commit themselves to ensure vocational retraining to employees at the company's expense or to find other jobs for them.

As a rule, the social package usually commits investors to maintain regulations concerning the rights and duties of employees, which are contained in internal rules issued in agreement with trade unions. The social package also includes additional allowances from the owner in favour of employees; for example, granting loans for purchase of company shares by employees, commitments made by the owner to redeem these shares and a promise to offer shares for sale.

Social packages continue to be an important component of buyer commitments and the frequency of their use (of the 315 privatisation transactions concluded by the end of 2001, the social package was signed in 263 cases or, in other words, 20 cases less than in the case of the investment package) shows that a high priority is given to labour relations in the privatised company.

During the initial period of transformation, management and employees placed a stronger emphasis on the economic aspect of privatisation (prevention of economic failure of the company) rather than on social benefits. When the economic situation improved and companies were no longer faced with a serious threat to their survival, this element of privatisation lost its prominence as employees became interested in more elaborate social packages and longer periods of guaranteed employment, which became a kind of "price" for permitting privatisation.

At present, the Ministry of Treasury has adopted a more rational attitude towards social packages, emphasising the Ministry's role as a mediator in cases when the investor and trade unions are faced with difficulties agreeing upon arrangements for employees' benefits and guarantees.

2.2.4. Management and Employee Buy-Outs

Management and employee buy-outs (MBEO)s, typically refer to privatisation through the sale of the enterprise to a new legal entity in which a significant, or a majority, stake is owned by the employees and managers. The buyers may be only employees, or only managers, or a mix of the two. In some cases the transfer to this group of buyers takes place as a matter of policy on pragmatic grounds; for example, when the entity's size and characteristics warrant it, and where the balance of political, economic and fiscal objectives favour this approach. In this context, this approach constitutes a method of privatisation. In such transactions the transfer could involve all or part of the assets or shares in the company, and the method by which the sale is financed may or may not[45] involve a commitment of funds by the employees and managers. Financial institutions can also be involved in these transactions as a source of credit or as a buyer.

In its broader form, management and employee buy-outs could be regarded as a special type of trade sale, where the entire stake in the company as a whole, or a portion of it, may be sold to management and/or employees with the actual sale taking place through a negotiated sale, or as part of a competitive process, with this group of buyers as one participant in the process, and the distinguishing feature being the identity of the buyers.

It has been widely argued that the introduction of a significant amount of insider equity ownership can have a positive effect on corporate governance and efficiency in that it leads to closer monitoring of performance and helps align the employee and management incentives with those of the owners (converts agents into principals). In many OECD countries the governments have sought to encourage privatisation buy-outs as a means of improving corporate efficiency, gaining employee support for privatisation and in some cases to help increase competition among buyers.

However, this approach to sale can also have corporate governance weaknesses in that insiders may seek to pursue objectives such as job security and job-based utility and forgo the increase in the value of the company. This could be particularly the case where the acquisition of the stake has not involved a financial commitment by this group of buyers (i.e. the stake has been a giveaway) and where effective external monitoring by outsiders and hard budget constraints (e.g. through the lending financial institutions and the need to meet debt service payments) is absent. Furthermore, where employees are a heterogeneous group in terms of their skills, interests and objectives, effective decision-making can be hampered as a result of the need to reconcile conflicting objectives.

As in other approaches to privatisation discussed in the earlier sections the choice of the method is shaped by the characteristics of the entity that is to be sold and, most importantly, by the relative importance of different privatisation objectives and the need to strike a balance among them. In this respect, the benefits associated with the use of this method (e.g. speed, worker support) need to be balanced against the importance of meeting other objectives such as increased efficiency and raising revenues. In general, management and employee buy-outs tend to be most suited to smaller companies, and where the tasks are non-routine and the company is heavily reliant on the technical/scientific skills and judgement of its employees.

In the OECD countries, a large number of privatisations have been effected through the use of management and employee buy-outs. In the UK over 270 privatisations have been carried out in this manner[46]. For example, in 1994, London's bus service was divested to its managers and employees after being reorganised. Also, rail privatisation in 1996 included some employee buy-out of one of the companies created. Other OECD countries where such sales have been used include Austria, Germany, Hungary and Poland among others. In Hungary, under the self-privatisation programme around one-third of enterprises privatised were sold as buy-outs using employee share ownership plans (ESOP)s. In Poland, leveraged buy-outs (employee leases) accounted for a significant portion of entities that underwent direct privatisation.

The experience with management and employee buy-outs and their performance in terms of their impact on employment, restructuring for improved efficiency and their longevity and survival is linked to factors such as:

- The extent to which employees participate in decision-making and whether they perceive themselves as owners

- The manner in which management and employees have acquired their stakes, i.e. whether they have a financial stake in the company or have received them for free, and the degree to which a hard budget constraint is in place

- The dynamics of the market in which the company operates.

In a review of the empirical evidence on the privatisation buy-outs, Wright (2002) discusses different aspects of the impact of their performance and draws the following conclusions with respect to such sales[47].These include the following:

- Higher levels of employee ownership are more likely to be associated with greater employee-oriented human resource management strategies, such as greater communication, annual appraisals and higher levels of bonuses.

- Privatisation buy-outs are generally accompanied by initial employment reductions followed by re-employment.

- There is more restructuring when the acquisition has been a purchase and has involved the commitment of a financial stake by this group of buyers, as opposed to the cases where it has been acquired for free (i.e. purchase rather than giveaway buy-outs)

- The longevity depends on the industrial sector dynamics and not buy-out mode. In sectors where there is a high level of structural change at play, the buy-out life cycle may be short, and employee ownership more of a transitional stage in the development of the company.

While employee and management buy-outs have been widely used throughout the OECD, a broader approach has been the promotion of worker participation in privatisation and has involved allocation of a portion of shares to company employees. Through this approach governments have sought to gain support for restructuring and privatisation and to create incentives for improving efficiency and worker representation on company boards. At the same time, this has enabled them to combine the above with meeting objectives that are typically associated with other methods of sale, such as raising revenues and providing the company with strong governance.

For example, in Poland up to 15% of shares are allocated to employees for free, and this applies to both trade sales and public offerings. In the UK, incentives have often been offered to employees for participation in trade sales and public offerings. In France, privatisation buy-outs have involved the divestment of parts of large manufacturing conglomerates, just before or after their flotation on the stock market, and specific incentives for worker participation have been put in place. Other countries where specific incentives for worker participation are in place include Italy, Hungary and the Czech Republic. On the other hand, countries such as Mexico, Sweden and the Slovak Republic do not have a specific policy in place[48].

Table 2.4 **Methods and Objectives**

The choice of method of sale is determined by the country's conditions and policy objectives of privatisation. Choice of method has a direct link to the objectives.

Method of sale	Capital Market Development	Corporate Governance	Transparency	Revenues	Comments
Stock Market Share offering	High	May be low - unless share allocation to different market segments is managed to address corporate governance instability arising from dispersed shareholding	High	May be relatively smaller proceeds than trade sale and has higher costs associated with it.	Well--designed staging of sales can obtain higher price per share
Trade sale	Low	High	Less transparent than public offerings, therefore it requires establishment of clear rules and open competitive bidding.	Higher proceeds/lower cost	Competitive open bidding processes increase transparency and ensure better proceeds
Mixed Sales	High	Potentially high but needs to ensure protection of minority shareholders	Medium- depends on establishment of clear rules and use of competitive bidding	High	Meets multiple objectives

Method of sale	Capital Market Development	Corporate Governance	Transparency	Revenues	Comments
Management & Employee Buy-out	Low	Potential benefits for improved productivity, but potentially low impact on improving corporate governance, especially where employees are not homogeneous in skills and interests, and particularly if they do not have a financial stake in the company (i.e. received shares for free)	Low	Low	Suited to smaller enterprises and where human capital/knowledge specific enterprises are involved.

In Italy, promotion of employee participation in privatisation has been sought to gain employee support for necessary restructuring and privatisation to bring about a cultural change in the company, to encourage employee board representation and to achieve a reliable demand for shares. Promotion of employee participation has drawn upon incentives such as price discounts, bonus shares and grant financing. On average more than 70% of potential employees who were offered shares participated and retention rates have generally been very high. For example, in the case of ENEL 99% of the shares held by the employees were still retained a year later[49].

A notable example from Italy is the case of Alitalia. In 1998 a 20.5% of the stake was sold to the employees, the first large ownership scheme in Italy. The experience with Alitalia has been generally positive in that it helped improve labour relations, it allowed the company to undertake the needed restructuring in order to achieve cost savings and to bring about shared objectives and decisions. However, the size of the employee share ownership and its three-year lockup had a negative effect on stock liquidity and has potential impacts on the stock price once these shares are sold.

2.3. Post-Privatisation Control Devices

Post-privatisation control devices refer to provisions and arrangements that governments have put in place at the time of sale in order to retain some degree of control over the privatised state-owned enterprises, and to protect the newly privatised companies from the rigours of the competition for corporate control. These mechanisms have been typically adopted where the government has sought to prevent foreign takeover of companies in sectors that are deemed to be of national interest, such as defence, or on the grounds of protection of public interest.

One of the main objectives of privatisation is to increase corporate efficiency and performance. For this reason it is necessary to ensure that privatisation is not limited to a change in ownership alone, and that it is accompanied by changes in corporate governance. Therefore, schemes that aim to raise capital for the budget without changing the governance incentives and structures in companies, or create arrangements that are not conducive to effective governance are unlikely to produce the desired outcomes.

In this section three approaches to post-privatisation control are discussed.

1. Golden Shares
2. Stable core of shareholders
3. Retention of a controlling stake as opposed to full privatisation

2.3.1. Golden Shares

Golden shares provide governments with special powers and veto rights in the fully or partially privatised companies, and have served governments as a means of protecting the newly privatised company from hostile takeovers on national security or on public policy grounds, where this has been deemed to be necessary.

Golden shares were first introduced in the UK as part of the privatisation of the SOEs, whereby the government sought to protect the newly privatised company against being taken over. Since then golden shares have been widely adopted and introduced across numerous OECD member countries, and have served as a key element of their post-privatisation control devices. These have included France (*action spécifique*), the Netherlands, Spain, Portugal, Belgium, New Zealand (Kiwi shares), Italy, the Czech Republic, Poland, Hungary and Turkey among others. In contrast, countries such as Mexico, Sweden and Switzerland have not used golden shares. Australia too, despite its large privatisation programme, has not used golden shares or other post-privatisation control devices. Similarly, in Germany, according to company law, golden shares are not permitted and special post-privatisation control devices (beyond contract management) do not exist.

The so-called golden shares can act as an impediment to improved efficiency, in that they can potentially serve as a vehicle for government intervention in company decisions, and undermine effective functioning of the market for corporate control. For this reason their adoption can potentially create investor uncertainty, and generally is not favoured by the markets.

Experience in member countries suggests that the drawbacks associated with the introduction of golden shares are largely linked to the breadth of their scope, their duration and the manner by which the powers have been exercised. In this regard, when golden share provisions are given a very specific scope, are time-limited and are not invoked arbitrarily, they tend to reduce uncertainty about government intentions, and therefore minimise their potential drawbacks. For example, in the UK remaining government interests have been very narrowly defined and have been exercisable only within a framework ensuring that both the strategic and day-to-day control of the enterprise concerned rest with the private sector, and were typically introduced in the network infrastructure industries. Another important feature is that they have never been exercised and were given a limited lifetime, except for those cases where they were put in place for national security reasons. However, over time perceptions about what constitutes a strategic industry has changed substantially, with the result that the demand for golden shares is reduced.

In contrast, in Italy golden shares were initially more broadly defined, but in response to EU concerns over their effect on free movement of capital and establishment[50] they were revised in 1999, restricting their use to "strategic industries" and for very limited public interest reasons. In Portugal, golden shares have been more broadly defined and have included provisions that limit participation by non-nationals and apply to companies in sectors such as insurance, banking, energy and transportation. In Poland, the government has retained golden shares in some of the privatised companies to ensure effective and up-to-date Treasury control and supervision of investor commitments, and are closely linked to fulfilment of public policy goals. These golden shares have been of a temporary nature and expire once the terms of the buyer's commitments are fulfilled.

While the powers associated with golden shares have rarely been exercised[51], their existence has served as a deterrent to takeovers, as was the case with the merger plans of the KPN (a Dutch partially privatised telecom firm) and Telefonica (the former state-owned Spanish telecom company in which the government retains a golden share), preventing them from taking place.

The degree to which golden shares have proven to be detrimental to the spirit of privatisation is largely influenced by the breadth of their scope, their duration, and the extent to which the government has exercised the powers afforded to it by the golden share. In some cases the rights associated with golden shares are broadly defined and the shares are not given a finite life. Under these circumstances the potential for government intervention is greater, thus creating more investor uncertainty. In the absence of an effective regulatory capacity (e.g. where the institutions and the market need time to develop), and in the case of companies where there are specific national interests are at stake, golden shares can help facilitate privatisation. They may also offer greater flexibility than a standard policy of limiting foreign ownership and control by legislation, especially where the underlying public policy concerns are expected to be short-lived. Recent experience from the OECD suggests that for some countries adoption of golden shares has played an important role in making privatisation of assets in sensitive sectors of the economy (e.g. public utilities) feasible.

Box 8 **Examples of Golden Shares and European Commission Action on Golden Shares**

Golden shares have been adopted across numerous countries, but the extent of rights granted to the government, the duration of the rights, the circumstances and the frequency by which they have been exercised varies across OECD member countries.

In the UK, special shares, or the so-called "golden shares", confer special control rights to the government. The provisions and duration of golden shares has varied among industries. They have in general tended to be time-limited. A typical prohibition has been on one person or group of persons acting in concert to control more than 15% of the equity of the company. In case of companies with a defence or security related dimension, the shares have been time unlimited, and additional powers have been included, such as provisions to appoint or nominate directors, and disposal of material assets. The retention of golden shares has been the exception rather than the rule and often in practice the powers vested in them were not exercised. The golden shares have not included provisions that would allow government interference in the business affairs of the company. Over the years the government has been slowly abandoning its golden shares in privatised companies, with the exception of those held in defence industries. The rationale for the abandoning of golden shares has been that in a competitive market environment, and with globalisation, they will not be required. In some cases, the golden share has been relinquished at the request of the company to dispel investor uncertainty. This was the case with British Telecom's merger discussions with the MCI.

In France the introduction of golden shares "*action spécifique*" began in 1986. Initially, the shares had a time limit of five years after which they converted into a regular shareholding. However, the privatisation law of 1993 made the powers conferred under a golden share time unlimited. But the government had the power to convert to a regular share. Typically, French golden shares provide the government with the following control powers.

- Require prior authorisation from the Ministry of Economy and Finance for any investor or group of investors trying to act in concert and own more than a certain percentage of the firm's capital.

- To name two non-voting members of the firm's board of directors; and

- To block the sale of any assets to protect National interests. The assets could include shares as well as buildings technology, patents trademarks and any other tangible or intangible property.

Italy's 1994 law provided the state with special powers that could be used to safeguard the vital interests of the state, in particular public order, safety, health and defence. In 1999 Italy revised its golden share directive to clarify the scope of these shares. This was due in part to pressure from EU action against the use of golden shares. It was also prompted by Olivetti's hostile takeover bid for the privatised telecom firm Telecom …/

/… Italia (TI) and the planned defensive merger with Deutsche Telecom that was being proposed by TI management. Under the new directives, the government said that golden shares powers would be exerted where the ownership of significant shareholdings with the privatised companies were not transparent or where shareholdings compromised liberalisation, or were incompatible with the decision to privatise. The new directives, which were set up by a decree of the Prime minister (in 1999) and by law (number 488 of 1999, article 66), also introduced other requirements and criteria requiring that both the introduction and the exercise of golden share powers must be founded on overriding requirements of the general interest and be proportionate to the objective being pursued, in compliance with the fundamental principles of the Community Law, including the non-discrimination criteria. In this regard, both the decree and the law are fully in compliance with the 2002 ruling of European Court of Justice on the Golden Shares (discussed below).

EU Actions against golden shares

During the 1990s the pace of privatisation was particularly fast among the EU members of the OECD, accounting for around 60 % of all proceeds raised during that period. This period also witnessed the launch of the EMU, and the adoption of EU market liberalisation directives in sectors such as telecommunications, electricity and gas, and a wave of mergers and acquisitions. In many EU countries, privatisation of sensitive sectors of the economy has been accompanied by introduction of golden shares in the companies. In light of this background, the retention of golden shares has been an increasing source of concern to the European Commission (EC). This has been highlighted as more and more former state-owned companies reach out across borders to merge and acquire assets in other companies.

Despite their drawbacks, the experience of member governments has shown that golden shares have been instrumental in facilitating privatisation of assets in sectors that raise national security and public interest concerns. In recent years these shares have also served as a deterrent to the takeover of privatised state-owned companies by other state-owned companies.

In 1997, the EC communicated its concerns to the member countries, and in particular with respect to the use of control procedures such as rules requiring prior authorisation for acquisition of the company shares and rights of veto included in some members' golden shares. In 1998 and 1999 the Commission brought infringement proceedings against six countries. These included the UK, France, Belgium, Italy, Portugal and Spain. The member countries have noted that the use of golden shares has played an important role in making privatisation of certain sectors feasible. Also, in light of the uneven pace of market liberalisation across member countries, countries with fully privatised /more liberalised markets have been concerned about the acquisition of their privatised companies by other state-owned companies[52]. In this regard the use of golden share has been defended on the grounds that it helps preserve the spirit of privatisation.

…/

/… Against this background, in 2001 the opinion issued by the advocate general of the European Court of Justice stated that the golden shares held by Portugal, France and Belgium were not in violation of community law. However, in June 2002, the European Court of Justice issued its ruling on compatibility of golden shares with the EU treaty on three cases involving the following:

- France's golden share in Elf-Aquintaine,
- Portugal's restrictive procedures and laws that limit participation of non-nationals in privatisations in a range of industries; and
- Belgium's golden shares in two gas utilities, Distrigaz and SNTC

In its ruling, the court struck a balance, in that it allowed golden shares, but also set certain restrictions. More specifically, the ruling has determined that restrictions based on "the need to maintain a controlling interest in undertakings operating in areas involving matters of general or strategic interest" are acceptable. It also states that "The free movement of capital may be restricted only by national rules which fulfil the twofold criterion of being founded on overriding requirements of the general interest and being proportionate to the objective being pursued".

This ruling permits a more narrowly defined and limited golden share scheme through which the governments can meet overriding requirements of national interest. At the same time it requires that the measures be proportionate to the objective that is being pursued. The ruling would help define the scope and powers vested in the golden shares in the EU, and lead to the revision of the approach to defining golden shares.

2.3.2. Stable Core of Shareholders

Under this approach the ownership structure of the privatised company includes a stable core of shareholders made up of a group of national investors (such as banks, allied industrial groups, families) with whom a significant stake in the privatised company is placed. These investors are then required to retain their shareholding for a specific period of time, and they act jointly in exercising control over the company. The intent is to create a stable core of shareholders in order to provide the company with stable governance during the early years after its privatisation and thus protect it from hostile takeover bids.

This approach has been used during the early phases of privatisation programmes in countries with relatively less developed equity markets, and where traditionally the ownership of publicly listed companies has tended to be concentrated among a group of shareholders controlling a large block of shares that guaranteed the group's control. The use of this technique can be helpful where the domestic equity market has limited absorptive capacity, the institutional investor base is absent or too small and where there are concerns over the sale of large blocks of equity to foreign investors.

Box 9 **Establishment of a Stable Core of Shareholders-**
Sale of Autostrade in Italy

In Italy a stable core of shareholders is not a standard feature, and their formation has been used to remedy a capital market which requires further deepening and more sophisticated intermediaries. Typically the special agreements among stable shareholders which may have a negative impact on the transparency of governance decisions are not used in Italy, and privatisation offerings have sought to target institutional investors in order to strike a balance against the weight of core shareholders and to help enhance the corporate governance structures and decision-making mechanisms.

Autostrade is the Italian highway operator that was privatised in 1999. This sale provides an example of the Italian approach in that it is based on a mixed sale with a stable core of shareholders and was carried out as a dual track sale process.

The sale of the company was carried out by IRI and according to the Prime Minister's decree, whereby the sale was to be structured as one which includes a stable core of shareholders and involved a global offering of shares. This has been regarded as one of the most complex sales to date, as it embodied significant regulatory and legal issues that had to be handled in the years preceding the sale. For example, the regulatory complexities derived from the need for developing a new regulatory regime and introduction of tolls setting. The concession of extension and subcontracting rules had to comply with that of the EU regulatory framework. The rules also required that no more than 2% can be acquired by other publicly owned companies.

At the time of sale in 1999, the free float stood at 13.4%, with the remaining shares held by IRI. Of this amount 52.4% were sold in the global offering. It included sale to a stable core of shareholders (noyau dur) and a global offering of shares and resulted in a high retail (79%) versus institutional participation in the global offering (21 %), of which 51% of the shares remained with local institutions. Particular attention was paid to the preservation of the potential for a change of control, keeping the noyau dur to 30% of the shares and by ensuring transparency in its composition and competitive tension among the bidders. The stable core of shareholders paid a 5% premium on the price and are required to retain their share holding for a 5-year period, until 2005. The deal involved a clear shareholders' agreement that keeps management under a common strategic view, and the noyau dur controls 4/5 of Autostrade's board.

The process sought to create a high degree of transparency and a level playing field for all bidders, and to strike a balance between stable management for the company through the stable core of shareholders and a free float allowing a potential change in control.

…/

…/

The two tracks of the sale, i.e. the tendering of shares for the stable core of shareholders and pricing of the global offer were done within a six-month period and a minimum price guarantee was established. The method of sale consisted of a tender and private placement of shares with core shareholders and a global public offering. In recent years reliance on the stable core of shareholders in France has declined and instead there is a greater emphasis on the adoption of the golden share "*action spécifique*" coupled with public share offering. A significant proportion of large companies' shares are held by foreign institutional investors, and there has been a general trend in the unwinding of cross-shareholdings whereby inter-company holdings are reported to have dropped from 59% to less than 20% of the total market capitalisation between 1993 and 1997 [53].

This model has been a typical feature of the earlier French privatisations, whereby the government sought to ensure a stable corporate governance structure during the early years post-privatisation, and to protect it from foreign take over. In the absence of a powerful domestic institutional investor base and in an effort to create a transitional governance, groups of domestic investors such as banks, allied industrial groups, families and holding companies were invited to buy shares. Under this approach typically 20-30% of the share capital of the company was placed with such investors, where each member of the group had a 0.5% to 5% stake. The shareholders were interconnected through cross-shareholdings, and the sales were supplemented by shareholder agreements and a requirement for retention of the shares for a specified period of time[54]. The remaining stakes were then sold on the market through public share offerings, and sales to employees.

The use of a stable core of shareholders may give rise to corporate governance problems, through creating exclusive cross shareholdings and lack of transparency, resulting in significant discounts for the share prices of privatised companies. More specifically:

i. They can tie up the core shareholders' assets in cross-shareholdings and as a result capital may not be employed in the most productive manner.

ii. Management power is entrenched and the approach tends to protect the interests of the core shareholders at the expense of improved corporate efficiency and, hence interests of other investors.

iii. Is not transparent and tends to inhibit the emergence and functioning of the market for corporate control

The stable core of shareholders have also been used in countries such as Spain and its variant was adopted in Italian privatisations. The latter has been developed as a response to a relatively small stock market and the inadequacy of the institutional investor base in Italy, and seeks to address corporate governance problems, mainly through the prohibition of shareholder agreements.

The new generation of stable shareholder arrangements in privatisation are mainly designed to address issues of financial stability in countries with shallow, volatile stock markets with relatively low institutional involvement. Their main characteristic is that they expressly prohibit shareholder agreements and provide for relatively market-friendly arrangements for the stable shareholders (as opposed to the older "stable core of shareholders" that mandated concerted action by shareholders and allowed no exit).

2.3.3. Retaining a Controlling Interest

In some countries, the government has sought to privatise a minority stake in the company, while remaining committed to retaining public ownership and control over the longer-term as a means of protecting national or public interest. In this case, the intent is to sell a minority stake in the company to improve its performance through the infusion of private equity and management, but there are no immediate plans to relinquish control.

Through partial privatisation the government can address some of the problems associated with state ownership and help improve efficiency. For example, by going through the process of privatisation, the legal identity of the company is clarified and its financial structure becomes more flexible, resulting in better valuation of the company. These changes also help clarify the company's objectives and make the introduction of real performance-related incentives in managerial remuneration through stock options feasible. Infusion of private equity also helps subject the company to some degree of market monitoring and discipline. It focuses boards and management on producing shareholder value, as opposed to the pursuit of "political" objectives, and may foster greater transparency by imposing disclosure requirements on the company.

While partial privatisation offers important benefits, it can also give rise to the following drawbacks.

- If the structure of governance and incentives are left unchanged, the full benefits of improved efficiency are not likely to be realised. The company remains vulnerable to political interference and investor uncertainty results in the discounting of the value of

shares. This is also supported by empirical evidence showing greater efficiency and operating improvements of fully privatised companies compared to partially privatised ones.

- Partial privatisation does not severe the link to the government and as a result the government tends to remain exposed to risk, especially where the activity embodies public interest considerations; for example, in the case of public utilities where provision of goods and services must continue, or where the company is too big or too important to be allowed to fail.

Therefore, in order for partial privatisation to work, it is necessary to ensure that the state refrains from interference in the company's commercial decisions, and that it acts as a shareholder interested in increasing the value of its holdings in the company. Equally critical is the need to convince the markets that the state can be trusted to do so. However, the absence of a well-functioning market for corporate control in the company's shares, arrangements that would hinder the development of such a market, diminish the importance of capital market discipline as a vehicle for bringing about greater efficiency. The government also needs to strike a balance in how large a stake it privatises, in that if it is too small, the markets may remain unconvinced about its intentions to pursue commercial objectives.

In light of the above considerations, some observers[55] have cautioned against partial privatisation as a means of protecting public interest and have argued in favour of full privatisation, coupled with provisions such as golden shares, as being preferable to the retention of a controlling stake in the company.

Where the achievement of certain government policy objectives requires continuation of government control, retention of a controlling interest, coupled with a responsible exercise of ownership in accordance with principles of good corporate governance, can help promote greater corporate transparency, efficiency and performance. This could be particularly effective where company objectives are clearly identified and communicated, and where certain objectives cannot be achieved through a regulatory regime. In this regard, Norway's recent policy provides an example of such an approach. The recent Norwegian government White Paper on "Reduced and Improved State-ownership"[56] the government identifies principles upon which its ownership in individual companies ought to be based.

Table 2.5 **Instruments for Post-Privatisation Control**

Instrument	Description	Rationale	Advantages	Disadvantages	Comments & Examples
Golden Share	Also known as special shares, these confer upon government veto and special control rights over the company. They may be introduced in fully or partially privatised companies at the time of sale, or at a later date.	To protect against takeover of a newly privatised company where it is deemed that this is not in the national and public interest. In some cases it is intended to curb the development/ use of excessive market power and where an adequate regulatory capacity is absent or needs time to develop. Other cases where the privatised company is in a sensitive sector such as defence and the golden share seeks to protect the national interest.	Enables privatisation to take place. Less exposed to the risk of political interference than afforded by partial privatisation, provided that they have narrow scope, and a limited life. More transparent and less damaging for corporate governance of the company than stable core of shareholders. More flexible than legislation, especially where the issue is of a transitory nature.	Could potentially be used as a backdoor to political interference May create investor uncertainty	To fulfil their functions it is best if the golden share is defined narrowly and has a finite life span. They should be invoked rarely and carefully so as to not undermine confidence in government non interference. Examples include countries such as the UK, France, Italy, Spain, Portugal and Belgium.

Instrument	Description	Rationale	Advantages	Disadvantages	Comments & Examples
Partial Privatisation	Where the government sells only a portion of the State-owned enterprises. There is a distinction between partial sale as an end in itself, where the government has no intention to fully divest, and partial sale as transactional strategy, where the sale is part of a gradual approach to sale.	Partial privatisation as a longer-term goal The rationale is to retain government control over the company and to ensure protection of public interest, while infusing the company with private capital and management to improve performance. Transactional Where the company is too large to be absorbed by the domestic market. To overcome the initial discounting of the value of the company through establishing a track record to increase the value of proceeds from the sale of its subsequent segments.	Partial privatisation as a policy May contribute to improved performance if the government can establish credibility in the markets about its non-interference in commercial decisions. Transactional Tends to increase total proceeds Makes privatisation feasible when the absorptive capacity of the domestic market is limited, and where an adequate regulatory capacity is absent and needs time to develop.	It may be exposed to potential interference in management decisions and loss of credibility and benefits of private sector ownership. Can potentially lead to a discounting of the value of the proceeds from the initial segment of sales if: - Government intentions regarding future disposition of stakes are unclear, and - investors are concerned about potential government interference in management decisions.	Transactional Partial privatisation as a step in the direction of full privatisation and appropriate staging of sales has proved very beneficial for governments that have succeeded in acting as a shareholder with a view to increasing value of the company, refrained from interference in commercial decisions and have made their longer-term intentions known to the market. Examples from the experience from the UK and Italy have been very positive as far as proceeds are concerned.

Instrument	Description	Rationale	Advantages	Disadvantages	Comments & Examples
Stable Core of Shareholders	Typically involve the sale of some 20-30% of the company's share capital to a group of domestic strategic shareholders such as allied family or industrial groups, banks, and holding companies who agree to retain their shareholding for an agreed upon period of time. The earlier model typically involved cross-shareholding and the investors acted in concert.	To create a strong and stable governance for the privatised company in the early years after privatisation. It is also intended to overcome the limitation of selling assets in countries with shallow equity markets, and overcome the absence of a strong institutional investor presence, and to mitigate against the need to sell large blocks of equity to foreign investors.	Promote strong stable governance Protect against hostile takeover	They can be damaging to good corporate governance as they tend to create exclusive cross shareholdings and can inhibit proper functioning of the market for corporate control. They burden the core shareholder with unproductive assets in their balance sheets.	Examples include France, and its variation has been used in Italy and Spain.

3. LESSONS OF EXPERIENCE

Abstract

Some lessons can be drawn from the privatisation experiences of OECD countries. These experiences indicate that strong political commitment at the highest level is required to overcome bureaucratic inertia, resolve inter-institutional rivalries and move the process forward. Objectives should be clearly identified and prioritised up-front while competition and regulatory issues should be addressed prior to sales. The sequencing and staging of sales should be given due attention, and be decided based on commercial consideration. In order to gain credibility from investors and public support, the privatisation process must ensure integrity and be transparent. To achieve all these positive features, governments should draw upon external advice and allocate adequate financial and human resources. Finally, restrictions on foreign ownership should be limited and post-privatisation control devices used judiciously.

Privatisation policies are complex, in that they seek to meet multiple and, at times, conflicting objectives. They also involve many participants and are often contentious in that they affect vested interests and act as a catalyst for change. Therefore, sound design of management and implementation processes are needed to ensure the success of privatisation.

In each country, the approach to implementation has been shaped by domestic political considerations, the existing legal tradition and policy objectives of the government. Despite great variation and the fact that there is no single right or wrong approach, this report provides an overview of the issues that privatisation practitioners have had to consider and have found effective. The following are some of the key lessons based on OECD experience.

1. Political support at the highest level is an imperative

Given the political implications of privatisation and its impact on entrenched interests, the policy is vulnerable to bureaucratic stonewalling and extreme politicisation by opponents of the government. Therefore, it is necessary for the programme to be supported at the highest political level. This will signal the government's commitment to the policy and reassure potential investors.

2. Identify and articulate policy objectives up front

Privatisation policy objectives are multiple and often conflicting. It is therefore critical to begin with a set of clearly articulated and prioritised set of policy objectives and allow policy makers to be cognizant of the trade-offs involved from the outset.

3. Ensure transparency and integrity of the process

Privatisation is a highly controversial policy and susceptible to charges of abuse and corruption. For this reason transactions need to be free of conflicts of interest and conducted with the highest standards of probity. Trading off transparency for the sake of expediency sets back reform efforts, and undermines government's credibility with stakeholders, investors and markets. Selection of advisors and buyers based on open competitive processes would produce better outcomes in terms of price and performance, and contribute to the credibility of the process. Depending on the specific legal and political framework in place, subjecting privatisation transactions to post-privatisation scrutiny and oversight enhances the integrity of the process.

4. Draw upon external advice and dedicate resources

Privatisation entails tasks and requires skills that are often not available in the government. Depending on the method of sale, the size and the status of the

entity being sold, a wide range of financial, legal, strategic and sales advisors may be required. Advisors with experience in privatisation transactions and good access to network of quality buyers are critical in ensuring the desired outcomes. They are also a buffer to accusations of impropriety. At the same time, within the government it's important to dedicate resources and to develop the necessary skills and knowledge to use the advice effectively.

5. Address competition and regulatory issues prior to sale

Privatisation is more than just a sale of a company, particularly where the sale of infrastructure and public utilities are concerned. Government ownership of such assets embodies public policy and commercial functions which need to be separated, and issues related to the introduction of competition and establishment of an effective regulatory framework in the absence of competition should be addressed in advance of a sale. Unresolved policy issues and changes to the policy environment are extremely difficult *ex post*. They undermine investor confidence and erode the credibility of the privatisation programme.

6. Ensure that an effective communication is in place to explain the policy and to address stakeholder concerns

An effective communication of policy directed at stakeholders to explain the policy objectives of privatisation and the means by which they are to be achieved, along consultations at the earliest possible stage, helps identify and address stakeholder concerns and helps to gain support for the policy.

7. Limit restrictions on foreign ownership

An open policy regarding foreign ownership promotes buyer competition, increases the pool of capital, and allows governments to increase the size and speed of privatisation activity which would otherwise be constrained by the absorptive capacity of the domestic market. Furthermore, the sale of assets to foreign strategic buyers might infuse new management and technology, and builds links with foreign markets. However, concern over foreign ownership of strategic assets has meant that in some countries the degree of foreign ownership and its scope has been restricted. The experience of OECD countries has shown that only a very narrow limitation has been required to address specific national security and public interest concerns.

8. Sequencing of sales can affect the programme's success

Typically, privatisation programmes have started with the sale of assets that are in the competitive sectors of the economy, companies that are healthier and companies whose privatisation contributes to the successful privatisation

outcomes in other sectors. Choice of such candidates means that the sale is more likely to be successful and helps build credibility with the markets, gain experience and buy time to prepare for more complex transactions.

9. Staging of a sale should be driven by commercial considerations

The decision on staging sales or how much and how fast the assets should be sold is shaped by the size of the asset, the absorptive capacity of the market and the government's privatisation objectives. Partial and staged sales are suited to cases when an asset is too large to be sold at once, the market's absorptive capacity is limited and where government is seeking to maximise its revenues through sale in tranches, and has established credibility with investors (regarding its longer-term commitment to full privatisation and non-interference in company decisions). Addressing public interest considerations such as price, access and quality of service, when there is insufficient competition can be addressed through regulation rather than partial privatisation, unless the regulatory capacity is absent or needs time to develop.

10. Post -privatisation control devices should be used judiciously

Certain industries such as defence and public utilities are strategically important to the government and the need to protect the public interest has meant that governments wish to retain some degree of control over company decisions that are pertinent to the above concerns. However, in pursuing this objective the government needs to be cognizant of the trade-offs involved, in particular with respect to the implications of such policies for the governance of the privatised companies. In this regard, mechanisms that seek to raise revenues without seeking a change in governance incentives and structures of the privatised companies (for example, through the retention of substantial majority rights or the creation of cross-shareholding and closed "stable cores") bring fewer of the long-term benefits of privatisation to the companies or the economy as a whole.

The main vehicles for exerting influence over the privatised companies are: golden shares, stable core of shareholders, retention of a controlling stake, and regulation (price and service) in the absence of competition.

Establishment of an effective regulatory framework provides an effective solution where protection of public interest against abuses of monopoly power is concerned[57]. However, where the issues concerned cannot be addressed through a regulatory solution, retention of some degree of control through provisions such as creation of golden shares, a stable core of shareholders and retention of a controlling interest have been adopted.

- Where golden share provisions are used as a mechanism for post-privatisation control, it is important to ensure that they do not serve as a backdoor for interference in the privatised company. In this context golden shares that have a specific scope, are not invoked in an arbitrary manner, and are time-limited can help achieve this objective. In this regard, design of golden shares could be guided by the need to be "*founded on overriding requirements of the general interest and be proportionate to the objective being pursued*" [58].

- Where the establishment of a stable core of shareholders is adopted as a means of providing the company with a strong governance structure and protection from hostile takeovers, a transparent approach to the selection of the core shareholders, along with mechanisms aimed at making their governance practices transparent offer better outcomes. Lack of transparency both in the selection of core members, and provisions underlying their governance practices, are often not conducive to good corporate governance. This is particularly relevant where the domestic capital market features necessitate the use of this control mechanism.

- Finally where partial privatisation and retention of control is adopted as the preferred approach, the government will need to ensure that partial privatisation is accompanied by changes in the structure of incentives, governance and responsible exercise of its ownership role in order to help achieve the objectives of privatisation such as improved efficiency.

Privatistion is often part of a broader programme of economic reform. It never takes place in a vacuum and its success is critically dependent on the existence and adequacy of complementary institutions (such as regulatory bodies, competition authority, and the court system), legislation (for example, property rights, bankruptcy and competition law), and complementary policies (such as financial and labour market reforms, and trade liberalisation) that help support the proper functioning of the privatised assets .

NOTES

1. The OECD Privatisation Network was formed in 1996 as a forum for exchange of information on experience with privatisation policies and techniques among OECD member countries, and to guide the work on non-member country outreach activities. The Network consisted of senior government privatisation officials from member countries. In 2000, the mandate of the network was broadened, and in 2001 its name was changed to "OECD Working Group on Privatisation and Governance of State- owned Assets", to better reflect the mandate of this group of privatisation officials.

2. The Advisory Group on Privatisation met on a twice-yearly basis since 1992 and has served as a forum for the exchange of views on privatisation issues among policy makers from transition economies, OECD government experts and representatives of the private sector. Please refer to Annexes 1 and 2 for information on the AGP meetings and publications.

3. The treaty that aimed at bringing about greater economic political and social union of the EU. It set out the detailed timetable for monetary union (EMU), and the convergence criteria for economies that wanted to join the EMU. The criteria dealt with inflation levels, interest rates, size of the budget deficit and national debt, and exchange rates.

4. Compared with 75% for Europe.

5. Under capital or indirect privatisation a state enterprise may be transformed by the Minister of the Treasury into a joint stock company or a limited liability company (commercialisation) at the request of the enterprise itself or its founding body and also on the initiative of the Minister himself / herself. The Treasury holds the entire stake of such a company until its sale.

6. For example, the vast majority of banks in countries such as Hungary, Poland and the Slovak Republic have now been privatised. In France the last state-owned bank, (Banque Hervet) was privatised in early 2001.

7. Boutchkova and Megginson (2000).

8. Concerns capital privatisation revenues in the years 1990-2000 from the sale of the first block of Treasury shares.

9. Data problems include the lack of reliable and comparable data and selection bias in the sample of firms studied. The methodological difficulties arise from the fact that privatisation is often part of a broader programme of economic reform that may include market and trade liberalisation and tax reform, thus making it difficult to attribute improvements to privatisation alone. Similarly it is difficult to establish the counterfactual, i.e. how the company had developed had it not been privatised.

10. However, this conclusion is based on the first few years after privatisation. In recent years developments in the UK electricity market have increased competition and prices have dropped.

11. In some cases this has been reported to be by some 30-50%.

12. The issue of pre-privatisation restructuring is discussed in section 3.4.2.

13. Nellis, based on presentation to the OECD conference on Privatisation, Employment and Employees, October 2002, largely based on non-OECD countries.

14. EIRO, December 1999.

15. In former transition economy members of the OECD such as |the Czech Republic and Poland the process of restructuring and transformation, rather than the change in ownership per-se, has been largely responsible for the change in employment levels. For example see Novak 2002 for information on the Czech Republic.

16. Of some 27 empirical studies (by ILO) about half reported post sale job losses averaging 27%, some 40% reported little or no change, while the remaining reported an increase. In another review of some 17 additional cases average employment losses of about 45% were reported in about 40% of the studies, with half reporting no change, with the remaining cases reporting gains.

17. This issue is to be addressed during the next phase of their project on distributional impacts of privatisation noted in the next section.

18. According to a recent paper entitled "Winners and Losers: Assessing The Distributional Impact Of Privatisation". This paper reports on the first part of a larger project aimed at assessing the distributional effects of privatisation programmes in developing and transitional economies.

19. By naming the companies which are up for privatisation in the annual Federal Budget (without setting a price or price range for a single company) the German parliament only empowers the government to privatise these companies. The administration is then free to privatise or not (for example, in case of unfavourable market conditions privatisation will be postponed). According to the Federal Budget Code the administration must obtain the "full value" of the company, by ensuring that it realises the best price that the markets offer. Most decisions will be made at the working level. For

example, the Ministers' deputies (state secretaries) are involved in basic decisions such as approval of a price (or a price range) after book building in the course of a public offering.

20. Especially where the company has its own separate budget as is the case with Hungary's Apvrt.

21. According to the Italian Treasury between 1992 and 2002 assets sold under IRI's portfolio raised around 30.1% of Italian privatisation proceeds.

22 . Voivods act as representatives of the Council of Ministers and the Treasury in provinces.

23. Valuation methodologies are discussed elsewhere and are not discussed in this report. For example, see "The Case-by-Case Approach to Privatisation : Techniques and Examples", World Bank 1998, Dick Welch and Olivier Fremond.

24. UK Public Accounts Committee warns specifically about such conflicts of interest- source UK Treasury.

25. This is an example for illustrative purposes. The practice can vary according to the method of sale and each country's approach. For example, in Germany when privatisation is through a trade sale, advisors to the SOE have a limited involvement (these could be legal advisors and accountants to conduct due diligence). A capital market offering could involve both government and SOE advisors, while in a share increase exercise without government participation, the company hires and manages the advisors.

26. For a broader discussion of issues related to public sector transparency and accountability see *"Public Sector Transparency and Accountability: Making it Happen"*, OECD 2002.

27. Privatisation Law of 1993 created this in response to criticisms regarding lack of transparency and the discretion afforded to the Minister with respect to pricing of assets.

28. In June 1996, immediately before the IPO.

29. For example see the OECD documents on Competition and Regulatory Reform.

30. Lopez-de-Silanes.

31. It must be noted that even in case of private sector companies that are too big/important to fail the government might be faced with the risk of having to bail out/rescue the company. However, in such cases the intervention is transparent, as opposed to the case of SOEs where the subsidies/assistance are not as transparent.

32. NAO, 1998.

33. The Flotation of RailTrack, Report by the Comptroller and Auditor General, HC 25 1998/99, 16 December 1998.

34. In 2001, the government raised the foreign ownership limit in Korea Telecom from 33% to 49% , to facilitate privatisation.

35. Based on Kikeri (2002).

36. See Box 9 for a description of social packages in Poland.

37. Based on Czyzewski (2002).

38. Based on an example reported in Van der Hoeven and Sziraczki (1997).

39. The European Union rules, which do not allow the immediate use of privatisation proceeds to reduce budget deficit, also contribute to this.

40. Support for social security system reform with financial resources coming from the privatisation of the Treasury's assets was provided in Law on Amendments to the Law on Commercialisation and Privatisation of State Enterprises and the Law on Utilisation of Revenues from the Privatisation of Part of the Treasury's Assets for Purposes Connected with the Social Security System Reform (Journal of Laws of 2000, No. 31, item 383). According to art. 56, sec. 1 of this Law, at least 10% of revenues from the privatisation of each of the companies created as a result of commercialisation was used in the state budget for purposes connected with social security system reform. In 2001, a significant part of the privatisation revenues was used for additional financing of social security system reform. These resources were used to cover a deficit in revenues of the Social Security Fund (SSF). The Law was changed in March 2002 and according to new regulations the amounts planned and allocation of privatisation proceeds, including those earmarked for the reform of the social security system, are defined annually in the budget law.

41. These are outside the state budget and independent account for purposes set down in the law number 171/1991/coll.

42. This issue is discussed in more detail in the section on staging sales.

43. Such shareholdings tend to be limited, and rather unstable over time; in that the privatisation shares are often the only shares held (by these investors), and are not retained over time. For example, Boutchkova and Megginson (2000) have found that while large privatised companies have a significantly larger number of shareholders than their private sector counterparts (matched by their market capitalisation in the same markets), within five years the number of shareholders drop by 33%.

44. The issues of competition versus a negotiated approach and the type of auction used are discussed at length in other places and are beyond the scope of this report. For example see Klein.

45. For example in voucher privatisations in transition economies.

46. Wright (2002).

47. In developed economies as opposed to transition economies' experience.

48. Survey results.

49. Cuomo, 2002.

50. This issue along with the recent ruling of the European Court of Justice on the use of golden shares by member countries and their compatibility with free movement of capital and establishment is discussed in box 10.

51. However, in 2000, the Portuguese government used its powers to block the takeover of Cimpor (a cement company) by a smaller rival.

52. For example activities of the French publicly owned electric utility EDF have been seen in that light. Also the case involving Spain's fully privatised telecom company and Netherland's partially privatised Telecom firm KPN.

53. As reported in Loulmet and Morin.

54. In the early years, participation in the core was not necessarily determined based on the groups' strategic fit with the activities of the company on offer (See Goldstein).

55. Jenkinson.

56. The Norwegian Government Policy for Reduced and Improved State-ownership, April 2002.

57. The importance of promoting competition where feasible, and the role of regulation, has been discussed extensively and is beyond the scope of this report. For a full discussion of these issues refer to documents from the OECD competition and regulatory reform. Also see OECD Proceeding, "Competition, Privatisation and Regulation", Feb 2000.

58. This is consistent with the recent European Court of Justice ruling (June 2002) on the issue of use of golden shares by Portugal, Belgium and France (see Box 8).

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Annex 1

THE OECD ADVISORY GROUP ON PRIVATISATION

The **OECD Advisory Group on Privatisation (AGP)** is an international forum for policy dialogue on privatisation issues. It was created in 1992 by the OECD Centre for Co-operation with Non-Members to help transition economies with their privatisation efforts. Since 1997, its scope of activity has been broadened to include to all emerging markets. The AGP has sought to promote effective privatisation policies through policy discussion, exchange of experience and dissemination of conclusions/ "best practices". The AGP meetings bring together senior privatisation officials from member and non-member countries, as well as academics and private sector experts who engage in frank and open discussion about various privatisation issues. The AGP activities have also made it possible for OECD member countries to establish a dialogue with a much broader spectrum of non-member countries that are gaining importance in the ongoing process of globalisation and trade/investment liberalisation.

15 AGP meetings from 1992 to 2002 covered most critical areas related to the privatisation process.

The **first AGP meeting** took place in March 1992 and looked at **the role of financial intermediaries in the process of privatisation**, focusing on the role that commercial banks, capital markets, and investment funds play in the process.

The **second AGP meeting** took place in November 1992 and focused on **the institutional aspects of the privatisation process**. It is important, it was concluded, that the institutions entrusted with the performance of this task function in an efficient manner, and that the procedures should be both transparent and sufficiently flexible to assure that privatisation occurs in a highly competitive market for corporate control. The political sensitivity of the privatisation process is an important factor that should be taken into consideration in assessing the effectiveness of institutional arrangements.

The third AGP meeting, which took place in Budapest in March 1993, discussed **the role of management and employees buy-outs (MBO/EBOs) in the context of privatisation**. One of its main conclusions was that M/EBOs are a simple and rapid way of privatising smaller enterprises, especially ones in which human capital is an important part of the enterprise's value. On the other hand, it was pointed out that a widespread use of this method may "starve" privatised enterprises form much-needed fresh financial resources and create serious distortions in corporate governance, especially in the case of employee buy-outs. A serious conflict of incentives might arise from the exercise of both the employee and ownership functions in an enterprise by the same group of people. When this occurs in a large number of firms, specific policies should be adopted in order to enable the rapid emergence of an efficient secondary market for the employee shares, by facilitating insider exit and the corresponding entry of outside investors into the enterprise's capital.

The **fourth AGP meeting**, which took place in Prague in September 1003, discussed in depth the issues of **enterprise restructuring in the context of privatisation**. One of its main conclusions was that, given the sheer size of the public sector in the CEECs and the NIS and the need to proceed with privatisation as rapidly as possible, detailed restructuring operations at the enterprise level should, in principle, be left to the new private owners. However, legal restructuring, *i.e.* the transformation of state-owned enterprises into commercial companies wholly owned by the state, is an important prerequisite of large scale privatisation component. A number of other "broadbrush" restructuring functions can be performed at the stage of commercialisation, most notably the break-up of industrial combines for competition policy or efficiency purposes and the divestiture of "social assets" (hospitals, nurseries, etc.). A number of countries have undertaken financial restructuring of a limited number of enterprises, whose failure is not politically acceptable. This type of exercise is, in principle, related closely to restructuring plans for the banking sector. While financial restructuring might be necessary for a few "sensitive" firms, its widespread implementation might be extremely costly and thus jeopardise the macroeconomic stability of transforming economies.

The **fifth AGP meeting** took place in Paris in March 1994. It made a **first assessment of the results of mass privatisation**. It examined some of the different approaches that have been adopted by reforming economies to mass privatisation, including voucher schemes and state-owned investment funds, and some of the difficulties experienced in implementing the programmes. It showed clear evidence that mass privatisation is by no means a sufficient condition to ensure the development of private firms: it is only a prerequisite. Enterprise restructuring must be another component of the process. It has proved more difficult to implement. While instances of voucher sales in combination with

more traditional methods, such as trade sales, have often led to the necessary enterprise restructuring, they stand in contrast to examples where little incentive to impose rapid restructuring has resulted. An important task thus facing those economies in transition that have embarked on mass privatisation programmes is to overcome the many weaknesses that characterise corporate governance and the existing difficulties in corporate financing, which are the result of inefficiencies in the banking system and the underdevelopment of financial markets and institutions. The expansion and strengthening of secondary markets for privatised enterprises' shares could offer an opportunity for a new wave of ownership change that could lead to the concentration of shares in the hands of capable investors and entrepreneurs.

The sixth AGP meeting, which took place in Vienna in September 1994, discussed the issue of **corporate insolvency procedures as a tool for privatisation and enterprise restructuring**. Insolvency legislation is a fundamental component of the institutional framework in every market economy. It enforces financial discipline on enterprises, provides a mechanism for the orderly enforcement of creditor rights and allows for the re-allocation of productive assets in the economy. In principle, insolvency procedures and privatisation pursue different policy goals. However, in transition economies that are generally characterised by a large number of unviable public enterprises, there is a broad interface between these tow policy areas. As general insolvency procedures are expected to play a larger than usual role in the restructuring process, the legislative framework should be simple and relatively easy to implement, with clear-cut definitions of what constitutes insolvency, short time limits for the conclusions of re-organisation and liquidation proceedings and flexible rules that allow the preservation of debtor firms as going concerns, when problems of short term illiquidity are the cause of cessation of payments. As judicial courts ill-equipped, poorly funded, and lacking in training in most transition countries, they should act as oversight authorities rather than economic decision-makers: the creditors and their committees should instead become the main decision-makers in spurring reorganisation, ownership transfer or liquidation f the insolvent firms. Many countries have adopted transitional, quasi-insolvency procedures to help state-owned enterprises in difficulty funding areas. Some countries, in which the bulk of arrears were owed to banks, opted for creditor-led (*i.e.* bank-led), out-of-court arrangements that facilitate enterprise privatisation, through debt-equity swaps or asset disposals. In other countries, where arrears are mostly between enterprises or to the state budget, an independent government agency was given the task of facilitating privatisation restructuring and overcoming systematic creditor passivity. While these arrangements have had a positive result up to now, there is still need for some caution in this approach because of the potential for conflicts of interest and the scope for "hidden" subsidisation of inefficient industries.

The **seventh meeting of the AGP**, which took place in Moscow in March 1995, studied **the performance of privatised enterprises**, in particular their post-privatisation corporate governance, restructuring, and profitability. It showed that the success of privatised firms can bring benefits to the economy, in terms of increased employment and value creation, and has important political consequences regarding long-term popular backing of any privatisation programme. Empirical evidence from both transition economies and OECD member countries suggest that, in the medium term, firms perform much better under private ownership. This applies to shareholder value, employment creation, and general social welfare in the form of better services and goods.

The **eighth meeting of the AGP**, which took place in Paris in October 1995, focused on **the privatisation of utilities and infrastructure companies**. It discussed the need to create an appropriate regulatory framework for natural monopolies prior to privatisation and the techniques for large utility privatisation, an important new area of economic activity, namely the participation of the private sector in infrastructure projects, hitherto regarded as the exclusive domain of public sector investment. The geographical scope was broad: OECD economies, transition countries, and other Non-Member developing economies that have had extensive experiences in many of these areas.

The **ninth meeting of the AGP** took place in Berlin in May 1996 and **the management and sale of residual state ownerships**. It discussed the rationale behind partial privatisation, methods for residual share sales and how to manage residual shares. Governments should elaborate a clear strategy for managing their residual share portfolio. The institutions involved should be allowed to take an active shareholder role and government functions of owning residual shares and regulating enterprise activity should be clearly separated. While the creation of holding companies to manage long-term state shareholdings has a negative impact both on the performance and corporate governance of the enterprises concerned, temporary state shareholdings (mostly small minority stakes in a large number of companies) are likely to be better managed by professional asset managers who are given proper incentives to maximise capital gains in the context of future sales. A number of important issues will have to be decided by state asset managers, including dividend policies.

The **tenth meeting of the AGP** took place in Paris in November 1996 and assessed **the results of mass privatisation policies**. It discussed the political, legal and institutional framework for mass privatisation, and provided a comparative overview of the supply and demand side of mass privatisation. It also focused on the role of financial intermediaries and the effect of privatisation on capital market development. Finally, an overview of post-privatisation

corporate governance issues was provided as well as of the management and sale of residual shares.

The **eleventh meeting of the AGP** took place in Rome in September 1997 to discuss the subject of **banks and privatisation**. The meeting explored different areas related to banks and privatisation, including the policy aspects of bank privatisation, the design of bank privatisation programmes, the process and methods of privatising banks and the role of banks in privatisation. Presentations covered the experience of transition and OECD economies, whereas the discussions included also problems faced in other emerging economies. The meeting permitted senior experts, officials and policy makers in the areas of privatisation to get a comparative insight of different approaches to bank privatisation in OECD and emerging economies, as well as of the role of banks in privatisation.

The **twelfth meeting of the AGP** took place in Helsinki in September 1998 and focused on **regulation, competition and privatisation**. It showed that there is overwhelming evidence that privatisation has had positive effects on incentives, profitability and performance of privatised enterprises. However, competition and other privatisation objectives may sometimes be uneasy policy bedfellows: this might be the case in the area of the infrastructure and utilities sector of the economy where, historically, market structures have tended to be monopolistic. Incumbent firms may often argue successfully that they need to maintain their dominant position at home, by regulatory or other de facto obstacles to market entry. On the other hand, in the absence of competition, consumers are set to benefit much less from increased efficiency at the firm level, in terms of lower prices and better services. Whatever the chosen trade-off between preserving the incumbent firm and promoting competition, the first step to a successful privatisation in the infrastructure sectors is the clear separation between regulatory and commercial functions. Privatisation creates new performance benchmarks for remaining SOEs. A robust and credible privatisation programme thus delivers a lot of its benefits before the actual sale of a company.

The **thirteenth meeting of the AGP** took place in Paris in September 1999 on the subject of **Privatisation, Capital Market Development and Pension Systems Reform**. It showed that the privatisation process has significantly contributed to the on-going globalisation of the financial markets has been the most important factor in European equity markets growth throughout the 90's. Most privatisation-related offerings have had a strong retail component, which resulted in a significant increase of the number of small shareholders. Privatisation has also contributed to innovation in global capital markets and helped change corporate finance patterns. Along with desintermediation towards more market-based finance, it has changed the heavy reliance of European

enterprises on banks. Privatisation changed not only individual company behaviour, but also the whole corporate governance environment. In contrast to the experience of OECD countries, the focus of privatisation on capital market development is less obvious in emerging economies. Linking privatisation to pension reform can take various forms. Privatisation and especially pension reform programmes have important, long-term economic and political consequences. Linking privatisation and radical pension reform might be attractive in the short term, but may hide important pitfalls further down the line.

The **fourteenth meeting of the AGP** took place in Budapest in September 2000 on the subject of **Managing Commercial Assets under State Ownership**. The meeting explored the boundaries of privatisation and the scope for asset management, the related institutional framework, and the role of the state as corporate governance principal in commercial enterprises with state participation. The discussions covered the methods for managing residual state holdings and the lessons from the recent experience with public-private partnerships. It explored the changing pattern of state asset management by comparing policies across a large number of countries, in OECD as well as non-OECD economies.

The **fifteenth and final meeting of the AGP** took place in Istanbul in October 2002 on privatisation, employment and employees. It showed that many publicly run operations have been in need of restructuring and in some cases privatisation is a necessary step to take. A large amount of data also shows that restructuring and privatisation have adverse effects on employment. Nevertheless, immediate layoffs are also often mitigated by an increase in employment deriving from outsourcing and from the changes in activity that have been generated in relation to the privatised firm. Through various means, the bodies in charge of privatisation have been making real efforts to compensate redundant workers, ranging from severance packages to training and sometimes to very active labour policies. The difficulties in tailoring such packages optimally have been also documented. Public sector workers in companies that are being privatised are certainly not worse off than private sector workers in enterprises undergoing a similar process through restructuring. It is of the up-most importance to identify the impact of privatisation programs on employment and to integrate employment issues in the elaboration of these programs. Privatisation is also an opportunity to introduce labour market reforms. But co-operation at an early stage is needed and early and greater involvement of unions is very beneficial for both employees and smoothing the privatisation process itself.

Annex 2

PUBLICATIONS BASED ON AGP WORK AND MEETINGS

Because of broad repercussions of mass privatisation programmes, it was important that key innovations were communicated widely and rapidly. The AGP has contributed in monitoring such developments, providing for analysis and evaluation, communicating the results to members as expeditiously as possible, and providing for their publications. The AGP published six issues of "**Trends and Policies in Privatisation**". The aim of this publication was to keep members abreast of developments in a fast moving field, to serve as a basis for analytical discussion of the privatisation process, and to highlight important innovations. This publication provided summary data on the levels of transformation, restructuring, and privatisation activity, thus allowing an assessment to be made of the relative pace of privatisation throughout the region. Special sections reported on institutional and methodological innovations.

The first issue "**Trends and Policies in Privatisation**" was on "The Role of Financial Intermediaries in Privatisation". The second issue was on "Institutional Aspects of the Privatisation Process". The third issue was on "Management Buy-Outs in the Context of Privatisation". The fourth issue was on "Mass Privatisation, an Initial Assessment". The fifth issue was on "Corporate Insolvency Procedures as a Tool for Privatisation and Restructuring". The sixth issue was on "Performance of Privatised Enterprises: Corporate Governance, Restructuring, and Profitability.

Seven other publications were also based on the AGP work:

- "Methods of Privatising Large Enterprises" in 1993;
- "Privatisation of Utilities and Infrastucture: Methods and Constraints" in 1995;

- “Corporate Governance, State-Owned Enterprises and Privatisation” in 1998. The book brings together contributions from different countries highlighting different approaches to governance in state-owned enterprises and the impact of the choice of privatisation method on post-privatisation corporate governance and performance;

- “Privatisation, Competition and Regulation”, in 2000. This volume brings together papers discussing the interrelationship among privatisation, competition and regulation. The papers make reference to the experience of different countries with privatisation in a wide range of infrastructure sectors;

- Recent Privatisation Trends” has been published in the N°76 June 2000 issue of Financial Market Trends. The review is based on 1999 data from the OECD's privatisation database;

- “Recent Privatisation Trends” has been published in the N°79 June 2001 issue of Financial Market Trends. The review is based on 2000 data from the OECD's privatisation database;

- “Recent Privatisation Trends in OECD Countries” was published in the N°82 June 2002 issue of the Financial Market Trends. The review is based on 2001 data from the OECD's privatisation database.

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