

BUILDING AN INSTITUTIONAL FRAMEWORK FOR PRIVATIZATION

THE IMPORTANCE OF STRONG INSTITUTIONS

A discussion paper

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There are many choices in how to undertake a State Owned Enterprise (SOE) reform programme – do it quickly, do it slowly; involve many enterprises, or just a few; use these methods, or those. But international experience shows that however a country chooses to design its programme, it's important to construct a very robust institutional framework to implement it. The purpose of this short paper is to set out international best practice in this area, so that policy-makers can consider how best to adapt this to their own circumstances.

1. INTRODUCTION

Past experience throughout the world has shown that:

- The effectiveness of, and respect for, the institutions dedicated to implementing privatization are critical to success of the policy.
- Transparent, publicised procedures are essential for aspects of the privatization process.
- Decision making at macro and micro-management levels must be clearly divided so that the same decision is not continually revisited, or revised.
- Clear allocation of roles and responsibilities confines different decisions to the persons best placed to recommend or take the decisions.
- Approval of the overall approach and approval of specific details in individual transactions must be separated.

The process of privatization requires special provisions as well as skills and experiences that are not usually found in the public sector. The purpose of privatization is to increase private sector participation in the economy and the manner of carrying it out is a public process requiring private sector skills. From past experience in many developing countries, it is clear that privatization is a policy that is not suited to being carried out by existing governmental administrative structures and processes.

The skills and experience needed - as well as the decision-making process and accountability requirements - demand a unique approach. As a privatization programme will continue for several years and will involve major enterprises, it makes sense to invest in solid institutional foundations.

Political commitment is very important and an effective institutional framework cannot substitute for it. However, without an effective institutional framework it is very difficult to translate what political commitment there is into action. Furthermore, establishing an effective institutional framework is a key sign of the necessary political commitment and can provide the confidence required for increased commitment. Thus effective institutions and political commitment go hand in hand.

2. CORE REQUIREMENTS FOR AN EFFECTIVE INSTITUTIONAL STRUCTURE

Most institutional frameworks for privatization comprise three different levels of decision-making:

1. Cabinet/Prime Minister or President level – few decisions are taken at this level and they are usually of an overall policy nature that formulate approaches on labour issues, liabilities to banks and financial institutions, environmental liabilities and other recurring issues, as well as decisions on which enterprises to include in the programme at any given time.
2. A Cabinet Sub-Committee or Privatization Board. This is normally comprised of key ministers supplemented, in the case of a privatization board, by experienced private sector/civil society figures. This is the body that takes the key decisions in the course of a transaction, such as approval of choice of privatization method and choice of preferred bidder.
3. The executive/implementation level, which comprises a dedicated Privatization Unit of professionals headed by a senior figure who leads the privatization programme.

In many cases levels two and three are combined in the same organisation, with the board being the overseeing body for the executive body.

International experience demonstrates that an effective institutional structure for privatization will have the following key characteristics:

An effective institutional setting

The executive body needs to be close to key decision-makers where it can have maximum influence and access. In many countries it reports to the Prime Minister's/President's Office or to the Minister of Finance. The nature of the relationship of the body to the political leadership will vary according to its legal status, but the key factor is the attention and the support of a key central figure within government.

Legal authority

International best practice and experience illustrates that the privatization process, programme and institutional framework should be underpinned by primary legislation. The adoption of privatization legislation gives political legitimacy to privatization and gives legal authority to act to a specialised unit. It explicitly displays the government's political commitment to the policy. It sends a clear message to the public and to SOEs that the government is serious and committed. A specific law on privatization clearly establishes the powers, duties and functions of the supervisory and executive body and the roles to be played.

Strong executive body

A weak executive body will fail to overcome opposition from vested interests. An effective body needs the following attributes:

- The administrative authority to require SOEs and government ministries to comply with its requirements. SOEs and line ministries frequently resist privatization and unless the executive body has the power to obtain information and instruct actions to be taken, progress will be frustrated. Thus bodies that are purely advisory are unlikely to be effective.
- The necessary professional skills to implement the programme. Privatization requires special skills and experience not usually found in the public sector, such as financial, accounting, legal and communications skills, as well as the experience to utilise these skills in the context

of a privatization transaction. For this reason a unit staffed by civil servants is unlikely to be effective, not least because it will be constrained by civil service pay scales.

- Adequate resources to implement the programme. Privatization is a resource intensive process, which requires both a substantive core team in an executive body, as well as access to considerable quantities of external consultancy. Governments frequently underestimate costs and inputs needed and they often need access to external resources in order to finance the programme.

An effective head of the executive body

This person should be able to command respect both within government and with the public at large. He/she should have excellent managerial skills, good experience in successful project implementation and commercial negotiations, but critically, also needs to be a public advocate of change and committed to the success of the process.

A close relationship between the executive body and the political decision-makers

This is essential in order that the unit and its advisers gain the support, confidence and understanding of the decision-makers. An effective executive body produces well-formulated, high quality recommendations that are subsequently approved in a timely fashion and are not altered in any significant way by the political decision-makers. This means, in particular, that the professionals in the executive body should have ready access to the decision-makers. Thus structures which involve reporting through civil service lines of command are unlikely to be effective.

Appropriate delegation of decision-making

Privatization is a time-consuming and technically complex process. Within a privatization programme there are many thousands of individual decisions that have to be taken. Many of these are quite complex and require extensive analysis. It is not really possible to divide a privatization process into 'decision-making' on the one hand and 'implementation of decisions' on the other. For a process to work smoothly the institutional structure must exhibit two key features:

- Decision-making must be delegated, as far as possible, to those who have the greatest competence to take the decisions in question.
- A high degree of professionalism is required in every part of the institutional structure in order to ensure that complex matters are handled effectively and decisions taken quickly and by the appropriate individuals. This means that the executive body will take the large number of implementation decisions that are needed in the course of a transaction; the supervising Cabinet sub-committee/board takes decisions on key or sensitive issues; and that Cabinet takes very few decisions other than on major policy.

The following chart sets out the options for a potential division of decision-making between levels of authority:

General issues	Cabinet	Privatiz. Board	Exec Agency
Approval of procedures for different stages of process (e.g., bid procedures)			
Policy on financial liabilities of SOEs to banks / financial institutions, State Government guarantees, as well as other potential, actual, contingent or hidden liabilities e.g., environmental			

Policy on labour issues (inc. employee liabilities)			
Time-bound, recurring matters			
Approval to analyse an enterprise			
Approval to include an enterprise in the privatization programme			
Approval of annual time bound privatization programme listing enterprises in different phases			
Quarterly and annual review of performance against programme			
Approval of annual communications strategy for policy and programme			
Transaction specific issues			
Approval of paper on aims of transaction and criteria for evaluation, method and technique of privatization and other issues			
Commission & approve valuation reports and work of other advisers			
Implement communications strategy including contact with media			
Finalise & issue bidding documents			
Select evaluation committee members & conduct evaluation			
Approval of preferred bidder			
Finalise sales contract in discussion with preferred bidder			
Approval of finalised sale contract with preferred bidder			

A strong communications capability

This will facilitate a substantial, positive communications effort and an ability to respond publicly to statements by others or incoming questions. Creating a supportive public atmosphere towards privatization is a key factor in achieving success. This requires the buy-in of all key stakeholder groups and an effectively deployed public awareness campaign. This campaign should start at the beginning of the process and should include the list of companies to be privatized, the methodology, the budget for the process and the time frame. There should be periodic updates, to include bid results (i.e. names of winners and – if disclosure is permitted - price achieved and conditions of sale). Such transparency will do much to build public support.

3. SUMMARY OF PRIVATIZATION LAW CONTENTS

This section sets out what is usually contained in a privatization law. The contents of the law and the institutional and decision-making framework must avoid over-design and elaborate processes, instead adopting an approach that reflects the needs and resources of the country in which it is employed. It is desirable that policies, procedures, institutional and organisational frameworks contain much of what is set out here so that the primary privatization law is not over-burdened.

Principal Contents of Objectives of a Privatization Law

A law should:

- Make provision to establish an institution responsible for privatization (e.g., Privatization Board (PB)) with a supporting executive made up of specialists (supported with specialist advice and assistance).
- State the powers, duties and functions of the PB and grant the necessary authority to the Board to carry out privatization policy and implement transactions according to a specified process.
- Ensure that the PB will be small enough to be effective but representative of government, the private sector and different elements of society.
- Ensure that privatization is a private sector activity in a public sector setting and brings to bear a mix of commercial, political and administrative skills and experience as needed.
- Enable the PB to meet regularly – e.g., once a month.
- State what can be privatized – e.g., all government property, broadly defined to include direct and indirectly owned, managed or controlled property.

Detailed Provisions of the Privatization Law

A privatization law usually has two main types of provisions:

- Enabling provisions setting out powers, duties and functions.
- Facilitating provisions permitting the body to undertake certain activities which would otherwise be in conflict with prevailing law or the responsibilities of other bodies.

Enabling Provisions

These may be provided for in the primary law, in secondary legislation (rules or regulations) or in procedures adopted under the authority of the primary law.

- Who can initiate and request the initiation of the process for a specific enterprise.
- Who can prepare the enterprise for privatization.
- Who can prepare documentation.
- Who can perform processes.
- Who can determine the extent of authority of the privatization body if there is a dispute with other parts of government or SOEs.

- The methods and techniques that can be used.
- Arrangements for carrying out privatization.
- Who negotiates.
- Who signs agreements.
- Who implements the process and transactions.
- Who executes steps in the aftermath of a sale.
- Who monitors ongoing issues.
- Who resolves conflicts between privatization law and policy and other laws and policies.
- The milestone approval system and who gives the approvals.
- What happens to revenues raised in sales.
- Whether there is a need for sunset provisions (i.e. special powers that cease after a defined period).
- Reporting and accountability requirements, including Parliamentary oversight, once created.

Facilitating Provisions

These usually provide for:

- Ease of conveyance and registration of property by the body in a manner that expedites the process and determines who has power to vest property/title issues.
- Authority to exercise ownership rights over assets/shares that the privatization body does not own, (although it is better if the board owns them all, as it makes the negotiation process a lot easier).
- Entering into agreements on behalf of other bodies to sell the assets of a company/unit of government or to re-organise/merge/consolidate enterprises or activities.
- Management and restructuring prior to - and in the process of - privatization (legal/corporate restructuring, financial restructuring and ironing out debt issues but rarely production restructuring).
- Power to perform functions through other bodies might be established, or to act through advisers/sub-contractors etc.
- Power to enforce disclosure of information /co-operation.
- Power to investigate and obtain information from SOEs and units of government.
- Power to receive and take possession of property, rights, obligations, liabilities, shares etc.
- Power to wind up/dissolve/liquidate/legally restructure/break-up/hive off/convert legal form etc (needs examination of interaction with other laws, rights and obligations).

- Powers of entry and inspection.
- Power to handle claims against bodies.
- Power to receive payments and to operate a privatization fund/special accounts (to be compatible with general government accounting requirements).
- General approach to recurring issues such as (a) debt and non-performing assets; (b) labour matters including Voluntary Redundancy Scheme (VRS)/compensation/protection of rights; (d) other liabilities; and (e) use of proceeds.
- Accountability, audit, prevention of fraud and corruption issues, avoidance of conflicts of interest.
- Financing of on-going costs including liabilities for VRS and other employee funding.
- Appointing advisers.
- Dealing with borrowings of SOEs.
- Warehousing of shares (perhaps a privatization trust).
- Development of government/public sector asset register.
- Private financing of infrastructure.
- Regulatory issues.

5. INSTITUTIONAL ARRANGEMENTS FOR SOES THAT REMAIN IN THE STATE SECTOR

Ownership arrangements for state enterprises in most countries are less than ideal. Enterprises are usually owned by line ministries and sometimes form part of line Ministries. International experience indicates that SOEs not already in a corporate form, which remain in the state sector in the medium term, should be converted to a corporate form under the Commercial Code. But who should exercise the ownership role over them?

Options in most countries would include (i) continuing with line Ministry control, but seeking to improve governance arrangements, (ii) creating a new holding company that would manage state assets and (iii) transferring ownership and control to the organisation responsible for privatization.

International best practice would suggest that rather than line ministries (and on occasion various other SOEs) being the shareholders of an SOE, ownership should be consolidated in the organisation responsible for privatization.

This would mean that the shares of all SOEs should be held by such a body (e.g., the Privatization Board (PB),) that would be responsible for exercising the rights, duties and privileges of shareholders conferred by Commercial Law. This means that it would be the responsibility of the PB to:

- Vary the Memorandum and Articles of Association.
- Appoint and remove the directors.
- Approve and receive dividends.
- Approve the amalgamation, winding up, or transfer of the company.

In discharging these responsibilities, the PB could be obliged to consult with the concerned ministry but would not be bound by the results of that consultation. As the owner, the PB would mandate changes in management, financial and human resource policies. In particular it would mandate a transparent and competitive procedure for the selection of board members and senior management.

It could be a requirement that recruitment to the positions of SOE board director and chief executive should be by open advertisement and through a competitive process. For each position there would be a requirement to advertise openly in several publications, stating the selection criteria and minimum qualifications. The shortlist formed should be available for public inspection (on a website, for instance).

An important corollary of this approach is that serving public officials would be barred from serving on SOE boards for the following reasons:

- The whole emphasis of the proposed reforms is to make SOEs operate in a manner more akin to private sector companies. Public officials rarely have any inclination for, training in, or experience of, commercial matters.
- The presence of public officials on SOE boards is another channel for political interference in the management of such enterprises.
- The primary duty of company board directors is to act in good faith in the interest of the company of which they are directors. In performing this duty they are neither representatives nor delegates of the shareholders and must not restrict their discretion in the way they discharge it. A public official has a similar duty to his ministry; the interests of the ministry and the company over any particular issue will not necessarily always coincide. This creates a difficult dilemma for the public official.

Any provisions in law giving ministers powers to intervene in the direct management of SOEs should be repealed.

In some countries SOE employees are actually civil servants. All employees of SOEs that remain in the state sector should lose any status as civil servants and should sign new employment contracts as employees of the SOEs.

A significant danger in passing responsibility for SOE ownership to a specialised agency is that it becomes over attached to its role and seeks to resist the privatization of enterprises under its control in order to continue to exercise the patronage opportunities available to it. A variety of approaches can be taken to guard against this danger. These include:

- Only transferring ownership of those enterprises to the PB that are subject to privatization in the short-term. (But this would have the disadvantage that many line ministries and SOEs would have an additional reason to resist classification of enterprises into ones for short-term privatization as opposed to retention in state ownership for the medium term).
- Restricting the role of the PB in respect of enterprises classified for retention in state ownership to only selecting board members.
- Placing a defined life on the PB, such that it has to complete the task of privatization of all enterprises in, say, 5 years, after which time ownership of remaining SOEs would be transferred to a new body.
- Recruiting the staff of the PB on short-term, rolling contracts and choosing people with a clear commitment to the privatization programme and no pecuniary motive for making a career out of controlling state enterprises. They can be paid good bonuses for early sales and completing the programme.

6. THE ROLE OF LINE MINISTRIES WITH REGARD TO SOES.

The key role of line Ministries is to take forward overall sector policy. It is obviously critical to define what sector policy actually is, as well as the range of instruments required to develop it. In too many countries SOEs have become a substitute for an effective sector policy with line ministries consumed simply with grappling with the problems of failing SOE performance.

Of course some SOEs can help line Ministries implement sector policy by performing various non-commercial roles. The fact that some SOEs have non-commercial objectives is often cited as a reason why they cannot be reformed or privatized.

However, one approach to the problem of non-commercial objectives is to change the relationship between the line ministry and the SOE to a contractual one. Each SOE's non-commercial objectives, functions and powers, once defined, could be set out in an enforceable contract. This would mean, effectively, that the SOE became the government's agent for implementing certain elements of social policy. In any case, if any SOEs perform social functions for their employees, (such as kindergartens, health and vacation facilities), these are best separated from the SOEs in question.

Once an SOE's non-commercial activities have been identified, a figure could be put on the cost to the SOE of undertaking them and, to the extent that this is possible, on the value of the benefits flowing from them, with some identification of the beneficiaries or classes of beneficiaries.

The basis of calculation would be set out clearly and in detail, in each case, in the contract. It would be necessary to create dedicated budgetary control and financial and management information systems for each non-commercial activity.

Once the costs and benefits of non-commercial activities have been objectively analysed on a case by case basis, it may well be some are found to no longer make a worthwhile contribution to social welfare and that their operation should be discontinued in favour of more effective approaches.

The government would then compensate the SOE (its agent) for the identified cost of undertaking non-commercial activities. The compensation should take the form of a grant payable before the calculation of the SOE's profit and declaration of dividend. This should not in fact affect the government's overall financial position, since any such sums that the government receives from the SOEs are diminished by the cost of undertaking non-commercial activities. This would create transparency where there is obscurity, produce a more appropriate allocation of responsibilities between ministries and the boards of directors of the SOEs, as well as improving SOEs performance by removing an obvious excuse for poor performance.

In summary under this model the line ministry's role would comprise:

- Responsibility for deciding the quantity and quality of the SOE's provision of non-financial benefits in line with the resources allocated to the ministry for the purpose.
- Responsibility for paying the compensation for non-commercial activities described above, which consequently will become an element of the ministry's annual budget, thereby automatically involving the Ministry of Finance.