

THE IMPACT AND POLICY IMPLICATIONS OF PRIVATIZATION IN ETHIOPIA

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1. INTRODUCTION

The record of financial performance of Public Enterprises (PEs) in Ethiopia during 1971-1981 Ethiopian Fiscal Years (EFY), was far from being adequate or satisfactory. At the end of 1981, the aggregated loss of PEs during 1971-1981 amounted to almost 13% of GDP.

The shift from a socialist-oriented centrally planned economy to a market-oriented mixed economy approach has ushered in privatization as a mechanism of structural adjustment reform programme. The aim of privatization is directed at promoting efficiency and productivity and enhancing sustained growth and at the same time ensuring the autonomy and accountability of management.

This paper attempts to discuss four issues concerning privatization. First, it tries to highlight some of the major objectives of privatization of PEs in each sector of the economy in the light of the new economic policy of the Transitional Government of Ethiopia(TGE). Second, a general review of the different approaches of privatization techniques is made so as to present a bird's eye view of the different modalities of privatization, with the objective of minimizing or overcoming the pitfalls of privatization and selecting the appropriate privatization strategy for Ethiopia. Third, an attempt is made to identify both the negative and positive impacts of privatization in the economy. Fourth and last, the policy measures and strategies required for a successful implementation of the privatization programme are briefly outlined.

2. THE AIMS AND OBJECTIVES OF PRIVATIZATION IN ETHIOPIA

Privatization in its broadest sense "encompasses the general reassignment of property rights from the state to the individual" (Berg and Shirley, 1987:2). The process of privatization covers not only the ownership and management transfer of a PE to the private sector through sales, but also other forms of privatization such as lease arrangements, management contracts, cut-backs, liquidation, deregulation, etc. In general, the main objectives of privatization often include the following:

- 1) achieving wider share ownership;
- 2) introducing more competition;
- 3) changing the public-private sector mix;
- 4) improving the performance of state-owned enterprises(SOEs);
- 5) ensuring adequate revenue; and
- 6) reducing the frequent political interference in the day-to-day activities of PEs.

In most cases of privatization, however, the revenue angle seems to be of critical importance. In fact, the most important single objective of privatization, particularly in underdeveloped countries like Ethiopia, is often the desire to reduce fiscal and credit pressures on the national budget. Thus, privatization or divestiture is often viewed as a budget-relief and credit-reducing exercise.

In the Ethiopian context, what is the essential goal of privatization? Is it merely to reduce losses of PEs and government subsidies? Is the objective to switch ownership to the private sector, in order to make the enterprises efficient and profitable and thus, stimulate economic growth?

These questions have to be answered in the light of the new economic policy framework of the TGE. In general, the major criteria for the government ownership of enterprises could be based mainly on profitability. However, the relevant characteristics for PEs ownership in each sector of the economy, is highlighted in the new economic policy. Accordingly, the new economic policy, briefly qualifies the nature of PEs to be privatized in each sector of the economy in the following manner.

In the industrial sector, enterprises that qualify for state ownership are large-scale engineering and metallurgical plants, large-scale fertilizer and pharmaceutical plants and those industries which supply strategic raw materials to major chemical industries. The policy clearly states that PEs in the industrial sector which the state cannot operate profitably should be privatized and those PEs which it can run profitably should be retained as a source of revenue.

In the agricultural sector of the economy, state farms are to be drastically reduced. In principle, unprofitable state farms will be handed over to the community around the farms or to workers employed on them or to private investors on a concessional basis. The state may also operate state farms that are strategically important, on a joint-venture basis with foreign or domestic investors.

PEs in domestic trade, both in the retail and wholesale trade will be privatized. However, the state could still engage itself in the wholesale trade of "basic goods of mass consumption" in view of stabilizing prices. PEs in foreign trade will limit their monopoly control over those "areas that cut across sectors" (TGE, 1991).

PEs in the transport and communications service sector, that are difficult for the private sector to operate, e.g. air, sea, and rail transport services as well as posts and telecommunication services, will be retained. However, domestic capital participation in these areas, particularly in road transport, are welcomed and encouraged.

In mining and energy, PEs will continue operations in major mining and energy activities that are strategically important for economic growth.

In the construction sector, PEs will be reorganized and continue operations in a competitive environment on the basis of profitability. Similarly, financial institutions such as banks and insurance companies shall be under government control.

From the foregoing review of the new economic policy, it becomes evident that the new economic policy stipulates that in industry and agriculture, only unprofitable public enterprises will be privatized. Those enterprises that the state can run profitably should be retained as sources of revenue. Thus, the essential goal of privatization will be to reduce losses of PEs and government subsidies to them. Secondly, the privatization of PEs in the trade and road transport sectors in particular are encouraged. However, the new economic policy clearly stipulates that the state will engage itself in the "wholesale trade of basic goods of mass consumption" and "restrict its monopoly over foreign trade to areas that cut across sectors which will be studied and defined by law." The study must identify and specify the so-called "basic goods of mass consumption" as well as the "trade areas that cut across sectors." In general, the objective to switch ownership of PEs, to the private sector, will be to make the enterprises more efficient and profitable and thus, stimulate economic growth. Thirdly, the existing public enterprises in the transport and communication, mining and energy as well as the financial sectors will continue operations. However, the determination of domestic private capital participation in these sectors shall be studied and defined by law.

The goal of achieving maximum economic growth is quite different from a desire for a wide distribution of ownership and from maximum revenue from the sale of a PE. Whatever, the objective or combination of objectives, a priority list of enterprises to be privatized must be established. The review and analysis of PEs' financial performance in the different sectors of the economy during the EFY 1975-1982, show that 72 PEs have been identified as loss-making for at least three years and considered to be in critical financial condition. At the end of 1982, the major loss-making PEs registered over Birr 191 million, out of which 70 per cent was that of PEs in the agricultural sector and 25 per cent was that of PEs' in the industrial sector. Thus, agriculture and industry should be given higher priority, because their losses, particularly in agriculture, are the most serious.

3. THE DIFFERENT APPROACHES TO PRIVATIZATION

It is common knowledge that PEs that are viable can be easily privatized. The most difficult enterprises are those which are loss-makers and those which the government considers of public or strategic importance. Whatever the case may be, no meaningful privatization strategy can be planned and implemented without a systematic approach and development of the privatization programme. To this effect, the major privatization modalities and their limitations are reviewed and discussed with the objective of ensuring an appropriate selection.

3.1 Sales of PE Shares

The ownership of a PE could be transferred from the public sector to the private sector through partial or total sales of shares in the privatization process.

The sale of PE shares could be complete divestiture or partial divestiture. Complete divestiture involves the outright sale of all shares to a single buyer, to the public or to the workers and management of the PE being privatized. In all cases the government is divested of all its interests in the enterprise.

Partial sale of shares refers to cases where the government decides to sell part of its shareholding or a certain percentage of the total outstanding shares, to the public at large. The remaining shares may be retained in view of controlling or influencing decisions in accordance to some predefined objectives.

Another mechanism of privatization is the selling of the shares of a company to its workers and management through direct give-away, leveraged buy-outs, or some combinations of the two.

This approach has its own serious limitations. One key problem is its fairness. Transferring a PE to workers and managers at low prices, could become unfair to the rest of the society. Secondly, a firm owned mainly by its employees tends to be isolated from capital markets, because potential investors have the fear that employee owners will appropriate the profit and also have an incentive to push for wage increases.

On the other hand, through an employee stock ownership plan (ESOP), employees of a PE may be entitled to buy 15-20 per cent of the shares at concessional prices. Employees may be allowed to acquire individual shares on credit, without any cash payment deduction. According to this scheme, the employees pay for their shares through increased productivity. The employees receive their shares upon retirement, but from the first year they are entitled to obtain dividends on their share if the company shows a profit.

This financing technique has been extensively used in the USA and Bangladesh. Employees become motivated to work harder and to make fellow employees do the same to cut waste and increase production. Experience has shown that profitability can increase with the percentage of employee ownership. This technique may be good from a socio-political and from a productivity view point. On the other hand, its economic drawbacks may be great, due to its inability to generate any cash. It can be considered as an indirect form of subsidy.

3.2 Cut-backs in PE Activities

Another approach to privatization is the cut-back in PE activities. The centrally planned economy, as experienced in Ethiopia, has allowed the PEs to engage in too many economic activities that could be done more efficiently by the private sector. Consequently, PEs experienced poor record of financial performance. Therefore, the restriction of PEs activities and the encouragement of private capital to participate in the economy will enhance competition and ensure the efficient use of resources.

3.3 Liquidation and Withdrawal

In the case of a public sector company or enterprise which has been a chronic money-loser and is technically bankrupt should be liquidated by law. By liquidation and withdrawal the state will create a vacuum which can thereafter be filled by the private sector.

Other forms of privatization mechanisms include joint venture, management contract for a fee, lease arrangements, deregulation, debt-equity swaps, franchising, etc. Each mechanism has its own advantages and disadvantages.

In view of the multitude of approaches to privatization, the objectives and intentions of the government must be clearly defined and clarified in advance so that the proper approach to privatization can be selected. This implies that the privatization approach for each PE would tend to depend on its unique circumstances. Therefore, each PE considered for privatization must be thoroughly studied and understood, so that the proper mode of privatization can be recommended.

It has been already noted that the aim and objective of privatization in Ethiopia is to reduce losses and government subsidies. At the same time, the objective is to retain profitable enterprises so as to generate revenue to the government. In the light of these objectives, the outright or partial sale of PEs shares to the public is the practical approach to privatization. However, the appropriate institutions required must be established in advance. In view of creating special incentives to employees, employee stock ownership plan (ESOP) ought to be studied and tried. The lease arrangement can be extensively used in the hotel industry.

4. THE MAJOR PITFALLS OF PRIVATIZATION

The major pitfalls of the privatization process must be clearly understood by policy makers before embarking on privatization. In this section attempt is made to review some of the major problems and constraints that may be encountered in the process of privatization.

4.1 The Absence of a Developed Capital Market

The transfer of shares from the public to the private sector requires the presence of a developed capital market. The transfer generally takes place through the mechanism of the stock exchange. The process also requires the intervention of the investment banks and securities brokerage firms. Their role is to undertake the valuation of a company and eventually act as underwriters to buy the shares from the government and retail the shares through the stock exchange at market prices. However, in underdeveloped countries such as Ethiopia, the required capital market and the institutional infrastructures necessary for the privatization process are non-existent. The Share Dealing Group of Addis Ababa, which existed during the EFY 1965-1975 had helped to create a small but steady share market in the sale and/or purchase of stocks in local companies. However, this important service was discontinued after nationalization. There is an urgent need, therefore, to revive and create the institutions that will be responsible for valuation, transfer of shares, etc. Thus, successful privatization will require that such institutions be created in advance.

4.2 The Problem of Valuation

Before the share of a PE can be sold to private individuals, it is necessary to determine the price of each share and by implication, the value of the company concerned. However, it is generally difficult to determine the value of a company where accounts were not kept regularly or systematically, or whose accounts were not regularly audited. Nevertheless, proper valuation remains of critical importance, because the government has a public responsibility of ensuring that the property of the society is not undersold to private individuals. At the same time, the government has the social responsibility of ensuring that it is not selling a fictitious asset of no value.

4.3 Social Equity

The privatization process involves the transfer of assets that belong to the entire public, to a small and exclusive class of individuals that possess wealth. There could be a danger therefore, where key sectors of the economy on which the lives of the majority depend, would come under the control of the small class of wealthy individuals who are primarily motivated by profit, at the possible expense of social equity.

4.4 The Distribution Dilemma

The distribution dilemma relates to whether the best interest of the country are served by ensuring the widest distribution of shares or one that is restricted. If the widest distribution of shares is allowed, it is generally feared that foreign shareholders who would generally control large blocks of the shares will be able to wield uncontrollable power. On the other hand, a much more restricted distribution of shares might result in the overconcentration of economic power

in the hands of a few individuals, who may use the economic power to pursue objectives that may be at variance with the national good.

4.5 The Problem of Unemployment

PEs in Ethiopia, are generally unprofitable due to the fact that their employees enjoy a semi-civil service status which makes it difficult for management to compress the labour force. Moreover, PEs tend to be overstaffed with unproductive labour because of the employment creation objective pursued by the Government. In many instances, many PEs were subsidized in order to protect jobs. Therefore, in the pursuit of privatization, the new owners and managers of the privatized company must be allowed to operate freely. They must be allowed to reduce the labour force based on the standard of labour productivity which will be consistent with the profit motive. As a result, the prospects of massive redundancy cannot be underestimated. The social and political repercussions of massive redundancies is a serious problem that requires urgent solutions. In addition, the transferability of the various social benefits such as social insurance, pension benefits, and disability insurance has to be studied carefully, in order to protect the rights and privileges of workers. This is the main reason why the new economic policy of the Transitional Government has stated that in order to minimize the problem of unemployment in all sectors of the economy, privatization will be gradual, based on appropriate studies.

4.6 Business Confidence

As previously noted, business confidence in the private sector during the last 17 years was systematically destroyed. The slogan of the day was that "private wealth and entrepreneurship were equated with greed and obstacles to economic growth." In view of building the appropriate business confidence in the community, some practical measures including the restitution of property rights to previous owners by the government must be taken, alongside the implementation of the new investment proclamation of May 25/1992. As of today, the promised "fair compensation" for already nationalized enterprises have not been paid for Ethiopian nationals.

4.7 The Role of Foreigners

There is a persistent fear that privatization might eventually lead to uncontrollable take-over of key sectors of the economy by foreigners. The sensitivity of this problem of foreign encroachment of national sovereignty, requires that adequate steps must be taken to delimit the role of foreign investors and thereby protect national interest.

4.8 The Purchasing Power of the Public

It might be politically expedient to exclude foreigners from participating in the process of privatization of public companies. However, because of the low savings rate, the question to be addressed is whether there are indigenous investors that possess the financial resources, the purchasing power and the willingness to buy the shares thereby offered. Will the commercial banks be willing to extend loans to individuals so that they acquire shares in privatized companies? Will the Government be prepared to allow workers to acquire shares on privatized companies on credit? What kind of guarantees and incentives are necessary to attract the purchasing of shares in privatized companies? These are some of the various questions that must be addressed if privatization is to become a reality in Ethiopia.

4.9 Inadequate Awareness

There is often inadequate awareness on the part of political authorities that some SOEs which the government is willing to privatize are not economically viable. If SOEs are not economically viable, they should be liquidated, because the transfer of ownership will not alter their profitability.

4.10 The Problem of Selling Loss-making SOEs

In underdeveloped countries, governments rarely want to sell profitable SOEs. The money-losers they do want to sell can rarely find buyers at mutually acceptable prices. The problem even becomes more aggravated, in the absence of a developed capital market.

4.11 Special Privileges to SOEs Purchasers

Another pitfall of privatization relates to the extension of special privileges to SOE purchasers' request. These privileges often include, tax holidays, protection against external competition, subsidies, special access to funds or inputs, etc. The granting of these privileges will ultimately result in government subsidy. This may be contrary to the objectives of privatization and requires careful assessments.

4.12 The Danger of Poor Bargain

In general, the divesting government is not in a strong position vis-a-vis potential buyers. There is the danger, therefore, that government will often make a poor bargain. In addition the issues of whether to sell or liquidate, and how best to structure a deal for SOEs, are often ambiguous and deserve careful attention.

4.13 The Danger of Too Much Focus on Privatization

A final pitfall of privatization as noted by Berg and Shirely(1987) is that some governments attach too much focus on privatization rather than efficiency - as the ultimate goal. Privatization, in and of itself, may not yield efficiency gains. It all depends on the policy environment. The government allocation of foreign exchange, and government protection through tariffs and quotas, etc. may enable the enterprise to be profitable, but it may not necessarily make it efficient.

Therefore, the most critical question in privatization is to design and work out an appropriate privatization strategy that could minimize or overcome the major constraints and pitfalls of privatization mentioned above. Based on a comprehensive study of PEs performance, there is an urgent need to identify, prioritize and classify which enterprises :

- a) could be sold immediately;
- b) would need rehabilitation before sale;
- c) should be considered for leasing or management contract;
- d) should be considered for closure; and
- e) should remain as PEs.

Once a list of candidates for privatization is agreed on, the enterprises have to be "readied" for sale or liquidation. Assets of PEs will have to be valued and net claims on those assets have to be determined. An overvaluation entails the risk of chasing away potential private investors while an undervaluation would invite criticisms for having given away the nation's assets. The latter might be even more serious, if the sale is to foreigners. Moreover, if recent balance sheets or profit-and-losses statements are not available, additional financial audits may be required. In addition, claims of employees as well as their severance pay will have to be considered and determined. Furthermore, unrecorded arrears will have to be investigated and uncovered.

5. THE IMPACT OF PRIVATIZATION

5.1 Negative Impacts

The impact of privatization can be positive or negative. An overview of the negative impacts have already been encountered in the analysis of the major constraints or pitfalls of privatization. In the first place, privatization is always associated with the reduction of redundant labour, resulting in unemployment. At the end of the EFY 1982 the total number of permanent employees working in PEs was more than 206,000, out of which 59,000 were working in the major loss-making PEs. The major loss-making PEs registered over Birr 191 million loss at the end of 1982 (EFY) out of which 54.8% was in state farms while 25% was in industry.

Secondly, the problem of determining the appropriate value of each PE becomes conspicuous. The choice has to be made whether to rely on book values or market values, in order to reflect the real values of the shares of PEs. Thirdly, the institutional problems that are associated with the transfer of the ownership of shares, from the public to the private, are non-existent in Ethiopia. As noted earlier, the former Addis Ababa Share Dealing Group ceased operation at the time of nationalization, seventeen years ago. The financial intermediaries and private share dealers have discontinued their services. The Commercial Nominee, which was a subsidiary company of the Commercial Bank of Ethiopia, is no longer active in the registration of shares. Fourthly, because of low savings and lack of capital, the availability of domestic private capital is a constraint. This fact undoubtedly creates the fear that privatization would of necessity result in "foreignization", which is not desirable. Fifthly, the business confidence of private entrepreneurs in the last eighteen years have been shattered. The "fair compensation" which was promised for the former owners of nationalized enterprises have not been paid at all, in spite of the fact that the foreign nationals were paid through hard negotiations and international political pressures.

5.2 Positive Impacts

The shift from a socialist-oriented economy to that of a market-oriented economy clearly recognizes the crucial role of the private sector in the economy. The monopoly powers of PEs in controlling prices of inputs and outputs will be curtailed through the privatization process. Consequently, private enterprises are enabled to freely compete not only amongst themselves but also with other PEs. This encouragement of private capital to freely compete in a liberalized market will create an enabling environment, where resources are rationally and efficiently utilized by means of correcting the distortions in prices and markets. Thus, the general assumption that private enterprises are relatively more efficient than PEs under highly competitive conditions can be a reasonable assumption.

Through privatization, the monopoly or monopsony privileges of parastatals will be abolished and the PEs will be forced to compete on more equal terms with private enterprises. Private enterprises are driven by the profit motive and the fear of bankruptcy. Thus, the profit approach will enhance the rational and efficient use of resources in both the public and the private sectors of the economy and will ensure the increase in output and productivity. Furthermore, the autonomy of management will reduce the red-tape and enable managers to take appropriate and timely decisions regarding the operations and activities of the enterprises. If the enterprise becomes profitable, management can be rewarded, if the enterprise makes continuous losses, management may be penalized. In short, management will be made accountable for all its activities in carrying out its assigned duties and responsibilities. Therefore, privatization will enhance an enabling environment, in which resources are rationally and efficiently utilized. This will ultimately result in the improvement of the performance of enterprises and thereby ultimately increasing output, income and investment.

6. THE IMPLICATIONS FOR POLICY

From the foregoing review and analysis of the aims and objectives of privatization as well as the different approaches and major constraints of privatization, it can be realized that the implementation of privatization is not simple. The practical application of the following policies and strategies are prerequisites for a successful implementation of the privatization programme:

- 1) Privatization involves complex procedures such as the valuation of PE shares and the transfer of share ownership. In Ethiopia where the institutions of stock exchange, share dealers, brokers, etc. are practically non-existent, the sale of PE shares requires advance preparation.
- 2) It must be realized that privatization is a complex process requiring difficult decisions because of the project size, its influence on the economy, employment situation and financial repercussions. PEs in industry are relatively doing well than state farms. At the end of 1982 the share of the loss of state farms in the total amount of loss from the major loss-making PEs was 54.8% while the share of PEs in industry was only 25%. Thus, the prioritization of the agricultural sector deserves careful consideration.
- 3) In organizing the assessment and evaluation of PEs to be privatized, various expertise and skill in such areas as engineering, technology, finance, law accounting, economics, etc. are required. Better guidance is required not only in the technical aspects of sales, but also in the economic issues of privatization. Therefore, the creation of a central administrative unit to give technical advice in the management and the selection of the appropriate modalities of the privatization scheme becomes of crucial importance.
- 4) If privatization is to be successful, a coherent approach regarding the policies and objectives of privatization must be clearly established. To this effect, the new economic policy and the market economy approach must be better synchronized.
- 5) Diagnostic studies of PEs' financial performance has to be reviewed and evaluated as soon as possible, in order to classify and prioritize PEs' that should be sold, considered for lease or management contract, considered for closure or liquidation, or remain as PEs. Since many PEs are likely to remain as PEs, ways to improve their internal efficiency and performance should also be studied.
- 6) It must be recognized that without an efficient capital market, it is practically impossible to achieve privatization that is socially acceptable. Privatization requires a class of private investors who would like to buy shares of PEs. This requires a capital market where sellers or purchasers of PE shares can conclude their transactions. As noted earlier, this important service had been discontinued in Ethiopia after nationalization. The urgency of reviving or developing a capital market is self-evident.

- 7) Financial intermediaries such as investment or commercial banks can play a key role in the development of capital markets. In this respect, the Agricultural and Industrial Development Bank of Ethiopia can make credit and financing facilities available, so as to encourage the purchase of PE shares. In addition, banks, pension funds and mutual funds should be encouraged to participate in the development of capital markets.
- 8) The practical measures that should be taken in order to create and develop business confidence can vary, but their goals and objectives remain the same. The *Encouragement, Expansion and Coordination of Investment Proclamation No 5/1992* came into effect on 25 May 1992. Undoubtedly, the favourable objectives and impact of this proclamation on domestic private investors is critical. However, its practical implementation can be greatly increased if concrete measures are taken in paying "fair compensation" for already nationalized enterprises or return the nationalized enterprises to their rightful former owners. In this respect we can learn a lot from the experiences of other countries such as Egypt and Sudan. The practical implementation of the payment of fair compensation or the restitution of property may involve certain administrative problems. However, the positive impact that these efforts can create on domestic private investors cannot be underestimated.
- 9) Technical advice on the relative merits and demerits of different approaches to privatization schemes in Ethiopia is useful. However, to rely solely on foreign consultants for the valuation of PEs may be expensive. Experience has shown that the cost of valuation of the companies could range from 12-25% of the values of the companies.
- 10) The importance of *policy environments* that encourage the efficient operations of private enterprises cannot be underestimated. The gains from privatization approaches can only be sustained if the reforms to promote competition and efficiency pricing are fully implemented. In this respect, a strong position must be taken against special privileges that may be requested by the purchasers of PEs. In cases where PEs are difficult to sell, potential purchasers of PEs often request special privileges such as the protection from competition, tax exemption, special investment credits, protected domestic markets, etc. It must be understood however, that the granting of these privileges could be contrary to competition and efficiency pricing.
- 11) Transparency should be taken as a major element in all divestiture related programmes. This implies that the PEs considered for sale must be properly studied so as to indicate their individual problems and disseminate the findings of the studies. This will ultimately help in the decision whether to liquidate or rehabilitate the PE in question.

7. CONCLUSION

A successful implementation of a privatization programme involves very long and complex procedures. The objectives of privatization within the framework of the new economic policy of the Transitional Government of Ethiopia require further clarification and specifications. In order to avoid the pitfalls of privatization, an enabling environment such as the creation of proper institutions for the development of the capital market as well as the necessary business confidence must be established in advance. Furthermore, diagnostic studies of PEs must be conducted in view of developing systematic privatization strategies. Then, the readying of PEs for sale or liquidation will have to be prioritized. In addition, the impact and policy implications of privatization will have to be carefully assessed and considered. These long and complex procedures imply that privatization must be properly designed in order that it can be a potential source for growth. The efficient and rational use of resources both financial and managerial can be ensured through competition. If on the contrary, the design and the strategy of privatization is poor, the consequences will be financial disaster.

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