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FINANCIAL RESOURCES DEVELOPMENT

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## I. REVENUE MOBILIZATION

1. All countries in the world are experiencing financial stress due to shifts in global, regional and domestic economies. For the developing countries these issues are manifested in two areas: resource mobilization, utilization and budgeting; and reforms and shifts in the public enterprise sector.

2. The period 1990-1992 has been characterized by attempts to introduce change to the area of revenue mobilization policy in developing countries, in accord with revised macroeconomic objectives set by those Governments.

3. The principal factors promoting Governments to review tax and customs regimes, and their administering agencies, are as follows:

(a) Sources of external funding previously available to supplement domestic savings, thus making higher levels of investment possible in the short term, are becoming increasingly difficult to mobilize. This is due to a diminished level of net resource inflows to developing countries in the late 1980s and early 1990s compared with the early 1980s;

(b) Competition for concessional external finance is growing with the emergence of a large number of transitional economies, following the political reorganization of Central and Eastern Europe and the Baltics;

(c) Access to private capital markets is restricted to credit-worthy countries;

(d) Economic structural adjustment programmes, formulated by multilateral agencies and implemented by a number of traditional developing countries, encourage liberalization of trade and promote efforts to become an integral part of the international trade and production network. These programmes incorporate streamlining of tax/tariff rates and regulations and promote domestic manufacturing and exports by replacing indirect taxes with value-added taxes (VATs). The short-term impacts of these programmes on revenue can be negative. Implementation of these macroeconomic changes is administered by resource-mobilizing agencies which find that their organization needs adjustment in order to accommodate the programmes and counteract revenue declines through improved abilities;

(e) A projected decline in interest rates during the 1990s will offer an opportunity for countries with large amounts of variable-rate debt to reduce their total indebtedness, since lower interest rates have an effect on scheduled interest payments. This requires consistent resource mobilization and controls over government budget deficits;

(f) Commodity prices are projected to remain stable, increasing slightly in real terms, in the 1990s, following a United States economic recovery. Debt servicing and debt reduction on existing debt portfolios will only be made from domestic resources; in many cases commodity-exporting countries will not be able to borrow concessional or otherwise since their existing debt servicing capacity is now fully utilized and seems unlikely to increase in the coming

decade. Full mobilization of all available domestic revenue sources will be needed if debt-servicing capabilities are to be enhanced.

4. Tax revenue has continuously accounted for about 80 per cent of government finances, although it experienced a minor decrease in terms of its ratio to government current revenue in the mid 1980s. There were no significant shifts in the structure of taxation away from indirect taxes towards direct taxes during this period. But tax structures vary among country groups. Within the developing economies, the major sources of tax revenue come from taxes on international trade and transactions in low-income economies, particularly in sub-Saharan Africa. This is in contrast with the major source from taxes on domestic goods and services in lower-middle income economies and from taxes on income, profit and capital gains in upper-middle income economies. In sub-Saharan countries, taxes on international trade and transactions have accounted for more than 50 per cent of total government current revenues. The dependence on taxes on international trade reflects the extent of the openness of the developing countries and dependence of the economy on external transactions.

5. Different measures of tax reform have been taken by many developing countries, with varied degrees of success. Tax reforms have concentrated on expanding the base, thus avoiding the higher tax rates and adverse effects on incentives. This has been particularly relevant in those 60 developing nations which have reduced trade barriers over the past five years and which now focus on economic adjustment and a shift towards trade surpluses on exported manufactured goods to support economic development. They have also tried to promote equity by limiting tax deductions from the wealthy and by avoiding taxes on the poor. Some tax loopholes were closed in 1989 tax reforms in Guatemala. VAT was introduced with the objective of generating substantial revenue, with fewer distortions than import or excise taxes in emerging manufacturing countries. Finally, tax reform is a long-term task and requires periodic changes in order to take account of external circumstances and internal needs.

6. Tax and tariff reforms alone will not be sufficient to augment public revenues. Tax administration in most developing countries also needs to be reformed to improve tax collections, tax audit procedures and overall tax policy organization. Besides, it is generally believed that the tax potential in many low-income countries has not been fully exploited. Another major cause of poor revenue performance is tax evasion due to laxity in tax administration.

7. Countries facing these issues, including countries in transition, are seeking new governmental roles and functions to lead them to economic recovery and new social levels. Although there are many recent proposals for the reduction of government functions and pressures to reduce the proportion of national resources consumed by the public service, there is a persistent need to strengthen governmental capacity to manage these challenges in the resource mobilization area.

8. During the late 1980s and early 1990s, most developing countries faced mounting domestic and external financial imbalances which resulted in unsustainable public-sector deficits. To contain these deficits and achieve financial stability, many of these countries have implemented economic adjustment policies to improve their fiscal position. On the revenue side,

significant measures aimed at expanding the revenue base and increasing the elasticity of the tax system were adopted. As a result, a more efficient tax administration contributed to improved resource mobilization and revenue performance. On the expenditure side, emphasis was put on limiting the growth of current expenditures through more efficient expenditure controls, closer scrutiny of public service and restraint in wages and salary adjustments. In addition public enterprises were reviewed and streamlined, and in some instances, their number and scope of operations were reduced.

9. Against this background and the gradual erosion of external flows of finance, many developing countries carried out policies entailing measures to strengthen domestic resource mobilization.

10. In mobilizing revenue for the public sector, most traditional developing countries continue to rely on taxation, particularly from consumption, domestic goods and services, income and profit and international trade. To further this trend, most countries have introduced tax reforms aimed at raising additional revenue and ensuring that tax policy complemented their macroeconomic framework. To overcome contractions of tax bases, decline of tariff revenues and reduction of income from depressed commodity prices, they also implemented reforms aimed at improving the performance of their tax systems and strengthening tax administration.

11. The reform of the tax systems focused on several major factors: increased neutrality, simplicity and horizontal equity of the tax system; broadening income-tax bases; introduction, in several cases, of VAT; reduction of tax-induced distortions; and adoption of expenditure approaches minimizing the prospects for future fiscal deficits and consistent with administrative capacities.

12. Simplification of tax systems resulted in a gradual shift from the taxation of production to the taxation of consumption. The introduction of the value-added tax in some countries contributed to raising substantial amounts of revenue while removing the burden of indirect taxation from export and investment expenditures. It also contributed to shifting taxation from international trade to taxation of domestic transactions and restructuring personal and corporate income taxes to generate higher revenue.

13. Successful implementation of tax reforms and mobilization of additional resources from this source also called for the strengthening of tax administration. To enhance efficiency and effectiveness of tax administration, a number of developing countries implemented programmes aimed at a comprehensive overhaul and improved operation of institutions concerned with the assessment, collection and enforcement of taxes. To bring reality in line with intentions, they also simplified administrative procedures, enhanced staff training and introduced data-processing capacities. Efforts were also made to improve tax auditing, to define tax bases more precisely in order to avoid litigation and to minimize difficulties in interpretation through the use of presumptive techniques and standard assessments.

14. Some Governments have noted the need for strengthening revenue administrations by reinforcing these agencies with the necessary legal, administrative and financial authority so as to enable them to participate more

actively in the process of tax policy formulation and afford them sufficient autonomy and flexibility in assessing and collecting revenue for the Government. They also noted that training facilities for all levels of revenue officials should be strengthened at the national level and, where economies of scale can be achieved, at the subregional level. Attention could also be focused on curricula development, model training programmes and training of trainers.

15. For most countries a well trained and effective tax administration can help meet revenue needs as well as contribute a means of attaining greater financial self-reliance and reducing dependence on financial transfers. Furthermore, rendering non-compliance more difficult and generating additional revenue through improved capacity in the revenue administration may also reduce the need to introduce higher tax rates or impose new taxes. Finally, efficient and effective tax administration would facilitate the implementation of stabilization policies and adjustment programmes and bolster prospects for economic growth. The revenue administrations are in charge of applying the tax and tariff system, and therefore, the success of fiscal policy will depend to a great extent on management by these organizations.

16. These issues, as well as the relationship of the revenue administrations with the decision-making levels of fiscal policy and the participation which the revenue administrators may have in this sphere, are topics which are more readily clarified where the senior officials and their staff are well trained and contribute to discussion and analysis of policy matters. A well trained revenue administrator can actively participate in the formulation of tax policy by providing a practical viewpoint. This opinion acquires great significance when related to the feasibility of effectively applying and controlling revenue policy decisions. Revenue administrators can assist the finance authorities by giving opinions on basic aspects of tax policy and projecting the effects of legislative changes in the collection of taxes.

17. Interregional institutions might also assist Governments in revenue mobilization measures. It might be useful to create a coordinated approach to the development of an interregional institution with training facilities. Such institutions would both promote complementary revenue policy development between developing countries and train senior tax administrators in compliance and management skills.

18. Preparatory activities in favour of a centre are in progress, and strong support is being received from a range of bilateral and multilateral sources, especially the African Capacity-building Foundation and other major development agencies in Africa.

19. Fiscal management and its major components continue to play a vital role in national development. Adequate, effective and equitable resource mobilization that is complementary to national macroeconomic development objectives has now become an issue of central concern in dealing with crucial issues of economic management and governance in developing countries. The presence of interregional institutions such as the one proposed above and related policy and programme actions to strengthen techniques and skills in relevant areas of tax and customs management would contribute to economic and social development through resource mobilization. Within the framework of available resources, these activities will be reflected in future work programmes.

20. In contrast with traditional developing countries where the development of sovereign institutions is largely complete and the efficacy of these mechanisms is being evaluated, the transitional economies confront a far broader series of developmental issues. The command economies of Central and Eastern Europe and the Baltics are going through fundamental structural changes which are much more complex and of a different order of magnitude.

21. Private entrepreneurial skills and experience of private-sector management were systematically suppressed; capital structures within the economy were not shaped by commercial considerations and were influenced by other governmental priorities; resource mobilization policies were constrained by a narrow focus on employment, wage and taxation issues. Reforms of public institutions in these economies will involve a long series of changes such as orientation towards commercial operation; reduction of governmental intervention in commercial activities; reforms of governmental agencies, legislation and procedures to become consistent with building open economic systems from mono-economies; and aggressively transforming existing administrations in response to both internal and external circumstances as they affect economic, social and political systems.

22. Faced with a variety of harsh economic conditions, many transitional Governments are focusing on programmes of economic recovery and development which take different forms in different countries. In each type of case, there is need to give attention to the full range of governmental policy alternatives. Since many Governments continue to reform their economic policies to meet the demands of economic recovery and development, public administrators have expressed the need to reform a number of their relevant management processes, for example, information-gathering and priority-setting mechanisms, analytical processes on economic and social trends, and coordination mechanisms. The United Nations programme is uniquely placed to assist these countries and can intensify its support to efforts to strengthen their civil service capacity for development.

23. It should also be noted that many Governments are revising and reforming their legal frameworks at various levels - constitutional, statutory, regulatory and legal control. From the perspective of resource mobilization, there will be scope for United Nations programme involvement in this area, especially with respect to simplification, rationalization and the complementary nature and readability of various laws and regulations.

24. Revenue officials from six economies in transition noted the disparity between the promulgation of legislation to raise revenue and the absence of trained administrators to implement these laws. In other situations, the apparent contradiction between promotion of industrial development and revenue collection gave rise to sharp contractions in revenue as very "soft" legislation was enacted to encourage economic development in specific sectors. Further, the absence of well defined administrative responses to requests for special exemptions from taxes/tariffs led to ad-hoc decisions being made by regional officials without consulting the central agency.

25. These examples, combined with the disparities between tax and tariff policies being pursued by neighbouring countries, indicate that policy reforms can benefit from collective assessment and that administrative capacity within

the region needs to be enhanced in order effectively to implement the resource mobilization policies initiated by Governments.

26. The current programmes of technical assistance in the resource mobilization area focus on:

(a) Direct support in the area of macroeconomic policy development, principally in the form of support to economic adjustment programmes;

(b) Institutional capacity-building with a strong emphasis on training administrators who become a focus for future organizational changes. These take the form of administrative improvement programmes.

27. The success of improvement programmes and projects has never been fully investigated. Prima facie, most can be seen to have positive beneficial effects, but for those working in this area, there is sometimes a frustrating gap between expectation and performance, particularly when such initiatives are judged on their sustainable results once a project ends and external assistance inputs are withdrawn. The constraints which result in lack of sustainability are conjectural. For the host country they probably include:

(a) Lack of full commitment on the part of the political class and those under them to honest and transparent financial dealings with revenue administrations;

(b) Lack of good training opportunities and failure to provide revenue agency staff with conditions of service sufficient to induce them to acquire and develop the skills needed for the job and to remain in the public sector once they have acquired them;

(c) Basic lack of resources, disguised during the currency of externally funded technical assistance projects, but apparent once they have ended.

28. For the donors/lenders, they include:

(a) A tendency to address revenue management improvement on too small a scale and reluctance to admit that real advances in capacity are likely to take decades to achieve;

(b) A tendency to diagnose wrongly the financial management needs of developing countries and therefore to prescribe inappropriate improvement programmes (for instance, to propose elaborate conceptual innovations before the reliability of basic system has been assured);

(c) Failure to insist on the necessary host country commitment to revenue management improvement programmes as a condition of technical assistance.

29. Revenue administration improvement projects will continue to be popular, both on the part of donors seeking improved domestic resource mobilization to promote the economic and social development that they fund and in support of their own aid resources and on the part of host Governments seeking better resource mobilization, revenue accountability, control and resource management

generally. Clearly the costs of developing a strong revenue administration are lower than the losses from weak revenue management.

30. Secondly, more realistic expectations will be needed in planning such projects. This applies both to the preparedness of host-country Governments to give full political commitment to improvement programmes and to the contents of these programmes. While favourable environments offer the possibility of ambitious objectives, less favourable ones imply the need for more realism and less rhetoric. In particular, those who plan projects should accurately gauge the recipient's capacity to absorb change.

31. Thirdly, more support is needed from Governments for this type of project. It is very common for Governments to offer to revenue administration staff remuneration and other conditions of service which are unattractive in relation to private-sector rewards. Inevitably, trained staff seek better conditions, and public-sector staffing suffers. Moreover, training becomes less effective. The same problem is commonly found in relation to trainers in revenue management subjects. Often the rewards for trainers are insufficient to keep the best of them in training roles. As a result, trainees are exposed to poor quality of training.

32. Fourthly, in the long run, developing indigenous training is likely to be both less costly and more effective in producing the necessary skills and in developing national capacity than sending staff abroad for training.

33. Finally, where there is a choice between supporting revenue administration ability or other fields, it is preferable in countries with underdeveloped governmental financial management systems to support revenue management, because it is the base on which all other elements of governmental rehabilitation projects will depend.

## II. GOVERNMENT BUDGETING

34. Of the many issues confronting the field of government budgeting, six stand out as particularly key to management improvement and productivity. The selection of these six areas focuses on selected items which either need improvements or reforms or whose problems and challenges must be addressed without delay.

35. Five are discussed in the present paper - i.e., strengthening institutional and macroeconomic frameworks, techniques of budgetary control, composition and size of government expenditure, cash and debt management, and budget reforms in former centrally planned economies. (The sixth, computerization of budgeting, is a critical issue and is dealt with in another document, "Information technologies development in public administration and finance" (S/SG/AC.6/1993/L.5). It should be noted, in passing, that personal computers are an increasingly important tool in all aspects of development. They are penetrating all phases of the budgetary process. With their constant diminution in cost and their facility in use they can change drastically the way budgets are prepared, implemented and controlled. But paradoxically, there is very little information on their use or advantages in government budgeting.



36. Many developing countries need to strengthen their institutional and macroeconomic frameworks without which government budgeting cannot properly fulfil its main functions. In a period of fiscal constraint and structural adjustment, budgetary control is a useful instrument for optimizing government expenditure. Experience indicates there is ample room to improve budgetary control techniques in developing countries. The study of the composition and the size of government expenditure gives a clear picture of the recent effects of stabilization and adjustment programmes on government expenditure and shows the sectors where a reallocation of expenditure is needed. Cash and debt management is a key element of a good financial management system but has not yet been given the attention it deserves. Cost-effective improvements in this field are required. Finally, a totally new budgetary subject deserves special attention: with the collapse of the communist system, the former centrally planned economies must adapt their budgetary structures to the requirements of the free market. This raises a multitude of questions to gauge the best techniques, mechanisms, procedures that these countries must adopt or adapt.

37. There is wide recognition that institutional aspects of public expenditure management have been neglected in most developing countries over the past decades. These deficiencies may be explained in part by the fact that budget reforms have too often been undertaken during periods of economic crisis when it is easier to take short-term corrective action than to question the rationale of the budgetary process and the macroeconomic framework in which it is embedded.

38. Many weaknesses in the institutional and macroeconomic frameworks were discovered when the structural adjustment programmes of the International Monetary Fund were introduced in various developing countries. The weaknesses were such that most programmes include reforms or improvements in public expenditure planning, budget structure and process, budget implementation, government accounting and financial reporting and other related areas.

39. To be efficient, public expenditure planning needs a coherent macroeconomic framework in which the institutional capability is shared between the ministries of finance and planning, the central bank and the statistical office. To improve this coordination at a technical level, some countries have established joint task forces of senior officials of these ministries and agencies to undertake key economic projections of the main macroeconomic variables. For instance, Ghana has an Economic Policy Review Committee, consisting of two ministers, the secretary of finance and planning and the governor of the Central Bank. Problems of fiscal adjustment in Bangladesh are referred to an Executive Committee of the National Economic Council, headed by the Prime Minister, meetings of which are also attended by members of the Planning Commission, senior economic officers and the Central Bank. In other countries the ministries of finance and planning have been merged to form one ministry.

40. Without a strong institutional and macroeconomic framework, it is difficult for the governmental authorities to adapt to the changes, crises or emergencies which may occur. It is not unusual to see across-the-board cuts which are detrimental to priority activities because the finance ministry has no yardstick for cutting expenditure on a rational basis. When across-the-board cuts are utilized too frequently, they have a demoralizing effect on the programme managers who keep second-guessing when the next cut will be delivered. Blind cuts may also seriously disturb the impact of programmes and be a source of

serious problems in the future. For instance, to face uncertainties in the transition to a market economy and swings both in revenue and expenditure, the new budgetary law of the Russian Federation makes a distinction between "protected" and "unprotected" governmental expenditures. "Unprotected" expenditures may be implemented only if adequate revenues are found.

41. In general, to avoid these pitfalls, the finance and planning ministries should agree on a "core plan" to identify programmes which need to be protected when the country faces a serious budgetary crisis. There is need for an institutional mechanism at a high level within the central government to enforce coordinated and effective curtailment of public expenditure, with full awareness of social and economic priorities, when the country faces an acute economic crisis.

42. Developing countries have to strengthen their data collection and analysis capacities in the macroeconomic field. Key economic variables such as inflation, rate of growth of the economy, sectoral growth rates, balance of payments and debt service, and tax and non-tax revenue data need to be calculated or estimated within a reasonable time.

43. For instance, Kenya has started a budget rationalization programme, the main thrust of which is to improve budgetary processes and institutional and managerial capacity in the Ministry of Finance, the Ministry of Planning and National Development and the sectoral ministries. Several improvements have already been implemented in the budget process, including the establishment and institutionalization of a macroeconomic framework to provide a basis for better medium-term and annual budget planning. The framework takes into account the key economic variables - namely, the expected rate of growth of the economy, sectoral growth rates, balance-of-payments projections, inflation trends and the money supply. Overall fiscal projections and expenditure plans are being prepared twice a year. The projections provide the basis for the three-year public expenditure planning and the annual budget. They take into account anticipated trends in the growth of tax and non-tax revenues, the anticipated commitments from donor agencies for grants and loans and the projections of existing commitments, adjusted for projected changes in the exchange rate, for interest and redemption payments.

44. India is another example of a country which has developed a large and sophisticated macroeconomic framework. Macroeconomic analysis and econometric modelling are widely used by the Planning Commission in preparing the framework for five-year plans. To a lesser degree, macroeconomic analysis is also used in framing the overall dimensions of the annual budget, which is both comprehensive and unified. The Planning Commission advises on the allocation of funds to projects and programmes for development, but the final decision on budget provisions rests with the Ministry of Finance. Thanks to a comprehensive set of key macroeconomic data, the Finance Minister, looking at the state of the economy, can decide how much he can mobilize through new direct and indirect taxes, and how much he can raise the administered prices of commodities such as petroleum products, coal and steel to match cost increases due to inflation. Past experience serves as a guide to determining what level of monetized budgetary deficit may be safe, taking into account the existing rate of inflation, the growth of inflation and other parameters. In spite of this already broad macroeconomic framework, the preparation of the annual budget

could be further improved by building econometric models within the Ministry of Finance. The models could provide a better approach on the size and the manner of financing the budget and the likely impact on growth, inflation and balance of payments.

45. Techniques of budgetary control in developing countries have received little attention over recent decades although these countries have been faced with many budgetary constraints. More attention has been paid to taxation than to ways of maximizing existing resources. In the current context of growing fiscal problems, one avenue is to develop effective budgetary control techniques and procedures during the phases of budget preparation and budget execution.

46. But, first, what is control? In the present context, it is restricted to the two above-mentioned phases - preparation and execution - and answers three kinds of considerations:

(a) From the strictly financial aspect, it must prevent waste and embezzlement by civil servants in charge of the preparation and execution of the budget;

(b) From an administrative aspect, it must facilitate efficient management of goods and public services;

(c) From a political aspect, it gives the legislature or executive branch the assurances that budgetary decisions will not be exceeded.

Excluded from this discussion are the ways and means to limit the growth of budgetary expenditures, a field where the experience of developed countries is described in many studies such as the recent document, "Planning and control of public current expenditure: lessons of country experience" (ST/TCD/SER.E/7).

47. Various countries, including the majority of the African francophone States, have budgetary systems in which control is already exercised during the preparatory phase of the budget by financial controllers (contrôleurs des dépenses engagées) who are reporters to the Minister of Finance and advisors to the ministry to which they are assigned. The financial controller must give his advice on all budgetary requests of the ministry that he controls. By his "visa" on all expenditures of the ministry under his control, he also provides the Minister of Finance with very sharp information on the ministry's authorizations expenditures.

48. At the level of budget execution, another characteristic of the French budgetary system is the strict distinction between sanctioning officers and accountants (administrateurs et comptables). The sanctioning officer commits the State financially and decides that the expense will be obligated. The accountant, who is a handler of public money, satisfies himself as to the propriety of the expense obligated and makes the payment.

49. In British budgetary practice this distinction between sanctioning officers and accountants is not as clear cut. The essence of the British system lies in the way in which internal and external administrative control and parliamentary control are organized. The Government is entitled to commit expenditure without the prior opening of a line of credit. Furthermore, control of commitment is

not as strong as it is in France. Appropriations are granted en bloc under main budgetary headings.

50. As these two different systems show, budgetary control in developed countries is a complex process regulated by precise regulations and procedures. In developing countries the regulations and procedures need to be strengthened. Moreover, mechanisms and procedures can be developed to assess whether funds are really needed and are being properly utilized. The introduction of computers should make easier the development of improved performance or management indicators. Such indicators are not new. They are an integral part of the Planning Programming Budgeting System, Rationalization des choix budgétaires (RCB), or Zero-base Budgeting which have been tried with varying success by many developing countries over the past two decades or more. What is new is the renewed interest in this type of management tool which offers an opportunity to improve control, enhances public service output and provides more information on the cost, performance, environmental impact, etc. of public expenditures. For instance, France uses four types of indicators in its budgetary document: indicators of resources, outcome, impact and environment. Resource indicators refer essentially to the number of staff assigned to a given task. Indicators of outcome and impact are more difficult to devise since the objective of the programme must be subject to a precise measurement. The difficulty of the task is often a challenge. If objectives or the clientele cannot be clearly defined, the programme manager may wonder whether something in the programme is wrong and needs to be re-evaluated. These indicators may also be used to study the relative priority of programmes so that future funding can be adjusted.

51. Generally, ministries, after prioritizing and then considering the scale and timing of their activities, must ensure that their total expenditure for the fiscal year conforms to the sectoral expenditure ceiling determined in consultations with the finance ministry. Expenditure on development projects and programmes should be assessed on the basis of recent reviews of estimated costs. No token provisions should be made for unapproved projects. Other than for the relief of natural calamities, no expenditure should be needed during a fiscal year for items not budgeted. Supplementary grants would exist for excess and unforeseen expenditure, which should be only a small percentage of the budget.

52. Budgetary control also needs to address the problem of public pay and employment policies which are essential to efficient management of goods and public services. If the wage bill is too large, few resources are left for other purposes. Failure to control it in the public sector can have serious consequences on basic programmes in education and health, for instance. Likewise, it is unproductive to have an excess of unskilled workers relative to skilled ones. Redundant or incompetent workers are a serious burden and are often the consequence of public employment programmes initiated to combat unemployment and of greater decentralization of hiring, which in the past was tightly controlled by the Ministry of Finance. Severance pay, even if costly in the short term, should be seriously considered to re-establish a balance between labour and non-labour. Techniques such as freezes on recruitment, elimination of vacancies and temporary positions, automatic retirement and voluntary retirement can be particularly useful.

53. Another problem is the phenomenon of "ghost employees" - i.e., those who receive a government salary but do not exist or are not employed in the position for which they are budgeted. To eliminate "ghost employees" countries such as Ghana and Zambia have resorted to civil service censuses. The World Bank reports that recent censuses in the Central African Republic and Guinea identified 1,300 and 7,000 "ghost employees", respectively, equivalent in both cases to roughly 7 per cent of civil service employment.

54. Economic difficulties, adjustment and stabilization programmes have required most developing countries to make major financial adaptations, particularly by cutting government expenditure. A comprehensive study on the economic and social effects of changes in the size and the composition of public expenditure for the period 1973-1985, 1/ seeks to retrace how developing countries have adjusted by changing the functional and economic structure of their central government expenditure. The study provides a global and detailed picture of recent budgetary trends, the most important of which are summarized below for the latest period, 1980-1985.

55. As far as changes in the economic structure of government expenditure during the period 1980-1985 are concerned, the study shows a dramatic increase in interest payments. They rose to over 14 per cent of outlays in 1985, after remaining at a stable 6-7 per cent throughout the 1970s. One of the immediate results of the sharp rise was a corresponding cut in the share of other components of government expenditure. The burden of adjustment fell mainly on capital expenditure, which was cut more than any other expenditure component. The most drastic changes occurred in Burkina Faso, Malawi, Kenya, Lesotho and Liberia, where capital expenditure as a proportion of total central government outlay dropped by about one third and, in some cases, by more than half during the five-year period ending in 1985. Another salient feature was the decline of current expenditures on goods and services. They declined from 27 per cent of total government outlay in 1980 to 19 per cent in 1985. During the adjustment period 1980-1985, the decline in purchases of goods and services was proportionally higher than for payments of wages and salaries. This suggests that in countries where the central government remains an important source of employment, there was more resistance to a cutback in public employment and wage compression than to a reduction in current purchases of goods.

56. As far as the functional structure of government expenditure is concerned, the study shows that, on the whole, the pattern of government expenditure in developing countries differs significantly from that of industrial countries. Economic services rather than social services constitute the predominant functional category of developing countries' expenditure, reflecting the overriding priority assigned to economic growth as a major policy goal. Increasing economic difficulties made it necessary to sharply cut expenditure on economic services relative to total government outlay of the developing world during the period 1980-1985. The cut was particularly large in Africa and Latin America. The share of economic services dropped from 33 per cent to 16 per cent in Zambia, from 35 per cent to 25 per cent in Lesotho, from 44 per cent to 30 per cent in Malawi and from over 43 per cent to 25 per cent or less in Gambia and the United Republic of Tanzania. In Latin America, the relative size of economic services declined markedly, from 24 per cent in 1980 to 17 per cent in 1985. For Brazil, for instance, there was a cut of 13 percentage points.

57. A look at other sectors of government expenditure shows that during the period 1980-1985, the share of defence in developing countries total outlay was progressively reduced, probably as a consequence of reduced overall political tension. To meet the urgent need for increasing human capital and skills, developing countries have continued to allocate to educational services a higher proportion of central government expenditure than have industrial countries. Moreover, despite economic difficulties, their share was allowed to decline only by 1 percentage point during the period 1980-1985. Expenditure on health has remained unchanged at 4 per cent.

58. What kind of budgetary lesson is to be drawn from this study? Given the facts that pressures from stabilization and adjustment programmes and difficulties in raising additional domestic resources will continue, developing countries must strive to increase the efficiency and effectiveness of their public spending. They need to set clear priorities. Shifting public expenditure from low- to high-priority areas can improve its effectiveness. In health more public resources should be allocated to basic health measures such as immunization and prenatal care. Education cannot, by itself, bring about economic growth, but there is no doubt that it is a vital factor in development. Emphasis should be put on primary education, since it is widely recognized that rates of return are substantially higher at the primary level.

59. In rural infrastructure, water supply, electrification and road construction are directly contributing to development. But developing countries must be careful in selecting the most cost-effective projects and techniques. For instance, mistakes were made in rural electrification programmes because very few were part of an integrated plan based on cost/benefit analysis. Some projects failed because maintenance expenditures were not correctly estimated or not annually budgeted. These pitfalls show that developing countries have ample room in which to improve the efficiency and effectiveness of their public spending. Techniques such as cost/benefit or cost-effectiveness analysis, which originated more than 50 years ago, are useful in project selection and can help planners avoid costly mistakes. But it is worth stressing that it is not so much the technique per se which matters as whether government programmes and projects are scrutinized according to rational and objective methods. Sophistication in quantitative analysis cannot be imposed as a norm on developing countries low in human resources. Countries such as Chile and Thailand are making extensive use of quantitative analysis in screening their potential investment expenditures. Botswana has developed procedures to ensure that careful attention is paid to the recurrent cost implications of its investment spending.

60. Although globally, inflation rates and the cost of borrowing money have subsided since the 1980s and, therefore, the urgency of the need for reform, cash and debt management systems are nonetheless a key element that a good financial management system cannot ignore. Unfortunately, in most developing countries, cash and debt management continue to be underused for two main reasons: government departments and agencies are not penalized or rewarded for managing their resources poorly or efficiently, and the prevailing philosophy of accounting focuses on the stricto sensu accountability of funds and neglects the efficiency with which funds are utilized.

61. The purposes of cash and debt management are twofold. Cash should be invested to provide maximum interest with safety. From the borrower's point of view, debt should be managed so as to pay as little interest as possible. Only a minimum cash balance should be held. Conversely, no borrowing should take place until available cash resources have been used to finance expenditure.

62. In a recent study of six developing countries undertaken by the Development Administration Division of the Department of Technical Cooperation for Development, United Nations Secretariat, 2/ all six countries recognized the need for cash and debt management. However, most of them were not well equipped to carry them out. In Sierra Leone, a first step in achieving cash and debt management is being taken by the Accountant-General's Department in the preparation of cash management reports on the receipt of daily bank balances from the Central Bank. This report, coupled with a report of foreseeable expenditures, could produce cash flow data which could be used to manage liquid resources and reduce interest payments. In Bangladesh there is a standing arrangement with the Bangladesh Bank to maximize the use of cash resources and minimize interest costs. When there is a surplus cash balance above the minimum required, it is used to liquidate ways and means advances, and if any is left over, to redeem treasury bills.

63. All six countries need to improve their cash flow forecasting. They need to know on a monthly basis the amount of receipts and payments that they can anticipate. This amount is very dependant on the seasonality of income tax, customs duty, and expenditure. In addition to these monthly variations, on any one day the Government may be short of cash to meet its obligations or may have more cash than it needs. There is therefore need to monitor the daily flows in order to keep the cash requirements of the Government to a minimum. The most serious weaknesses in existing cash and debt management are the absence of planning and inadequate procedures for cash-flow reporting. The institutional arrangements also need to be strengthened since it is not always clear where the administrative responsibilities start. Cash inflow and cash outflow control need improvement as well. Cash inflow control is useful for minimizing the time between the moment when money is due to be received and the moment when it is available for spending. When significant variations from planned collections occur, corrective actions may be required, and penalties should be imposed in some cases. Cash outflow control is useful for making sure that payments are made only when due. Here also, procedures that check the regularity of payments should be strengthened in order to reduce late or premature payments.

64. One may wonder to what extent cash and debt management should be centralized. Procedures to delegate authority to spending departments vary from one country to another. But in an increasing number of countries decentralization of responsibility from the centre to the spending agencies is prevalent.

65. During the 1970s and 1980s a lack of institutional and process mechanisms for budgetary adjustment was common in developing countries. As seen in section I above, various countries have recently begun institutional improvements. Now it is the turn of the former centrally planned economies to face these difficulties. In order to improve the current situation, and adapt their institutions to the new objectives of the free market, one of their first tasks is to identify the institutional factors that are unique to them and have

contributed in large part to the huge budget deficits that threaten their solvency.

66. A recent IMF book underlines these factors, 3/ four of which deserve special mention. First, there is little perception of financial constraint; resources are unrealistically expected to grow continuously. As a result, each new budget becomes a base for soaring expenditure in the following year. Secondly, the development plan is the basis for the budget. The budget is nothing more than the monetary translation of the plan at prices that are determined centrally and administratively. The budget is viewed more as a framework for spending and accounting than as an instrument of fiscal policy. Thirdly, in the centrally planned economies, public enterprises draw their finances not only from the budget and the development plan but also from a credit budget approved by the Government. Due to the importance of public enterprises, the credit budget becomes a kind of parallel budget. Finally, excessive reliance is placed on administrative decrees which represent decisions already taken and often lacking sufficient rationale. They are also too numerous to be implemented by an overwhelmed bureaucracy.

67. After independence, many former Soviet republics asked for new budgetary and fiscal institutional arrangements. As noted by IMF, an explicit recognition of resource constraint should govern expenditure. The establishment of new countries and Governments requires a clear delineation of the fiscal tasks and responsibilities at each level of government.

68. It is obvious that these new countries and other former centrally planned economies face enormous challenges in their budget management and other areas of public finance. The Financial Branch of the Department of Development Support and Management Services of the United Nations Secretariat should seek to reinforce its technical assistance and research programmes to help these countries in their creative and innovative efforts towards more effective mechanisms of budget management and control.

### III. REMODELLING THE PUBLIC ENTERPRISE SECTOR

69. Under the stimulus of structural adjustment programmes for countering continuing deficits on government fiscal and balance-of-payments accounts, the tide of privatization is rising. The public enterprise sector in most countries is now viewed by many observers as over-extended, and the role of government is being redefined to exclude the management of business. This applies more particularly to developing countries in which government administrative capacity is limited. In over 80 developing countries, privatization of public enterprises and concomitant development of the private sector are central strategies in their development plans. Since 1984, for example, Mexico has sold or liquidated over a third of its 1,155 public enterprises, while Chile has privatized all but 23 of the 524 public enterprises it had in 1973. Few countries are not contemplating at least some limited privatization.

70. In transitional economies, privatization is the centrepiece of national transformation. Tremendous strides have been taken in the past three years, often against a background of collapse of production, trade and employment. However, supply is starting to respond to new incentives. In most Eastern



European countries output is growing by 15-25 per cent per annum, mainly in the private sector. In 1992, Czechoslovakia accomplished the world's first mass privatization scheme; for a total of 1,700 enterprises, almost three quarters of the vouchers issued were invested in 437 investment funds, many set up by banks. Whether the scheme will be counted as a success remains to be seen.

71. Nevertheless, it is increasingly apparent that public enterprise will not disappear in the foreseeable future. Public monopolies in countries which have poor regulatory capacity, large enterprises in countries with poor restructuring capacity and/or thin capital markets and which are unattractive to foreign investors, and enterprises which are major employers in countries with high unemployment and fragile political/social structures tend to remain in government ownership.

72. The focus on privatization has sometimes taken on ideological overtones. Restructuring options are narrowed down to one - the restructuring of ownership. This tends to "crowd out" all other forms of restructuring, including the restructuring of enterprise markets towards greater competition and efficiency, the restructuring of enterprise management towards greater professionalism and autonomy, the restructuring of enterprise governance towards greater accountability for goal achievement and the possibility of exits for non-achievement. Privatization of ownership is sometimes regarded as a goal in itself, and all other strategies as unstable and reversible. In fact, privatizations are also reversible and may have to be reversed where national goals are not served, as has happened in Bangladesh, Chile and Ghana. Changes of ownership can and do make a difference but they may or may not be appropriate in each case to effect sustainable improvement. Each case should be diagnosed and prescribed according to the circumstances.

73. Public enterprise sectoral reform takes place at four levels, as follows:

- (a) Promoting fair and open competition by
  - (i) Deregulation of markets;
  - (ii) Break up of large monopolies;
  - (iii) Liberalization of imports;
  - (iv) Ending of public enterprise preferential treatment such as direct and indirect subsidies (the soft budget);
- (b) Clarifying government and enterprise roles and relationships by
  - (i) Better specification and mutual understanding of goals and performance indicators;
  - (ii) Intra-governmental reforms requisite to improved enterprise performance;
  - (iii) Removal of constraints on managerial autonomy in purchasing, personnel recruitment and compensation, borrowing, foreign travel etc.;

- (iv) Introduction of performance-linked management rewards;
- (v) Reinforcement of managerial accountability through central monitoring and evaluation systems;
- (vi) Separation of non-commercial and regulatory functions from commercial functions, transparent compensation for agreed non-commercial functions, and transfer of regulatory functions back to the government;
- (vii) Improved procedures for selection of directors;
- (c) Rationalizing the public/private sector mix by
  - (i) Divestiture of ownership (sale as a going concern, give-away, or liquidation of assets);
  - (ii) Divestiture of management (contracting out the delivery of public-sector services, management contracts, leases, franchises, concessions);
- (d) Restructuring of individual public enterprises by
  - (i) Financial restructuring (debt-equity swaps, clearing of intra-sectoral arrears, debt rescheduling);
  - (ii) Management changes;
  - (iii) Retrenchment of surplus staff;
  - (iv) Rehabilitation/modernization of assets;
  - (v) Introduction of corporate planning and management information systems.

74. These four levels are complementary - not alternative - options. Sustainable performance improvement almost always requires attention at each level of reform. Each level requires an active government role. Some areas are one-time policy adjustments, and some require substantial effort over a limited period (such as most ownership divestments). Other areas require continuing government involvement, such as divestments which carry continuing regulatory or monitoring obligations (monopolies, banks, utilities), contracting out services, management contracts and performance contracts.

75. The first level of reform is part of a standard set of macroeconomic reforms, including price decontrol, exchange rate adjustment and interest rate reform. Progress in implementing these reforms is normally built into the conditions for release of adjustment loans by the international financing institutions. Their objectives are threefold: to establish price signals which reflect changing economic costs and benefits; to increase the number of independent operators in each market (particularly foreign operators who can bring in risk capital, new technology and access to foreign markets); and to ensure that competition between them is fair (the "level playing field").

76. Public enterprises are commonly protected by statutory or regulatory monopoly rights: these have to be discontinued to allow more efficient operators into the market. In Poland in 1990, farmers were allowed to bring food directly to the market themselves, thereby bypassing the State monopolized food-distribution sector. In a matter of weeks, farmers' markets sprung up all over Poland. The free market prices for food are generally lower now than in the official stores. Another policy aimed at breaking up monopolies in specific sectors, such as coal, publishing and retail shops, mainly by dividing large, multiplant enterprises into several independent units and by eliminating industry-wide cartel-like associations.

77. This alone is not sufficient if the public enterprise can continue to operate at high cost, with the Government subsidizing its losses. An early step in many countries has been tighter financial discipline by ministries of finance. Enterprises whose primary goal had been satisfying their portfolio minister have been told that they must now pay close attention to the financial bottom line. In some cases, enterprises have responded to the new climate, not without stresses and social costs. In other cases, enterprises short of cash have turned to borrowing from banks, suppliers, and from each other, with government guarantees either explicitly given or implied by past behaviour. Poor information systems have made it difficult to see the extent of this "water bed" problem. The solution involves total financial sector reform and, ultimately, a readiness to allow an inefficient enterprise to be liquidated. Governments have tended to put off such unpopular decisions, and enterprises have been left to slow to a standstill as their working capital erodes: earlier attention might reduce both the economic loss and the socio-political cost.

78. The second level of reform is concerned with the government/enterprise interface and system of governance. An instrument increasingly used to implement any or all of the changes at this level is the performance contract, also called signalling system, contract plan, performance agreement, or memorandum of understanding. The most successful use of performance contracting so far has probably been in the Republic of Korea. In 1984, the Government-invested Enterprise Management Act was implemented. The result was a sharp increase in efficiency, calculated at shadow prices. Operating profit increased 50 per cent in 1984 and 20 per cent in 1985; top management became more serious and motivated; the quality of service to the public improved; research and development expenditures increased; and all government-invested enterprises began to use long-term and short-term plans.

79. In other countries, performance contracts have not addressed all policy issues and have tended to be only partially successful. It cannot be said, however, that the evaluation of the impact of performance contracts has been methodologically satisfactory; "successes" are sometimes due to favourable factors such as an upturn in the economy and "failures" to factors which would have applied equally without a performance contract, such as the inability of Governments to meet scheduled payments to the enterprise, as happened in Senegal. The World Bank continues to include the signing of performance contracts among its adjustment lending conditions, and Governments thus continue to sign contracts, but with less faith in the effectiveness or sustainability on either side.

80. A partial response to interface problems is commercialization, or corporatization, which reconstitutes the enterprise in the same legal form as that of privately owned commercial enterprises in the country. Associated with this legal change is a change in the roles and relationships of government and enterprise, with the aim of reducing the fiscal burden, minimizing the risk of random political intervention in operations and, sometimes, instituting an ex post control system in place of ex ante procedural controls by government. Nigeria has adopted commercialization for the enterprises which it does not plan to sell. Their budgetary support is being reduced, and each enterprise has or will have a performance agreement with the federal Government.

81. Much of the effort that went in the 1980s into building up focal agencies and information systems and reforming the government/enterprise interface has been diverted into privatization by divestiture of ownership. Though divestiture is newer and more difficult than sectoral reform, it has become more attractive to Governments faced by mounting financial demands from their public enterprises. However, the catch is that the biggest deficits tend to be caused by the largest and least profitable enterprises, which are precisely those which are most difficult to privatize. Privatization in many countries, such as Mexico and Sri Lanka, has started with profitable small and medium-sized enterprises. This initially worsens the fiscal deficit, since the Government loses dividends from its profit makers and still has to support its loss makers. The net proceeds from sale may be severely reduced by proportionately high transaction costs, severance pay to displaced employees and provision for environmental clean-up costs. On the other hand, it is easier for Governments to learn how to privatize by starting on small enterprises. Other countries, such as Argentina, Brazil, Kuwait, Malaysia, Republic of Korea, Singapore and Thailand, have preferred to begin with high-profile but inefficiently run public utilities, which are usually responsible for a large share of total public enterprise operating deficits. Successful privatization of, say, the telecommunications utility of a country fires the public's imagination and creates greater confidence among investors. This results in new capital infusions for acquiring new technology and expanding and improving the quality of services, as well as major relief to the government budget.

82. In order to reduce the size and spread of the public-enterprise sector, privatization policy should define privatization as transfer of majority ownership and control outside the public sector. Sales of minority holdings and sales by one level of government to another or to State banks, pension funds and government-controlled agencies, should not be counted as privatization, since they do not normally result in any change in enterprise behaviour. The policy paper may also include a moratorium on the creation of new public enterprises and on new capital investment in public enterprises, other than minimum replacement expenditures. Modernization and rehabilitation programmes are better decided by new owners. However political pressures may result in budgetary provisions for assistance to sick enterprises, as in Bangladesh, or entirely new public-sector investments, such as in sugar, fertilizer, steel, aluminium, machine tools and paper in Nigeria.

83. Where immediate divestiture is not possible, whether for political, financial, legal or administrative reasons, attention is directed to the possibility of privatization of management, usually as an interim strategy to improve performance, pending divestiture at a later date. Private-sector

management, typically in the form of a multinational firm, is brought in to run the enterprise, or part of it, for a fixed period. The underlying rationale is the same as for performance contracts: given sufficient autonomy and performance-linked incentives, productivity and performance (productive efficiency) are improved. Allocative efficiency is hardly affected since the capital requirements of the enterprise are not subject to the discipline of the capital market.

84. The main instruments are the management contract, lease, concession, franchise and contract out. Management contracts have been widely used for hotels, airlines and plantation agriculture; less in other sectors. Leases have an advantage, compared with management contracts, in that the management firm takes the commercial risk and is more strongly motivated. The Government gets a fixed return. On the other hand, the management firm is not bound to employ the enterprise personnel unless this is agreed and included in the terms of the lease, as was done in Cambodia, where 35 of the 58 industrial enterprises have been leased or are in the process of being leased. These legal instruments can be designed to meet the objectives of the parties. For instance, lease and management contracts may include options for the management firm to take equity in the enterprise at the end of the contract period. If so, the price should be fixed in the contract so that managers are not tempted to use their position to reduce the apparent value of the enterprise. Since State assets are operated by the new management, the Government has to ensure that they are properly maintained and that all conditions of the contract are met. All forms of privatized management need careful negotiation and monitoring.

85. Management privatization is very suitable for public utilities and other enterprises which operate in monopoly markets. Where public assets are used, the appropriate instrument is a lease or operating franchise; where the assets are provided by the private firm, the instrument is more often a service/purchase contract, owning franchise, concession or (for new, large infrastructural facilities) a build/operate/transfer contract. The instrument includes provisions covering tariffs (usually indexed for inflation), service availability and quality, and maintenance of capacity. Operating franchises (affermages) and owning franchises (concessions) are used, for instance, in water companies in francophone Africa and in joint ventures with transnational companies. A franchise may be awarded on the basis of competitive bidding, the award going to the bidder who undertakes to provide the service at the lowest price tariff. The lack of competition in the market is compensated by competition for the market. Even if a monopoly is losing money, such as railways in most countries, it can be franchised to the bidder who will run the service to specified standards on the minimum subsidy, as planned for British Rail regional passenger services. This can only work, of course, if there are firms that can provide the service and if they bid competitively. It works best when little or no capital expenditure is required by the franchisee, so that the period of the contract can be kept short, and when the technology and market are not subject to rapid change, so that the Government can negotiate and monitor more effectively.

86. Governments of developing countries considering privatization or already caught up in privatization commitments often lack the institutional strength and skills to formulate and coordinate policy or to implement privatization/reform programmes in a way that will realize the potential benefits. In Bangladesh,

for instance, waves of privatization in 1976, 1982/83 and 1986 have not resulted in greater long-term efficiency in the privatized enterprises or in significant relief to the government budget. Most developing countries also lack entrepreneurial capacity, machinery for capital mobilization, and essential legal and regulatory infrastructure. Transitional economies suffer from the latter constraints in varying degrees and may require reforms in private property law, debt enforcement machinery, company and liquidation law, business management education, accounting and auditing standards and training. In all countries, attention has to be paid to transparency and accountability. Transparency requires a clear statement of what the Government intends to do; education in the schools, army, unions etc.; announcement of each step in the newspapers; documents available to anyone, not just bidders; publicized rating criteria; a privatization commission of persons of known integrity; and approval of all decisions by the commission.

87. Country experience shows that four major problem areas have emerged: excess labour in public enterprise employment; valuation of enterprises; shortage of capital to purchase shares in enterprises for sale; and lack of the regulatory framework required after privatization. The first three are seen as constraints to the pace of the privatization process and in some cases as factors which prevent or limit the realization of intended benefits. The fourth problem area is being addressed in some countries but is more often ignored or deferred lest it send the wrong signals to the private sector.

88. The labour problem is the most acute, because public-sector workers (though not managers) are usually better paid than their counterparts in the private sector and more strongly organized and politically connected. Typically, between 20 per cent and 50 per cent of the employees of a public enterprise are designated as surplus, though this figure depends very much on the projected level of utilization of capacity, projected increase in capacity, and the possibility of hiving off sections of the workforce to provide their services independently on a contract basis. Where the only alternative is liquidation, privatization is the preferred option.

89. Retrenchment methods include natural attrition by resignations, death etc., coupled with an embargo on new recruitment, the institution of a mandatory retirement age (as in Bangladesh recently) or the lowering of the retirement age, and voluntary retirement induced by a financial package. In a country with no social security the last method is a safety net to provide each retrenched employee with a lump sum sufficient to start a micro-enterprise. An important component in the programme is a tie-up with retraining facilities, entrepreneurial development programmes and, in an increasing number of countries, business incubators and technology parks which provide a local network of support for new business start-ups. It is also a way of ensuring that employees share in the gains from privatization, thereby gaining their support for the programme.

90. It is important not to offer incentives to key managers and skilled employees. (In Kenya Railways, skilled engineers accepted the golden handshake and were promptly re-employed in the private sector at higher salaries.)

91. Questions arise as to who should undertake the slimming down of inflated payrolls and who should pay for retrenchment benefits. Although it is argued that purchasers should be able to choose the employees they need and do not need, and although in many countries enterprises are sold "as is", excess employment is historically a result of government policy. Pragmatically, the Government is in a better position to handle the social consequences of terminations. In fact, it may not be possible to find a purchaser who is willing to take on the problem of an inflated and highly militant labour force. The labour-restructuring programme and its financing is primarily a government responsibility. Donor agencies have been persuaded to finance retrenchment packages; otherwise, costs are borne out of privatization proceeds.

92. A sensitive issue is the selection of employees for retention or retrenchment. Ideally this issue should be handled by the management team, which will be held accountable for future performance. If managers are not considered to be competent and impartial, it may be preferable to replace them rather than set up outside bodies such as employment commissions and tribunals, which divide accountability for subsequent performance. On the other hand, there may be strong pressures for regional or ethnic balance which make compromise a political necessity.

93. The price at which the enterprise is offered is of critical importance in most divestments. Prices that are too high have prevented sales altogether, while very low prices have resulted in suspicion of the Government's motives, especially sales to foreign interests or to unpopular ethnic groups or sales that worsen the concentration of wealth in the country. This is more a political than an economic issue, since, from a cost/benefit standpoint, the price in a domestic sale is a transfer payment and its size is economically irrelevant. It is politically acceptable for shares to be sold at a discount to employees or to all comers so as to encourage smaller investors or simply to reduce the risk of failure of the issue if it is not fully underwritten. In the former Czechoslovakia, shares were given virtually free to all adult citizens, and similar mass privatization schemes are planned in other transitional economies. Apart from these exceptions, shares should be sold at their full value.

94. In private sales, open competitive bidding or auction establishes the highest value that any purchaser places on the enterprise. Since bidding is susceptible to collusion (or there may be only a single bid), it is important for the Government to have an independent and expert valuation, at least for large enterprises. Since such a valuation is costly, Governments often take the book value of the enterprise (original cost reduced by proportionate depreciation, indexed for inflation) as the reserve price, though the book value may have no relationship to the highest price obtainable, and there is still a danger of over-valuation. This is frequently the case in enterprises in which assets are obsolete. It is difficult then for the government to let the enterprise go at a lower but realistic price, since this implies a big write-off, and it may be politically necessary for an independent valuation which confirms the reality.

95. Whichever method of valuation is used, the value of a going concern represents the expected future profits from the enterprise. This should be based on the expected future regulatory and policy environment. If the

government intends to liberalize product markets, the enterprise will be adversely affected and its value will be lower. Where this is not recognized the sale may go through at too high a price and result in the failure of the enterprise in the future, liberalized environment. This happened to some privatized textile mills in Ghana, and the Government had to take the enterprises back. If the danger is foreseen, bidders may ask for special protection, such as maintenance of the status quo, and the Government then has to consider whether its objective is greater efficiency or higher proceeds from the sale. Generally the rule should be that no purchaser should get conditions more favourable than any other operator, so that the "playing field" is kept level and the more efficient firms do better.

96. In countries in transition from socialism, just as in most developing countries, capital markets are thin or non-existent. This was once thought to be a major constraint on the pace and scale of the privatization programme. It is rather a constraint on the methods used. By far the greater number of privatizations have been private sales. Even public sales are possible without a stock exchange, as was demonstrated in the successful sale of the National Commercial Bank in Jamaica, where mass publicity was followed by sales through banks and post offices.

97. Private sales to domestic or foreign investors or, commonly, a consortium of both may be preferred even where a capital market exists, since it is possible to identify and target a core group that would inject new technology and management into the enterprise. Even enterprises currently losing money or needing radical restructuring can be privatized through private sales, provided, of course, that the purchasers can see a way of making them viable in the future. Private sales can also be conditioned, for instance, on retention of employees. Subject to the conditions laid down, a better price is obtainable than through public sale, where the price is discounted for risk and targets a broader response from small shareholders. The preparations for private sale are simpler and less costly, since no prospectus or other stock exchange requirements have to be provided. Financing is more flexible. Debt swaps may be used in some cases. If the privatization is successful, the management may come to the market later and float a proportion of the equity to broaden share ownership.

98. On the other hand, private sales are negotiated behind closed doors and, in some countries, they are notorious for corrupt deals. Transparency requires the publication of the full terms of the sale after it is concluded.

99. The shortage of capital can be met to some extent by leveraging the buyer. This applies to all forms of disinvestment, particularly management/employee buy-outs. The Government or banks in effect lend much of the purchase money to the buyer - e.g., by allowing sale on credit with payment in instalments, which are a first charge on the enterprise cash flows. This is risky, because the cash flows may prove inadequate to service the debt and to meet capital and other needs. The capital structure has to be engineered so that there is an adequate cushion of equity but not so high an amount that a majority interest is out of reach of the purchaser. In some cases the Government is willing to convert debt due from the enterprise into non-voting non-interest-bearing "quasi-equity" as an interim solution. However the rule should be 100 per cent cash down wherever possible, because this results in the cleanest transfer of



ownership and the greatest commitment to the future of the enterprise by the new owner.

100. The problems of market failure were not solved by taking enterprises into public ownership. It is now being more widely appreciated that the problems of government failure will not be solved by taking enterprises into private ownership. Government and the private sector have complementary roles. A more pragmatic, enterprise-specific and time-specific approach may be needed to determine the nature of those roles.

#### Notes

1/ "The economic and social effects of change in the size and composition of public expenditure", document issued in September 1991 by the Financial Branch of the Department of International Economic and Social Affairs.

2/ "Government financial management in the least developed countries" (ST/TCD/SER.E/15).

3/ A. Premchand, Public Expenditure Management (Washington, D.C., IMF, 1993).

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