

Is there a 'Privatization Trap'?

The Case of the Manufacturing Industries in Eritrea

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Abstract

Privatization is a popular topic in many countries. However, the more a country needs development, efficiency and the proceeds of the sales, the more difficult privatization will be. This can result in a long period of privatization in developing countries. But when privatization takes a long time, the vitality of companies may reduce. In this paper we present the case of the manufacturing industries in Eritrea, where privatization has been slow. After the privatization announcement the companies deteriorated quickly with respect to operations, investments and finance. This makes it even more difficult to sell the companies and the implied vicious circle results into a 'privatization trap'.

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1. Introduction

The 'poverty trap' is a well-established phenomenon.

“Poverty itself generally breeds poverty. Once the poor get poor, they tend to stay that way.... The poor man has no capital, human or physical, to improve his lot. He is malnourished and therefore diseased, and so his labour is less productive-but he cannot make it more productive as he lacks money to invest in improving his land or his tools. Therefore, he stays poor and because he is poor, is less able to organise with others of his kind to improve their lot. If he finds himself in a situation of competition with the rich, he will probably get even poorer.... Poverty is self-perpetuating.” Weisband [1989, p. 37].

One of the emerging options to escape from the poverty trap for developing countries might be privatization. Privatization is sought for a multitude of reasons [United Nations Industrial Development Organization, 1996; Megginson and Netter, 2000], but trying to increase the economic efficiency within the country and within the companies to be privatized is a major issue. Moreover, privatization is frequently propagated when bad economic conditions, high foreign debt, high dependence on international agencies and budget deficits prevail [Ariyo and Jerome, 1999; Ramamurti, 1992; Yarrow, 1999]. Such economic circumstances may make privatization urgent.

In general, urgency is high in developing countries, and many of these countries started privatization programs. However, a weak regulatory framework, an ineffective private sector, a low level of domestic income and savings and the absence of adequate capital and stock markets constrain the success of privatization [Gordon, 1996; Schneider, 1999; Ariyo and Jerome, 1999]. It might then be difficult to use the solution of privatization in the developing countries. Moreover, the underdeveloped infrastructure and environment does not add to the value of the enterprises and their attractiveness. Potential buyers will only pay small amounts of money, unless they are allowed to

restructure the companies and to lay-off workers. Governments, however, hesitate to give carte blanche to a buyer, because restructuring may imply asset stripping and that reduces the value of the company to the country. Moreover, the firing of employees generates unemployment and the larger the company, the more the governments will restrict future buyers.

Sometimes even profitable companies cannot be sold easily in developing countries. When the domestic financial market cannot provide the finance of buying a large profitable company, foreign investors might be approached. Foreign investors, however, discount the value of a company, because in the beginning they will not be as adequate as local investors in running the company and in using the local business networks and regulations. While a foreign investor may not want to pay the local value of a profitable company, governments may feel pressure not to sell profitable companies cheaply. In that case the search for the highest bidder for a profitable company will take time.

In Eritrea the aforementioned environment and the conflicts of interest between potential buyers and the government slowed the pace of privatization and both profitable and unprofitable companies listed for privatization became stuck in a long privatization period. This made it possible to study companies during the process of privatization. Because slow privatization is not yet studied in depth at the level of the firm one may learn what aspects are relevant for a company during a long privatization period in a developing country.

This article presents background literature on privatization in section 2. Section 3 gives an overview of the methodology used. The Eritrean privatization policy and the direct privatization results are shown in section 4. Section 5 compares the development of the state-owned companies with the development of the private companies in Eritrea before and after the privatization announcement. Section 6 gives information on the financial developments within three industries in Eritrea before and after that

announcement. Section 7 gives the opinion of managers on privatization and section 8 concludes the article.

2. Impact and Speed of Privatization

The concept of privatization can have various meanings [Starr, 1988], but in most economic literature the word "privatization" generally implies a shift of ownership of companies from the state to the private sector. The intended shift of ownership stems from a multitude of reasons [United Nations Industrial Development Organization, 1996; Megginson and Netter, 2000], but two major general economic reasons are the endeavor to create a more efficient economy as well as the need to alleviate governmental budgetary problems. The transfer of ownership changes the aims of the firm from the 'public interest' to 'value maximizing' and it will change the relation between managers and owners. The question then arises how the change of ownership influences the performance of enterprises and whether companies should be publicly or privately owned.

Berle and Means [1932] already stressed the relevance of ownership and control implying that the maximization of value to the owner is no longer guaranteed with diffuse ownership. Firms with concentrated ownership would be valued higher because there are more incentives on the part of owners to monitor the firm and to make the necessary changes [Demsetz and Lehn, 1985; Megginson, Nash and Van Randenborgh, 1994; Denis and Denis 1995; Shleifer and Vishny, 1997]. Within these views private ownership concentrates power and public ownership dilutes it, because the inhabitants of a country only have inefficient political systems to create adequate control. In developing countries with very inefficient political systems the situation could even be worse and badly equipped bureaucrats then might run the business [World Bank, 1995]. Privatization would, according to those authors, be beneficial for the efficiency of a company.

These positive effects of private ownership should, however, not be overstated, because managerial incentives with a separation of ownership and control depend also on the availability of performance information to shareholders and on the potential force of take-over mechanisms [Yarrow, 1986]. If there is no stock market in a developing country both assumptions may not be valid. A stock market easily informs the shareholders on the value of their shares, but in the absence of a stock exchange accounting information might be needed to replace the information contained in the stock prices. Because the management will make the accounting information itself, auditing and evaluation procedures might be needed to check company value and managerial performance. The monitoring of managers may thus become very costly.

But even if shareholders would be able to monitor the managers cheaply, they may not act upon the information. In particular small shareholders may not be prepared to incur the costs needed for disciplining managers. They may even try to get a 'free ride' as they might correctly assume that large shareholders have more to gain from disciplining managers. When there is an efficient market for corporate control, large shareholders could overcome this problem by simply buying additional shares and then wresting the control from the incumbent management. It will, however, be clear that such a market for corporate control will be absent if there is no stock market.

Thus, although one could question whether state-owned enterprises should be privatized indiscriminately, quite a number of authors find positive financial post-privatization results [Galal, Jones, Tandon and Vogelsang, 1992; Ramamurti, 1997; LaPorta and Lopez-de-Silanes, 1997; Pohl, Anderson, Claessens and Djankov, 1997; Boubakri and Cosset, 1998]. The positive financial results may, however, come together with reductions in employment. Positive financial post-privatization results are also found for less developed (Non-OECD) countries [Megginson, Nash and Van Randenborgh, 1994]. Other authors find positive privatization results with some firms, but a negative impact on others [Martin and Parker, 1995], or only positive results with viable firms [Estrin, Gelb and Sing, 1995]. A third group of authors only find positive privatization

results when special conditions are met, like large stakes owned by a bank [Claessens, Djankov and Pohl, 1996] foreign ownership [Carlin and Aghion, 1996] or the entrance of new human capital [Barberis, Boycko, Schleifer and Tsukanova, 1996].

Despite the mixed results, governments of many developing countries have decided to privatize [Megginson and Netter, 2000]. Even if the efficiency arguments do not tip the balance, the fact that governments of most developing countries dearly need the proceeds of company sales might. When a country decides on a privatization program the speed of privatization becomes relevant. Some researchers advocate rapid privatization (a "Big Bang") and others favor slow privatization (the "Gradualists").

The advocates of rapid transformation suggest that governments are much better served if they simply divest as rapidly as possible [Murphy, Andrei and Roberts, 1992; Boycko, Shleifer and Vishny, 1996]. They argue that the gradual approach to privatization would allow managers greater latitude to sabotage reform, than would be possible with a fast divestment strategy. Moreover, if companies are slated for privatization but not actually sold, companies may deteriorate:

"Enterprises are living things, and deteriorate very quickly once they are "for sale". It is imperative, therefore, not only to complete divestitures as quickly as possible, but also to manage the business well in the interim. While a firm is for sale, key employees doubt the firm's commitment to them, are less motivated, are attracted to alternative employment....[and the] selling process is a distraction to management, which is tempted to leave critical matters unattended because they assume a new owner will take them in hand" Donaldson and Wagle [1995, p. 36].

On the other hand advocates of gradual transformation suggest that gains from hasty privatization must be weighed against the social costs of speed like high unemployment [Aghion and Blanchard, 1994; Katz and Owen, 1993] and that speedy privatization can result in poorly conceived privatization schemes [Ramamurti, 1999]. Therefore, even if

privatization is adequate for a developing country, the question on how fast to privatize remains to be decided upon.

3. Methodology

In order to identify the effects of a long privatization period, we studied the effects of the privatization announcement in four different ways. First, we present the direct privatization results in Eritrea. Then we show macro-economic developments before and after the announcement of privatization in public and private companies. Thirdly, the performance before and after the privatization announcement will be discussed in three industries: beverages, footwear and leather, and textile. We selected the beverage industry because it was the most profitable one and the textile industry because it generated the highest losses. From the other industries we looked for an industry with a large number of unsold companies. We then have chosen for the footwear and leather industry, because the companies in that industry generally produced for private (or intercompany) markets, while some of the food processing companies were producing large amounts of food for the army. When considering the stressed situation with Ethiopia and the increased demand for food products by the army, we expected that these companies would not show the regular developments of a long privatization period. Within each of the selected industries we have chosen the companies that were slated for privatization but not sold (nor in the process of being sold) at the end of 1998 and we studied the development in these companies per sector from the annual accounts. Accounting data measure the financial success and failures of the firm and the changes in performance over time. We evaluate the performance of the companies to be privatized in the three industries with respect to operations, investments and financing for the years 1995-1996 respectively 1997-1998. This gave the financial results during two years before the privatization announcement (end 1996) and the two years after the announcement.

Fourthly, we show results of interviews with company managers. In the privatization literature opinions of individual managers are often neglected. This may be caused by the fact that managers are considered as agents of the state. If the state wants to sell a company, the incumbent managers may not be needed for the future of the company, and they may be dismissed when the company is sold. Nevertheless, if privatization takes a long period of time, the incumbent managers are needed during the transition period. Moreover, potential purchasers require future oriented business evaluations [Bennell, 1997, p.1799] as well as information from the annual accounts. For these reasons the elicitation of management knowledge may be more informative than solely gathering information from annual accounts [Earle, Estrin and Leshchenko, 1996].

We, finally, interviewed managers, because we found in the previous section that the proponents of rapid privatization not agreed in their ideas about managerial incentives. Some of the authors assume that incumbent managers fear dismissal when the company is sold and that they try to postpone privatization in order to keep their positions. These authors implicitly suggest that managers are prepared to use social costs for private benefits. Donaldson and Wagle [1995], at the other hand, think that key employees will be less motivated when privatization takes time. Their suggestion is that managers would like to move to companies where ownership is not in question and that managers incur personal costs by staying with the company. We do not know of research where managers were interviewed on the impact of a protracted privatization period and on whether or not they would prefer their company to be privatized quickly. With our study we hope to identify managers preferences.

Management opinions were collected via open interviews aimed at general, financial, production and marketing managers. The managers interviewed were asked what efforts were taken to improve company operations, investments, financing and how the privatization policy was influencing their companies' operations. We intended to interview four managers of each of the nine companies. Because four positions were not filled and because one manager was not available during 3 visits, we interviewed in total

31 managers. This gave a response rate of 86%. Further details of the research procedure are described in Hailemariam (2001)

4. Privatization in Eritrea

Prior to 1975, Eritrea had a flourishing private industrial sector accounting for 40 % of the industrial output of Ethiopia [GOE, 1994, p.4]. In 1975, the Marxist government of Ethiopia adopted a command economic system and nationalized large manufacturing enterprises. During the period 1975-1991 it neglected the factories and drained their resources without giving necessary inputs to develop the industries. When in 1991 Eritrea became independent, the new government adopted a free market policy to resuscitate the economy.

The government of Eritrea began to sell small co-operative shops in 1992 and returned nationalized houses and other buildings to their former owners. In 1995 the Eritrean government issued proclamation No. 83/1995 for the establishment of the National Agency for the Supervision and Privatization of Public Enterprises (NASPPE) to reduce the number of public enterprises. The objectives of NASPPE are to privatize public enterprises and to implement appropriate management policies in order to vitalize productivity and to establish a competitive and conducive economic ambience in all public enterprises [GOE, 1995, p.4]. At the end of 1996, the Board announced that 39 of the publicly owned manufacturing enterprises should be privatized. The remaining state owned enterprises were either liquidated or not offered for sale because the government considered them as strategic.

The government has been using a direct sales method. Usually, companies are advertised in local as well as international newspapers such as The Economist. Enterprises are auctioned and investors bid for the companies. The Board evaluates the

price offered and the business plans of investors regarding investments, technology transfer and job creation and then makes its decision.

Table 1 shows the companies sold in each sector as well as the number of enterprises owned by the state in June 1999 and some of the company characteristics.

Table 1 about here

Table 1 shows the direct consequences for the sale of 18 companies until June 1999. In these companies 1,681 employees were employed, while 5,797 employees were with companies still to be privatized. The Eritrean government raised 156.2 million Nakfa from the sales of the enterprises out of which 52.7 million Nakfa (34% of the total value) was received from the sale of Gash Cigarette Factory. The other 17 companies were sold for 103.5 million Nakfa. Table 1 also indicates that the enterprises sold are relatively small and that relatively large manufacturing companies are still owned by the state. The metal and wood products industry and the chemical industry (soap factories) were privatized quickly. Food, textiles, leather and shoe and non-metallic minerals (cement, and salt factories) industries were less easily privatized. In fact, some of these companies have already been offered for sale three or four times, but have yet not been sold.

We can conclude that the Eritrean government used the 'Big Bang' approach in slating all the relevant companies for privatization at the same time, but that the actual privatization process did take a long time for many large companies. Though we will not study in depth all the reasons for the protracted privatization period in these companies, some aspects may be mentioned. Firstly, before slating the companies for privatization, the government asked consultants to set a minimum price. However, because of toughened relations with foreign countries (in particular Ethiopia) Eritrea became less attractive to foreign

investors as was expected at the moment of fixing the minimum price. When in the meantime that price is not reduced, foreign investors may not be found. Secondly, as we will see in the next sections, when a company is not sold quickly, it may deteriorate and in that case a fixed minimum price may also be too large for potential investors. Thirdly, some investors were prepared to pay a reasonable price, but then the business and/or social plans were not acceptable to the government. The social aspects for the employees are of course very relevant, but there may have been also other, more strategic, aspects that the government may have taken into account. For example, rumors could be heard that the profitable Asmara Brewery was a take-over target for a foreign company that wanted to close down the Asmara Brewery in order to get rid of a nasty competitor. This article will, however, not further address the reasons for the slow privatization process, but it will aim at what happens when the privatization process is slow.

5. State- and Privately Owned Manufacturing Enterprises

In this section we compare the performance of state-owned and privately owned manufacturing enterprises in Eritrea before and after the privatization announcement. We use census data of the manufacturing enterprises employing 10 or more persons prepared by the Eritrean Ministry of Trade and Industry (see table 2). This means that many Eritrean companies are not taken into account in Table 2, because most private companies have less than 10 employees.

Table 2 about here

Table 2 indicates that the state-owned enterprises are a relatively large and have a major economic impact in Eritrea, if the companies with more than 10 employees are considered. The number of state-owned enterprises remained the same, while that of private companies increased by 48 firms in 1997 in comparison to 1996. Though the time base differs between Tables 1 and 2, we may conclude that the number of companies in the private sector increased autonomously, because only 18 companies were privatized by June 1999. The number of employees in the state-owned enterprises decreased by 970 persons in 1997 in comparison to 1996, while during the same period the number of employees in privately owned companies increased by 2,537. Again the latter number is higher than the number of employees that worked for privatized companies according to Table 1.

Gross output of the state-owned enterprises decreased by 52 million Nakfa in 1997 compared to 1996, while in the same period that of privately owned firms increased by 179 million Nakfa. Gross input in state-owned enterprises decreased by 13 million Nakfa in 1997 in comparison to 1996, while during the same period that of privately owned enterprises increased by 109 million Nakfa. The value added at factor cost in state-owned enterprises decreased from 315 million Nakfa in 1996 to 270 million Nakfa in 1997, while during the same period the value added of the private companies increased from 37 million Nakfa to 103 million Nakfa. Because the state-owned enterprises performed worse than the private enterprises, while both types of companies are affected by the same general economic circumstances, it is obvious that something went wrong between 1996 and 1997 in state-owned enterprises; this was precisely the time when the privatization program was announced.

6. Financial Performance within Three Industries

In order to assess the impact of slow privatization, we compared the performance of companies in three industries before the privatization announcement (1995 and 1996) and after the privatization announcement (1997 and 1998). The companies studied had been not yet privatized by the end of 1998. Within the Beverage industry we studied the Asmara Brewery and the Asmara Wine and Liquor Factory. From the Footwear and leather industry we studied four companies that were not privatized, namely Dahlack Shoe Factory, Deluxe Shoe Factory, Keih Bahri Tannery and Asmara Pickling Tannery. The companies from the textile industry studied were the Asmara Textile Factory, the Eritrea Textile Factory and the Lalmba Sack Factory. A fourth company from the textile industry was in the process of bidding and was therefore left out of the sample. We will show the aggregate development in operations (Table 3) and in investment and finance (Table 4). We will here only report on the aggregate development, but these developments can in general lines also be found in individual companies (Hailemariam and Von Eije, 2001).

Table 3 about here

Table 3 shows that the companies to be privatized in the beverage industry dominate the companies to be privatized in the other two industries with respect to the financial variables. Sales and value added are highest in the beverage companies. Profits are also highest in these companies. With respect to employment, the textile industry dominates the other two industries. The high labor usage will undoubtedly have been contributing to the losses in the textile industry.

After the privatization announcement the sales within all industries decreased. Such a decrease was also found in value added and profits. Because in all industries the profits declined more than the sales, the profit margin declined after the privatization

announcement. Also the average employment declined in all industries, but most in the textile companies to be privatized. The shakeout of labor after the privatization announcement, however, did not improve the profit margin in the textile companies; it declined by five percentage points. We may thus conclude that the operating performance declined after the privatization announcement.

Table 4 about here

Table 4 shows that the average amount of total assets was reduced in the beverage industry, but that it did not change much in the other two industries. Because the profits declined fast, the return on assets declined in all industries after the privatization announcement. Table 4 also shows the liability side of the balance sheet. The debt decreased for the beverage industry because the government collected the dividends to be paid for 1993-1996 in 1997 and this resulted in a reduction of debt to the government. It may be noted that the changes in assets and debt resulted in a shortening of the balance sheet: the decline in debt was almost equal to the decline in assets. The amount of debt increased in the other two industries. In the footwear and leather industry, the debt to total assets ratio increased by 8% mainly because the managers of Dahlack Shoe Factory resorted to bank overdrafts when the NASPPE restricted the retention rate of profits to 20%. The other managers of the footwear and leather companies believed that the bank interest rates were too high and they tried to finance their operations and working capital with retained profits. The managers of the textile companies financed their operations and working capital investments with government guaranteed bank overdrafts and the debt to total assets ratio increased by 14%. We may conclude that the balance sheet information is not positive: after the privatization announcement the assets declined in the beverage industry, while the debt increased in the other two industries.

7. Opinions of managers on privatization

In order to learn why the privatization announcement influenced operations, investment and financing we interviewed managers on the relation between these aspects and privatization. Moreover, we also asked them about their opinion on the privatization process. A selection of their remarks can be found in Table 5.

Table 5 about here

Operations With respect to operations the managers claimed that the uncertainty during the process of privatization affected the relationships with existing customers and that it hindered the finding of new customers. When a manager tries to find new customers, the organization is entering into a new contract to supply them, but there is always the possibility that the new owner will not agree with the agreement already reached. The tanneries, for instance, have been selling semi-finished leather to customers in Italy. There is an option of selling finished leather there too. But because the companies are going to be privatized, the company managers are not seeking to extend their network of relationships.

The process of privatization also affects the purchase of materials and the extension of trade credit. In Eritrea, the NASPPE restricted the amount of inventory to three months of production. This guideline did not affect local purchases, but it created a problem for foreign purchases. Some companies were buying stocks from foreign countries on a six months basis, because it takes a long time until the goods are delivered. Such restrictions on inventory inconvenienced the normal operations of companies. In addition, the NASPPE ordered managers not to extend credit on sales, except for government institutions. Even for government institutions the maximum was limited to one month only. This credit policy did not affect companies in the beverage industry

because they are selling mainly for cash, but it created a serious problem for the textile and the footwear companies where a longer period of trade credit was usual.

Finally, the managers also complained that qualified employees were leaving the company. The government was not adjusting the salary of the workers in the state-owned enterprises in order to avoid leaving highly paid workers for the future owners. Though the salary of the civil servants increased, no salary adjustment has been undertaken within the companies to be privatized. The process of privatization, moreover, created considerable uncertainty, and technical and other professional employees have been leaving their jobs for more lucrative ones in the private sector. These experts are taking with them the knowledge acquired in the companies over several years and after privatization the companies will lack technicians and experienced senior managers. In addition, the NASPPE has prevented companies from recruiting new personnel. Due to this, several key positions in the enterprises such as heads of marketing (in Lalmba Sack Factory, Deluxe Shoe Factory and in Alpha Food Products) and production (in Deluxe Shoe Factory) are vacant. The Ministry of Trade and Industry in Eritrea also stopped the custom of giving employee benefits in kind, i.e. company products and the employees are complaining about this and it is affecting their morale.

Investment and financing The management interviews revealed that the meager development of assets shown in the previous section (Table 4) is due to the fact that the privatization process is hindering innovations and investments. According to the managers nobody wanted to make a decision on the pretext that "the new buyer may not want this". The NASPPE considered that the prospective buyer of the company should decide on investments. The investment restriction was, according to the managers, preventing companies from investing in the future. The government did not want to invest money that might not be recovered from the sales price and there was also the fear that higher prices for companies would deter potential buyers. In fact the government opted to continue operating companies "as they are" until they could be sold.

Since the government knows that it no longer wants to keep the companies to be privatized, it does not permit investment in human resources. Training is a long-term investment and since it will benefit future buyers, the government does not want to spend money on training. The managers interviewed stated that there is a need to train people in engineering and export marketing to improve the viability of the companies to be privatized. However, the same managers also reported that the government does not want to train employees and management. The lack of training due to the long process of privatization is causing companies in Eritrea to incur costs. The management of Asmara Brewery, for instance, installed new machinery, but due to the lack of trained manpower in programmed logic computer systems, the company managers have to bring in technicians from Germany to repair it, and for even minor problems they are paying first class travel and high allowances.

According to the managers, the process of privatization also influenced the financing of the companies. The government declared an 80% dividend payout due to privatization on the assumption that companies did not need much money for short-term investments. The managers at the other hand said that 20% of retained profits (if any) are not enough to meet the companies' operating and working capital needs. The government was 'milking' the profitable companies, which were then encountering shortages of money, and some companies thereupon resorted to bank borrowing despite the high interest costs to be paid. Though the government does not want to sell cash-rich companies, it can be difficult at the other hand to sell companies that have large amounts of credit outstanding. Therefore the government has restricted the credit offered by the firms too. Only government enterprises were allowed one-month payment terms.

Privatization process The qualitative interviews reveal that the slow privatization process also negatively influences the governance of enterprises. The NASPPE did not vest complete and real authority in managers. In addition, the slow privatization created uncertainty and disengagement with employees and diminished future orientation.

Employees became disinterested due to the privatization and were not certain of their jobs; when the factory is to be sold there is no need of working hard or to plan for the future. Once the government decided to sell companies, the government as owner cared less about the companies. The managers interviewed stated that it seems as if there is no owner. The managers further elaborated that the government as an owner does not help to solve even minor problems. It also emerged that political appointees fill the board of directors of NASPPE, rather than qualified managers. It was moreover understaffed and under-funded. Due to this, there were many vacancies in the approved structure of the NASPPE and even the director works only on a half-time basis.

To our amazement, the managers of the industries did not complain about the fact that their company was slated for privatization. Actually, the managers supported the idea that privatization would be good for the company and the country. These findings are quite contrary to the general idea that privatization should be accomplished quickly to avoid managers sabotaging the process in order to retain their perks and positions for as long as possible. In fact the Eritrean managers prefer quick privatization. They are government officials and they will retire or receive new (if not better) jobs when the company will be privatized. Because the managers thus have a security basis, they prefer the company to be privatized as soon as possible. Only without the severe privatization restrictions they will be able to develop their and their company's full potential.

When the privatization process takes a long time, a weak privatization institution and a disinterested government thus contribute to the destruction of value, rather than enabling companies to become competitive and attractive.

8. Conclusions

Privatization is considered to be of the utmost importance for developing countries. It helps to create efficiency within the country and within the companies. Moreover,

privatization reduces government expenditure on loss making companies, while the selling of profitable countries even adds cash to government budgets. However, privatizing large state-owned enterprises in developing countries may take a long time. A weak institutional framework, a low level of domestic savings, the absence of adequate capital and stock markets and social as well as strategic considerations may reduce the speed of privatization.

We studied the privatization case of Eritrea, where the privatization process indeed took a long time. Within the privatization period the state-owned enterprises did perform worse than the private sector companies. We also found that profitability declined in the companies after they were slated for privatization, while the balance sheets showed disinvestment or increased debt ratios. Moreover, employees became disengaged and managers frustrated because investments were restricted, financing curtailed and because the government as an owner did not show interest in a prospering company. Finally, the privatizing agency could not add value to the companies for various reasons. The case study of Eritrea thus provides evidence that a protracted privatization period decreases the revenue to be generated at the time of sale because the enterprises are neglected during the privatization process and because the institutional environment reduces the ability of managers to create value. This makes the companies to be privatized less attractive to buyers and the longer the process of privatization takes, the less attractive the companies are becoming to potential buyers.

We are aware of the fact that the Eritrean example may not in all aspects be relevant in other developing countries. The tense relations with Ethiopia and the lack of attention by the NASPPE may apply only to Eritrea and this may have negatively biased the findings. At the other hand, the full cooperation of Eritrean managers with the privatization policy of the government cannot easily be found elsewhere and this may give the Eritrean case a positive bias. Nevertheless, the observations of the previous two paragraphs suggest a vicious circle in developing countries. Companies are not easily privatized there, and therefore the privatization process takes time. This protracted

duration of the privatization period decreases company value and this makes companies again less apt for privatization. In the end the government may still be left with enterprises to be privatized, but the quality of these enterprises has declined. This downward spiraling phenomenon can (in analogy with the concept of the 'poverty trap') be summarized with the term 'privatization trap'.

If the 'privatization trap' also exists in other developing countries, it is a dangerous phenomenon. Companies that are difficult to privatize will be even more difficult to privatize if they are not sold directly. In a protracted privatization period the prospective price to be paid for the company will decline and governments may have to add more and more money in order to let the companies survive. The longer the time the privatization process takes, the more value is destroyed. These findings suggest that the process of privatization itself can endanger value creation. If governments of developing countries strive for efficiency and a reduction of budget deficits by privatization, the companies should be sold quickly after their privatization is announced.

These findings give also a nuance to the 'Big Bang' approach to privatization. In Eritrea the government slated companies for privatization with a 'Big Bang'. It may have been the government's intention to carry out quick privatizations after the announcement was made. These quick privatizations, however, did not take place and the privatization process took a long time. This means that it is not always wise to announce privatization for all companies at the same time. Nobody is forcing governments to announce privatizations for all companies in one blow. In fact, it seems wise to apply privatization with discrimination and to consider the possibility that it may be better not to announce privatization of some companies if there is reason to believe that the selling of that individual company will take time. This, in fact, creates a paradox: the more urgent privatization is for a company and a country, the more care has to be taken in announcing the privatization of individual companies.

Our results suggest that slow privatization deteriorates individual companies, but we were not able to disentangle the impact of a long privatization period from the impact

of a weak functioning of the NASPPE. It would therefore be interesting to study whether the deterioration of companies is also found in other developing countries where privatization is difficult. Only in that case one might speak of the general phenomenon of a privatization trap. Moreover, it would then be worthwhile to give measures of slow privatization and to distinguish developing countries with a weak and a strong (if any) privatization authority. It would then also be relevant to learn, whether companies that were faced with slow privatization, will ever be privatized. Finally, it would be important to know whether companies that are eventually sold are able to free themselves from the consequences of the privatization trap (if it exists elsewhere) and whether they start to flourish and to fulfil the ideals at which the privatization process was aiming.

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Table 1. Number and characteristics of manufacturing companies sold or still for sale in various industries in Eritrea (June 1999)

Sector	# Sold	# of employees	Sale price (mln. Nakfa)	# not sold	# of employees
Foods	1	62	5	5	849
Beverages	1	47	8.8	2	627
Tobacco & Matches	1	136	52.7	1	104
Textiles & Fibre	2	731	15.2	4	2,544
Leather & Shoe	1	121	5.4	4	964
Metal & Wood Products	8	365	36.4	2	109
Non-metallic Minerals	-	-		3	600
Chemicals	4	219	32.7	-	-
Total	18	1,681	156.2	21	5,797

Source: information received on request from the NASPPE

Table 2. Comparison of State and Privately Owned Manufacturing Enterprises with 10 or more employees by major indicators for 1996 and 1997 (Amounts in million Nakfa).

Performance Indicators	State-Owned Enterprises			Private Enterprises		
	1996	1997	Change	1996	1997	Change
Number of establishments	46	46	0	111	159	48
Number of Employees	10,969	9,999	-970	2,385	4,922	2,537
Gross output	811	759	-52	111	290	179
Gross input	466	454	-13	70	179	109
Value added at factor cost	315	270	-45	36	103	66

Source: State of Eritrea Ministry of Trade and Industry, *Report on Census of Manufacturing Establishments 1992-1997*, Asmara, November 1998, p. 11, 13 and 14.

Notes:

1. Gross output includes revenue from sales plus revenue from other services or income
2. Gross input includes cost of materials and supplies used plus cost of fuel and electricity as well as cost of repairs and maintenance.
3. Value added at factor cost is computed as gross output - gross input - indirect taxes.
4. The number of state-owned enterprises (46) differs from the number of companies in Table 1 (39), because two companies included in this Table are administrated by the Ministry of Agriculture and two by the Ministry of Information (and not the Ministry of Industry and Trade). Moreover, Table 1 does not take into account one company liquidated before June 1999 and two companies that were not offered for sale.

Table 3. Average annual operating performance and employment before (1995 and 1996) and after (1997 and 1998) the privatization announcement (amounts in million Nakfa)

	Beverage Industry (2 companies)					Footwear and Leather Industry (4 companies)					Textile Industry (3 companies)				
	Sales ¹⁾	Value added ²⁾	Profits	# of employees	Profit Margin ³⁾	Sales ¹⁾	Value added ²⁾	Profits	# of employees	Profit Margin ³⁾	Sales ¹⁾	Value added ²⁾	Profits	# of employees	Profit Margin ³⁾
Before	141	106	73	558	52%	69	16	13	954	19%	57	-2	-5	3,335	-9%
After	134	93	52	501	39%	59	12	8	949	14%	40	-3	-6	2534	-14%
Change	-7	-13	-21	-57	-13%	-10	-4	-5	-5	-5%	-17	-0	-0	-801	-5%

Source: annual accounts received on request from the companies. Information on some individual companies for longer time periods can be found in Hailemariam (2001) and Hailemariam and Von Eije (2001)

Notes: 1. Sales are net of sales taxes. 2. Value added equals sales-cost of sales 3. The profit margin is (operating profit/sales) x 100%

Table 4. Investment and Financing before (Average of 1995 and 1996) and after (Average of 1997 and 1998) the privatization announcement (amounts in million of Nakfa)

	Beverage Industry (2 companies)				Footwear and Leather Industry (4 companies)				Textile Industry (3 companies)			
	Total assets	ROA ¹⁾	Total Debt	Debt Ratio ²⁾	Total assets	ROA ¹⁾	Total Debt	Debt Ratio ²⁾	Total assets	ROA ¹⁾	Total Debt	Debt Ratio ^{2,3)}
Before	169	43%	102	60%	70	19%	30	43%	55	-9%	62	113%
After	152	34%	83	55%	69	12%	37	53%	56	-10%	67	121%
Change	-17	-9%	-19	-5%	-1	-7%	+6	+10%	+0	-1%	+5	+8%

Source: annual accounts received on request from the companies. Information on some individual companies for longer time periods can be found in Hailemariam (2001) and Hailemariam and Von Eije (2001)

Notes: 1. Return on assets (ROA) is (operating profits/total assets) x 100%. 2. Debt ratio is (total debt/total assets) x 100%. 3. Equity capital is negative in the textile industry because the companies are owing equity capital to the government

Table 5 A sample of quotes from managers on privatization in general

General Manager of Asmara Brewery

“Privatization has been the main constraint in upgrading machinery. The Board of NASPPE does not allow long-term investment in machinery, except minor investments that solve critical items that could stop company operations such as spare-parts. We are not allowed to invest in expansion or upgrading. We succeeded in implementing the first phase of renovation before the privatization process started, but even though we have enough cash, the Board has stopped our second phase, renovation of the Bottling Department, due to the privatization process.”

and:

“We are not allowed to keep a large amount of stock and this is hampering our production. The buyer is obliged to buy the stock at the time of privatization. Therefore, in order to minimize the burden on the buyer, we were restricted to a limited period of inventory. This restriction increases our ordering costs and since our factory requires a large stock of malt, it creates a problem.”

Financial Manager of Asmara Brewery

“Privatization is taking a long time. At present, since we are thinking that the company will be privatized soon, we are not working under normal condition. ... If this situation goes on, the company will face problems.”

Financial Manager of Asmara Brewery

"At the moment privatization is taking a long time and this is becoming a problem for various business decisions that we make.”

Marketing Manager of Asmara Wine and Liquor Factory

“Privatization does not help in long-term and future planing.

Production Manager of the Asmara Wine and Liquor Factory

"People have become disinterested due to privatization. They say the factory will be sold. So there is no need for working hard or for future planning.... The enterprises management team used to meet monthly but now -since we heard that the company is to be privatized- we never meet".

and:

“Due to the possibility of privatization, we are ordered not to keep large quantities of inventory, but the process of ordering raw materials takes time.”

Marketing Manager of the Asmara Wine and Liquor Factory

"Privatization does not help in future planning. Also the people do not work on full mentality and they do not have any vision at the moment because their future is not secure."

Marketing Manager of Asmara Pickling Tannery

“The idea of thinking that the company will be sold tomorrow is affecting management decisions. Nobody wants to make a decision on the pretext *that ‘what if the new buyer does not want this’* and we are not planning our activities. The privatization process is slowing purchase decisions, affecting planning and personnel administration negatively. We are also not increasing the salary of employees due to privatization.”

Production Manager of Keih Bahri Tannery

“It seems that the factory does not have an owner.”

Marketing manager of the Eritrean Textile factory

"To solve the problems that the company is facing, the privatization process should be accelerated".