The State Holding Company

Issues and Options

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Anjali Kumar

The World Bank
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FOREWORD

Many countries today are attempting to move away from controlled and centrally planned economic systems towards more liberal economic environments. Large state-owned enterprises pose a particular problem in this process of adjustment and transformation. While their performance in many instances has been demonstrated to be relatively inefficient, the solutions to address these problems are less obvious. Privatization is increasingly advocated as the solution, but not all countries are in a position to move towards this rapidly. This may be not only for reasons of political acceptability but also because of the practical difficulties involved and the lack of concomitant conditions, in the form of interested buyers, adequate savings and the existence of multiple other market failures. Even in the presence of a strong will to privatize, this may be difficult to achieve, on a major scale, in a short time frame.

Faced with this situation, some countries are groping towards more nuanced solutions towards the issue of public enterprise reform, which in some cases combine elements of ownership and regulatory change. One such experiment, which has been adopted by many developed, developing and transforming socialist economies is the establishment of state holding companies. The government thus attempts to separate its ownership and management functions, distancing the enterprises from the state and permitting them greater operational freedom. Such holding companies or funds have sometimes had additional roles; undertaking the restructuring of the enterprises below them, stimulating the capital market through share trade, and increasing the returns on shareholdings in their enterprises through active portfolio management. This paper offers a framework for the analysis of such institutions, and discusses the results, based on the empirical examination of state holdings in several countries.

Ms. Kumar began this work in the Maghreb department of the World Bank, observing, over a period of some years, the process of establishment of state holding funds in Algeria. The proposal to examine these institutions in greater detail was strongly supported by other departments in the Bank, in particular, the department dealing with Egypt, which has also experimented with state holding companies on a major scale. There are also some interesting parallels between holding institutions in these countries and new institutions emerging in some transforming economies in East Europe. Ms. Kumar has now transferred to the China and Mongolia department of the World Bank. Her work is of considerable relevance here as the Chinese experiments towards gradualist reform leads them to search for interim institutions in the movement towards a market economy. This paper, which synthesizes the results of detailed empirical investigations on state holding companies is being presented, at the request of the Systems Reform Commission of the Chinese government, at a seminar in Beijing in November 1992. We hope that this will also be of interest to all those who are struggling with the issues of public enterprise reform in economies undergoing transition.

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Part I. Public and Private Corporate Forms

1.1 Rationale for the Examination of State Holding Companies

Whether in specific enterprises or industries in the context of a mixed market economy, or across the entire economy, in a system of centralized planning, state owned and operated production units have frequently been associated with economic inefficiencies leading to low levels of output and profits, a diversion of resources from their most productive uses and internal economic inefficiencies in management and motivation within the productive unit. A major cause of the economic inefficiencies of public enterprises is the difficulty of reconciling the multiple political, social and ideological aims of governments and government-appointed managers guiding the operations of these enterprises, with the achievement of economic efficiency. These concerns have led to the adoption of a wide spectrum of mechanisms to modify or alter the controls and obligations between governments and state owned enterprises to better achieve these multiple and sometimes conflicting objectives.

Such reforms have taken many forms, from the radical to the conservative. Radical reform through privatization has been increasingly advocated due to the observation that some of the more moderate forms of reform have frequently had little lasting impact or long run success. In some countries fiscal reasons have often been a major imperative, in terms of both reducing the burden of operational deficits of public enterprises as well as realizing capital gains from their sale. This certainly been an important reason in mixed market economies such as the UK and Italy. In addition, and particularly in some formerly centrally planned economies of East Europe undergoing transition, privatization has been adopted not only for reasons of economic efficiency, but also because this helps achieve broader ideological objectives in terms of the creation of private property rights.

There are some persuasive recent works, with several empirical examples which suggest that there are economic gains from privatization. However, even if these benefits, under particular circumstances, are conceded, it is recognized that is not always possible to proceed immediately and directly towards complete divestiture. Difficulties have been encountered with the privatization of individual enterprises even in mixed market economies with a private sector, and at least the nexus of a stock-market, already in existence. The process of transition from public to private ownership, in formerly planned economies where transformation is being attempted on a major scale, is considerably

1/ This paper draws extensively from a longer work on the subject of state holding companies in transitional economies, to be published shortly (Macmillans, UK, 1993). While the focus here is on a general framework of analysis for state holding companies, detailed case studies have been undertaken and are presented in the longer work. Findings and conclusions from these are drawn upon here.


4/ Examples include Turkey, from 1986 or Morocco, where a privatization program was first announced by the Prime Minister in 1985, and where concrete proposals were finally drawn up five years later. Brazil’s privatization program, launched in the early 1980s progressed very slowly at the outset. More recently the pace accelerated but was dramatically interrupted due to worker protests (Financial Times, Oct 2, 1991). Heald (1988, 1990) and Ramanadhan (1989) illustrate the differences in undertaking privatization in developed and developing economies.
more difficult. These economies are faced with multiple market failures, including limited or absent capital markets, a lack of procedures for asset valuation, limited labor mobility due to the linking of housing and other benefits to employment, and the absence of a basic legislative framework for a market economy, including laws on ownership and private property rights, contract law, and corporate law for the creation, operation and dissolution of enterprises. Limited domestic savings or credit for the purchase of state assets and a reluctance to relinquish large shares in state assets to foreigners further restrict the market for these enterprises. Objections raised by workers' councils who have sometimes enjoyed de facto ownership rights, and a shortage of experienced managers can further retard the process of privatization. If the public enterprises concerned are also in the process of adjustment to a rapidly changing macroeconomic and policy environment, this may necessitate their prior reorientation and restructuring. Selling large loss-making enterprises is difficult and liquidating them has severe employment implications. The capacity for simultaneous adjustment on all these fronts may be limited. The severe practical difficulties of this process can lead to long delays and the achievement of privatization may be spread over several years.²⁵

The difficulties and delays of the large scale privatizations facing such countries are prompting a search for 'more nuanced solutions' in this process. Attempts at improving the performance of public enterprises without changes in ownership have focussed on ex ante improvements of the incentive structure facing public enterprise managers and workers, to simulate a competitive market environment, combined with improved ex post monitoring of public enterprise performance. Other solutions include the transfer, on a temporary or long term basis, of ownership or management functions to institutions outside the government. It is expected that this will distance public enterprises from the government, in a first step, and permit their gradual and subsequent transfer to private ownership at a second stage. Experiments with partial transfers of ownership, to enterprise employees or management, have also been introduced.²⁶ Among these conservative solutions for public enterprise reform is the transfer of public enterprises to indirect state ownership, through the establishment of holding companies. It is a solution which combines elements of both regulatory and ownership changes. This paper examines the characteristics of the state holding company and then aims to see whether these institutions have achieved the purpose of improving public enterprises' efficiency and encouraging them to simulate the behavior of private enterprises in competitive markets.

⁵/ Many instances of the difficulty of privatizing loss-making enterprises have been encountered by the Treuhand of East Germany, the state holding agency responsible for privatization, particularly in ailing industries, such as shipbuilding. The need to maintain employment has been an additional constraint.

⁶/ To the extent that raising revenue is an objective, it has been shown that rapid privatization may not be desirable, from this point of view, even in market economies. This is due to the underpricing of first offerings which becomes necessary to overcome the uncertainty faced by prospective buyers regarding the government's commitment and its intentions with regard to future policies. Perotti (1991) shows that, based on the evidence of ten countries, both developed and developing, revenue proceeds increase gradually over time as privatization programs proceed and investor confidence increases. Nahmijas and Pera (1988) discuss the underpricing of first issues in the context of Italy. In transforming economies, prices would be further lowered by the glut of companies on sale and the small number of bidders, and by the uncertainty regarding future earnings, as major policy changes are introduced.

⁷/ Employee stock ownership schemes in the context of increased private participation in public enterprises have been discussed by Barbara Lee (1991) and Bogetic (1991).
The aims of governments setting up state holding companies have been varied, and are not always explicit. At one extreme, the aim is to permit the gradual introduction of market forces in the public enterprise environment, with a strong emphasis on financial independence and a binding budget constraint, prior to any ownership change (Algeria). At the other, the aim can be to make the holding institution responsible for the eventual transfer of its enterprises to private ownership (Germany). In addition, the government may require the holding institution or institutions to assist with the restructuring requirements of public enterprises and the development of a new class of managers, realize financial gains on behalf of the government (or eventual private owners) on these enterprises through active portfolio management, and assist with the stimulation and development of the capital market through a gradual increase in share trade. This paper analyzes the extent to which holding companies can assist the gradual introduction of market forces in the environment of state enterprises in economies undergoing rapid change, and whether they can also help with the realization of other objectives, such as enterprise restructuring, the development of a capital market or the eventual privatization of enterprises, which form a part of the process of transformation.

The existence of state holding companies, in many variants, is widespread. Large scale state holding companies were set up both before and after the Second World War in some European countries, notably Italy, but later also in Austria and Sweden. Numerous developing countries in Africa and Asia also established state holding corporations in the 1960s and 1970s. In Zambia, Pakistan and Bangladesh, virtually all public enterprises had been transferred to holding companies in the 1970s. On a lesser scale, state holding companies holding small numbers of public enterprises have also been introduced in other developing countries, including India, the Philippines, Nigeria and Ghana.

New versions of holding institutions are appearing rapidly. New holding institutions were established in Algeria, on a major scale, as recently as 1988, and in 1991, Egypt introduced major changes in the framework of its state holding company system. Since 1990, new institutions have begun to appear in the transforming economies of East Europe, notably in Poland, but also in Czechoslovakia and Romania, which have taken on some of the characteristics of older holding structures. At least three different varieties of holding groups appear to be emerging here; the funds of state enterprise shares, set up to manage the shares of partially privatized enterprises on behalf of their private owners; the organizations which are being created to manage the shares residually held by the government, and holding organizations set up on a temporary basis with the clear aim of achieving the rapid privatization of its enterprises. Although there are major differences between the holding structures adopted by different countries, there are also significant parallels which provide useful signals on the direction likely to be taken by new institutions. The framework of analysis and comparison of holding structures used here can be extended to cases which are not examined in detail in the present study.
1.2 The Holding Company as a Corporate Form

To what extent can the advantages or disadvantages of a holding company, public or private, be predicted by theoretical models of corporate behavior? Relatively little attention has been paid to the holding company as an organizational form. In his discussion of alternative corporate structures for large enterprises in market economies, Williamson describes two basic forms of corporate organization; the U-form, or unitary organization, and the M-form, or multidivisional organization. In the unitary or functional form, there is a chief executive at the top, with operating units organized as functional divisions, such as sales, finance, and manufacturing, below. The advantages of specialization by function lie in the possibilities it affords for vertical integration and the reduction of transactions costs; its disadvantage is the extreme load on the chief executive as the firm expands.

In the multidivisional corporation, the functional divisions of the U-form are substituted by quasi-autonomous operating divisions, mainly along product, brand or geographic lines. Below this level, individual operating units may still be organized along functional forms so that the advantages of the U-form are not lost. The peak coordinator's office alters from an individual to a general office with an elite staff, designed to provide it with inputs in its strategic decision-making responsibilities. The advantage is the insulation it provides the executives responsible for the destiny of the entire enterprise from routine operational responsibilities. The general office is then concerned with broad strategic decision making and also has the task of resource allocation among competing operational divisions, as well as their monitoring and control.

Reductions in uncertainty and consequent encouragement of research, risk-pooling and the internalization of transaction costs (as in a large U-form corporation) are other benefits. A major advantage of the multidivisional form is that it provides internal performance controls over the corporate organization's operating divisions. These are a substitute for the lack of effective external control, which is a consequence of the dispersed shareholding of the joint-stock corporation.

Concern over the separation of ownership and control was expressed decades ago by observers of the US economy who pointed out that the widely dispersed shareholdings of a joint stock corporation could imply that there was little effective control over its management. However, in market economies, it has been argued that the problem of ownership dispersal can be effectively substituted by the threat of takeovers, through internal managerial control, the threat of replacing managers or


9/ Berle and Means (1932).

10/ Marris (1964). The effectiveness of this threat as a form of control was however disputed by Grossman and Hart (1980). Singh (1992) reviews the theories and evidence.


12/ Fama, (1980).
through financial discipline imposed by the banking system. These corrective market interventions are absent in transitional or emerging market economies. Within the context of a market economy, the holding company or H-form of organization was characterized as a loosely divisional structure, in which the controls between the headquarters unit and the separate operating units are often weak and unsystematic. The divisions, or operating companies, thus enjoy a high degree of autonomy under a weak executive structure. At its weakest, the general office or headquarters unit is no more than an administrative office for the collection and aggregation of financial reports and earnings. While this form of organization has the risk-pooling advantages of a mutual fund, it does not have the managerial discretion to permit the appropriate reinvestment of its earnings. A schematic representation of the alternative organizational forms is given in Figure 1.1.

Empirically, there were a large number of US corporations which reorganized themselves from the U to the M form, often with a marked improvement in performance. The holding company form was relatively less common. In the UK, it was observed in the 1950s that the holding company form where adopted was largely the consequence of 'growth from below'. Thus, a firm acquiring new operating units as part of a corporate strategy towards diversification through acquisitions would organize itself and the newly acquired affiliates along holding company lines. The holding company was also associated with the growth of the multinational corporation with several overseas subsidiaries, which would then set up a head office in the UK in the form of a holding company. Many companies at this time underwent a process of internal restructuring and reorganization, and most holding companies were transformed into M-form corporations. In the 1960s, this was the predominant organizational form for large-scale British enterprise. Large and significant holding companies were still present in the UK during the 1980s.

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14/ The famed pioneering examples are the Du Pont corporation and General Motors, in the 1920s, as described in Chandler (1966).
15/ This was associated with a growth in product diversification. According to one author, the holding company form increased from 28 to 40 companies in the 92 enterprises, between 1950 to 1960, but 27 of these switched to the M-form by 1970 (Channon, 1973).
16/ In a detailed analysis of selected British holding groups in the 1980s, Hadden (1983) points out that British petroleum has around thirteen hundred subsidiaries worldwide; Unilever has around eight hundred.
Figure 1.1
Corporate Organizational Forms:
The Unitary, Multidivisional and Holding Company Forms

A. The Unitary or U-form

Chief Executive

Functional Division: Manufacturing
Functional Division: Sales
Functional Division: Finance
Functional Division: Engineering

B. The Multidivisional or M-form

General Office
General Office Staff

Operating Division A
Operating Division B
Operating Division C

Functional Division: Manufacturing
Functional Division: Sales
Functional Division: Finance
Functional Division: Engineering

C. The Holding Company or H-form

Holding Company

Operating Company A
Operating Company B
Operating Company C

Functional Division: Manufacturing
Functional Division: Sales
Functional Division: Finance
Functional Division: Engineering

One difficulty with accepting the schema presented above is that in practice the lines between these alternative organizational forms are often blurred. It is argued here that, as Figure 1.1 shows, the structural difference between the holding company and the multidivisional corporation is not large; it lies chiefly in the relatively limited powers of the holding company office, which is not endowed with its own elite staff, and in the relatively weak links in terms of strategic decision making or monitoring and control assumed to lie between the holding company and its operating companies. If the holding company is given, or is able to assume, the greater powers accorded to the general office in the M-form firm, it could also reap the benefits ascribed to the M-form organization. This has been known to occur in mature market economies. Cases in the UK are well-documented.\(^{17}\) As subsequent chapters in this study show, this has also occurred in the case of state holding companies. For example, the organization of IRI of Italy is closer to the M-form stylization presented above than the H-form. By contrast, the Public Sector Authorities which existed in Egypt from 1983 to 1991, are a good illustration of the weak form of holding company. The benefits of a holding company form therefore depend on the structure of vertical links and the nature of responsibilities given to each level.

An alternative range of descriptions for the H-form could therefore be the 'interventionist' holding company and a 'sleepy' holding company. One factor which is likely to influence the role of the apex office is its proportional ownership in the levels below it. In the Williamson analysis, there is an implicit assumption of a hundred percent ownership of the lower levels by the apex. This follows logically in the case of a single corporation, and therefore for the U-form and M-form stylizations, but need not be true of the H-form. In a holding company there is a range of possibilities from a hundred percent ownership to the holding of a minority interest only. The greater the shareholding interest of the apex in the operating units, the greater is its scope for active control. If the proportional shareholding is small, both the scope for and the interest in direct intervention is reduced. A mutual fund or asset management company can be regarded as one form of holding in which the shares held in all companies is small, and the role of the shareholding apex is thus largely passive, in terms of the strategic or operational decisions facing the company.

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\(^{17}\) Hadden (1983) provides a minute description of the corporate structure of four holding groups in the U.K., which shows that in many cases the head office chooses to retain considerable powers. For example, the articles of association of most subsidiary companies examined permit their directors to be summarily appointed or removed by the holding company without the need for a shareholders' meeting. Conversely, the variety of managerial styles of corporate head offices (including 'loose' M-form units) are discussed in Goold and Campbell (1987).
1.3 State Holding Companies

Another limitation of the schema described earlier is that it is derived from the context of private sector firms in mature market economies, particularly the US and the UK, and it does not attempt to capture the characteristics of state holding companies. In the case of state holding groups, particularly in developing economies and economies with a large parastatal sector, the relevant comparison for the H-form is not the M-form or U-form, but the management of public enterprises through a state holding corporation versus the direct exercise of ownership and management functions by the government. A major characteristic of the holding company then becomes the opportunity it provides for decentralization. In the context of an economy moving from centralized planning to a market-based system, the holding company may acquire additional functions and characteristics, as an institution intended to assist the process of transition.

It is conceptually useful to separate the benefits or drawbacks of the holding company in its most generalized form, independent of the market structure or context it belongs to, and then add to these the additional advantages or disadvantages it may have in the specialized context of a state holding corporation, in a country attempting to move towards a market based economic system. Claims which may be advanced in favor of holding companies in a general schema would thus include, first, greater autonomy and decentralized management for operating companies or units, as opposed to the 'unitary' form of organization, in an industrialized market economy, or relative to direct governmental control in the state holding company. Second, risk pooling is possible in holding companies with diversified activities and third, as a corollary, the lowering of financial costs of capital should follow. Fourth, holding companies permit the realization of economies of scale in the use of top management and in specialized functions, such as exports.

In the context of a state holding corporation, the holding company has the potential to acquire additional positive attributes. First of all, the separation of ownership and management has a new meaning. The issue is no longer the lack of any control due to the highly dispersed shareholding of a large corporation, but excessive control, typically through line ministries in the government, and the tendency to ‘departmentalize’ public enterprises. Greater separation of ownership and control in these circumstances may be a desirable feature rather than a source of concern. A holding company may increase the managerial autonomy of operating enterprises by acting as a buffer which insulates managers from day to day governmental interference in operations while still retaining a framework of accountability. An apex organization could also provide a single point of interface with the government, limiting the multiple ministries or agencies that a public enterprise under a specific ministry would have to deal with.

18/ For further discussions of corporate organizational form in industrialized economies, see, in particular, Williamson (1970, 1975).

19/ As pointed out above, it is important to remember that the separation of ownership and control has not been regarded as universally desirable. Rather, it has been a source of concern to economists in market economies as the dispersal of ownership could lead to a lack of managerial discipline. Some key elements of the debate may be traced through Berle and Means (1932), Fama (1980), Grossman and Hart (1980), Mayer (1988) and Hellwig (1991).
In addition, the state holding company could enable the appointment of professional holding company managers, superior to the civil servants who would otherwise have responsibility for managing the holding companies. It could also help to impose a binding budget constraint on public enterprises by limiting or stopping government financial transfers to the holding company, thus forcing these enterprises to improve their profitability and operational efficiency. State holding companies have also been used to take over and restructure loss-making enterprises which are too unattractive to be privatized and too large to be closed without severe social repercussions. Additionally, if the state holding company is encouraged to gradually begin trade in shares, it could stimulate the development of a capital market; and, if the government desires more rapid divestiture, the state holding could be entrusted with the task of undertaking this.

However, these goals have not always been achieved by holding companies, and numerous difficulties and drawbacks have been encountered in practice with such organizational forms. At the level of the general holding company, public or private, it has already been pointed out that in its traditionally loose organizational form, the office of the holding company may make few strategic contributions and may not be able to effectively play a monitoring role. This could be more generally expressed in terms of the 'principal-agent' problem. The agent, or operating company, has more information than the principal, or holding company, but inadequate incentives to use this to maximize the welfare of the principal. It is therefore not assured that the use of an agent will be in the best interests of the principal. Once the holding company begins to actively interest itself in the doings of its enterprises, it may use its position to cross-subsidize them, which is contrary to the assumed dynamic advantage of improved resource allocation and better investment decisions. Even without explicit cross-subsidization, there may be complex internal intra-subsidiary financial transactions which make the real profitability of the group or its constituent enterprises hard to follow and reduce overall accountability. There are few obvious sectoral synergies in a conglomerate holding. In the case of sectorally designed holdings, the benefits of sectoral synergies are still not obvious, as these typically arise from forward and backward vertical integration which lead to a reduction in transaction costs. A 'sectoral' holding company however typically has several enterprises producing the same output, rather than clusters of enterprises producing upstream or downstream products. The greatest benefit to the holding company in this case may be the ability to exercise market power. From the point of view of the economy as a whole the creation of such monopolies is not usually desirable.

In the case of the state holding corporation in particular, the desired goal of greater decentralization may be hard to achieve because of political considerations which affect managerial appointments. As a result holding company managers are not necessarily competent professionals. These managers moreover lack the appropriate incentives for improving enterprise performance. The government often continues to intervene directly in the affairs of these enterprises, and such holding


21/ A study of holding groups in the U.K. (Hadden (1983) has shown that there are heavy internal borrowings in these groups. These are not only 'vertical' borrowing of the subsidiaries from the parent holding company, but also 'horizontal' borrowing between various subsidiary and associate companies. While one motive for the major borrowing for new investments may have been to lower the cost of capital (by avoiding the stamp duty payments required on new capital issues), in many cases the reasons are not clear. The treatment of interest payment on these loans has been highly variable. Interest has been paid at or below market rates, waived altogether or allowed to accumulate.
companies become just another bureaucratic layer, especially if, as is frequent, they specialize by subsector, effectively becoming sub-branches of a Ministry. Financial discipline in the form of a binding budget constraint need not occur as funds can still be transferred to enterprises via the holding company or through other government channels. As long as the enterprises are publicly owned, they will continue to be used by their governments as instruments for implementing sociopolitical goals, and this limits the potential improvement in their economic performance. Tendencies towards collusion with supervisory agencies, or 'regulatory capture' has been of particular concern in the context of US government corporations.\textsuperscript{222} It is also argued that there is little evidence of stimulation of the share market or assistance with divestiture. This paper investigates the factors leading to these very different outcomes and determines the extent to which the benefits of this form of organization may be realized without encountering the drawbacks.

\textsuperscript{222} The debate is traced in Bolton and Roland (1992).
Part II. Holding Company Characteristics: Internal Structure and External Links

The great diversity of experience of many countries with holding companies stems in part from the fact that the state holdings put up in these countries have had very different structures. Certain key characteristics of such holding structures are pointed out in this section, which also shows how these have varied in different countries experimenting with state holding institutions. The following section (Part III) discusses the criteria for assessing holding company performance. In Part IV, some general results of a performance assessment of holding companies and the public enterprises below them are presented, based on the experience of selected countries which have experimented with holding companies on a major scale.23 Based on this, the final section (Part V) draws together the factors that must be taken into consideration by a country attempting to set up state holding company structures.

2.1 The Purpose of the Holding Company

The initial reasons or intentions of the government for establishing a holding company for its state owned enterprises can be various, and judgements of holding company performance must take this into account. It is difficult to expect a result from an organization which may have been created for a very different purpose.

- A first motive for setting up a holding company is to seek a means of control of a number of public enterprises, because the government ministries find it difficult and inefficient to deal with numerous firms directly. This may follow the gaining of independence from a colonial past, or a nationalization episode, where an appropriate government structure to deal with the enterprises does not already exist, or where the holding company is inherited from a former development corporation (eg, Tanzania, Nigeria). In this case the principal motive is control, and not the relinquishing or transferring of control. Social objectives, particularly following a nationalization, are also likely to be strong, and profits may well be secondary. The holding company in this case is essentially a facilitator of government control rather than a means of easing this control.

- The achieving of synergies through integration within a given sector or activity provides a second reason for state holding companies.24 These are a specialized form of holding company, usually found to a greater extent in particular sectors. The rationale for these lies more in the theories of economies of scale leading to horizontal or vertical integration than in public enterprise reform. Note however that in many cases such

23/ The characteristics and the performance of state holding companies in three countries which have undertaken experiments with these on a major scale, Italy, Egypt and Algeria, have been examined within the framework presented here. The results are summarized in Appendix Table 1.

24/ The formation of such structures in the petroleum sector are common. Examples are PETROBRAS of Brazil, PEMEX of Mexico, PETRONAS of Malaysia, PERTAMINA of Indonesia and SONATRACH of Algeria.
synergies have been assumed to exist without reasonable basis and some ‘sectoral’ holding companies end up becoming an excuse for collusive or oligopolistic structures.

- A third possible motivation is the ‘arms-length’ management of public enterprises, permitting their gradual exposure to market forces. This is the classic case for promoting greater economic efficiency, described in the preceding paragraphs. This was the principal goal for the establishment of holding companies in Algeria, in 1988. Egypt’s recent changes (in 1991) of the holding company structures for its public enterprises were also aimed at the promotion of greater decentralization and operational efficiency.

- Fourth, holding companies may undertake the management of government assets to increase financial returns to the government’s investment in these enterprises. This is relatively more recent. This was an important consideration, if not the sole criterion, of the sole criterion, underlying the formation of Algeria’s holding companies. This has also been an important factor in the formation of the new holding institutions of East Europe. However, a reduction in capital costs through risk-pooling or internal borrowing is not known to have been an explicit objective for state holding companies, although this may have been an objective for private ones.25

- State holding companies may also be entrusted with the task of rescuing loss-making companies, usually because of the social costs of liquidation, and generally with the intention of restructuring the enterprises and restoring them to financial health. This was the primary initial motivation for the establishment of IRI of Italy, in 1933, which was entrusted at the outset with enterprises which had collapsed with the stockmarket failure at the onset of the depression. In the case of IRI, the government also wished to insulate the banking sector from the effects of the collapse of heavily indebted enterprises. Enterprises’ debts to the banks were bought out by the government and transferred to IRI. The case of IRI also illustrates that in some cases the holding company then becomes a conduit for long term targeted government subsidies to specific enterprises or industries.

- A sixth objective encountered for the establishment of State holding companies is for transferring or restoring public enterprises to private ownership with or without their prior restructuring. This was the intended role of the GEPI of Italy which was intended to acquire ailing private enterprises, restructure them and then restore them to private ownership. More recent and more dramatic is the example of the Treuhandanstalt of Germany which aims specifically at divestiture, typically without prior restructuring.

- Last, a state owned holding group, usually with a smaller proportional holding in each state enterprise, may be required to undertake the management of the state’s shares in public enterprises until their divestiture to private owners. This is the explicit objective of some of the new holding institutions of East Europe. However, it is essentially a combination of the ‘arms-length management’, the ‘asset management’ and ‘restoration to private ownership’ functions described above. In some such cases, the holding groups

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25/ A reason for this may be that since all enterprises are ultimately owned by the state in any case, investments in these enterprises are ‘riskless’, or carry a sovereign guarantee.
are said to be managing the shares of enterprises on behalf of private owners, following a mass transfer of ownership rights to the general public. However, the highly diffused nature of share transfer implies that the private owners are unable, at least initially, to exercise ownership rights. If the managers of the holding company remain answerable to the state in some degree, this is arguably still a form of state holding group. If the state relinquishes control entirely, this would resemble a holding structure in a private joint-stock corporation.

Since profitability may not have been the primary intention behind the creation of some holding companies, following objective (i), it is not unusual to find that they are assessed as failures by general norms of enterprise efficiency. Knowing the original rationale for creating a holding company may therefore explain in large measure its subsequent orientation and performance. The achievement of group synergies, as in objective (ii), is not restricted to state holding companies, and besides, to the extent that these exist, they tend to be special cases. The focus of the present study is therefore on objectives (iii) to (vii) above. Thus, if holding companies are set up, or are to be set up with the objectives of greater decentralization, increased returns to earnings, improved and rationalized internal structures in subsidiary enterprises, and rapid or gradual transfer to private ownership, what is the likelihood of success, and what can be done to increase this likelihood.

2.2 The Legal Code for the Holding and its Subsidiaries

The legal code under which the holding companies and their subsidiaries operate is a major factor determining not only the autonomy of the enterprises concerned but also the degree of competition between public enterprises under holding companies and other public or private enterprises. It is not uncommon to retain the subsidiary companies under special public enterprise laws, which may endow special privileges or impose particular restrictions on them. The holding company itself may be under a similar regime, or it may have special quasi-governmental status, as in Italy. A notable feature of the Italian system however is that the operating enterprises below the apex holding company are incorporated under private law.

In some countries, such as Egypt, several different sets of legislation may apply to different enterprises, depending on the shares of public or private ownership, foreign capital, export orientation, sector of operation, etc. Thus under Law 97 of 1983, Egypt’s holding groups were nominally joint stock companies, and so were the enterprises below them. However in both cases, they were subject to special laws which had several restrictions, compared to corporate law for private enterprises. Egypt’s new public enterprise law, Law 203 of 1991, now stipulates that the law for private enterprises will apply unless specific provisions are made to the contrary. This is clearly a step forward, but is still a derogation from a uniform legal framework. Operating enterprises under the state holding funds of Algeria are also subject to special laws, which represent departures from the commercial code for private enterprises. Clearly such multiple regimes limit genuine competition. Holding companies with subsidiaries which are not incorporated under the same umbrella of company law as private enterprises, or a common commercial code, cannot be said to be actively promoting the introduction of market forces in public enterprises. Even in cases where there is a publicly expressed will to suitably alter the legal

26/ Egypt has however announced that it intends to promulgate a unified corporate law in the near future.
framework in this direction, this may take a long time to implement (Egypt, Algeria).

There are other specialized elements of the legal environment of a holding group which would affect holding company behavior. Most advanced market economies have some special tax provisions for groups, for example on the selective cancellation of subsidiaries’ profits and losses for tax assessment. This would affect the pattern of growth or diversification adopted by a private holding group and should also be of concern to public holding companies, if profit maximization has indeed been accepted as a central objective. If the government aims to eventually privatize the holding groups themselves, this will have to be defined. The definition of issues such as the liability of the parent company to insolvent subsidiaries will determine whether the possibility of exit through bankruptcy or liquidation is a reality. Although such issues have begun to receive attention relatively recently in mature market economies, their application in the context of state holding companies will need to be examined if public enterprises under the holding groups are to emulate market behavior.\footnote{Hadden (1983) provides a detailed discussion and describes early EC and OECD directives on these issues. Many of these directives evolved as a result of growing concern over corporate group regulation in multinational organizations.}

2.3 The Policy and Regulatory Framework

The performance of any public enterprise, whether or not a part of a holding company, depends critically on the policy environment in which it is expected to function. Certain key stylized elements of this, which are particularly relevant for the issues examined, can be isolated. First, looking at the product market, to what extent do the subsidiary public enterprises under the holding company operate in a competitive environment? Determinants of competition here refer to the presence or absence of free entry and exit, industrial concentration ratios, and the extent of development of the private sector. Second, the presence or absence of regulations on prices will affect market structure. If public enterprise prices are subject to control, this could lead to unrealistic gains or losses for subsidiary operating companies which are outside the control of the holding company. A third critical area is the foreign trade and exchange rate regime, in terms of exchange controls as well as the structure of the tariff and quantitative restrictions on imports. If trade barriers are low, this can compensate for high domestic concentration ratios or the limited development of the private sector. Fourth, the degree of flexibility in the labor market will strongly affect certain potential holding company objectives, such as enterprise restructuring. Finally, the overall macroeconomic performance of a country at any given time will obviously have a major impact on its enterprise sector, affecting both state holding companies and other public and private enterprises.

Returning to the examples of countries which experimented with state holding companies on a major scale, the overall policy environment of Italy was certainly more competitive than that of Egypt or Algeria, in terms of relative openness to external trade and the presence of significant private sector competition in many sectors where state holding companies operated. Price regulation, however, remained in several sectors, especially in those where the government had a monopolistic role. By contrast, Egypt had a heavily controlled regime in the early 1980s, with high external protection, virtually no domestic competition from the private sector in most industries, and extreme difficulty with enterprise closure and labor mobility. Significant moves towards liberalization began in the late 1980s. Algeria, like Egypt, was a strongly controlled economy with a very limited private sector and strong
discrimination in favor of state industry, which prevented private enterprise from entering many sectors. The creation of holding companies in Algeria, and significant changes in their structure in Egypt, were both associated with general moves towards increased liberalization and a greater reliance on market forces.

2.4 Accounting Procedures and Financial Regulation

The form of accounting adopted by a holding company depends in some respects on its purpose. Holding companies which are typically a hundred percent owners, or at least majority owners of their enterprises would be expected to produce consolidated financial statements which include such subsidiaries. After netting out inter-company cross-holdings, equity, on these statements, would aggregate the equity of the subsidiaries. In addition, the holding company's 'own' financial statements may also be prepared, based on its own equity or endowment. On the other hand, holding companies which are essentially asset managers, with minority and usually small stakes in their enterprises, would not be expected to produce financial statements where equity includes the shares held in subsidiaries, rather, its shares in various enterprises, where tradeable, appear as some form of short term assets. Earnings from these subsidiaries, however, would be reflected in the form of dividend income, while losses would appear in a diminution of the total value of the shares held in that enterprise.

In practice, holding companies in some countries such as Algeria and Egypt where the holding does have a majority or at least controlling interest in its enterprises, continue to produce financial statements of the latter sort. Thus the real value of the enterprises in the portfolio is not known. Losses suffered by the enterprises are said to 'remain within the enterprises', and there is no adjustment to the nominal value of shares held by the holding company on its balance sheet. As a consequence, there is a severe lack of transparency in terms of the financial performance of subsidiary companies. Attempts at consolidation which are sometimes made (e.g. in Egypt) are typically aggregations rather than consolidations (inter-company transactions are not netted out). If the financial performance of the holding company or its subsidiaries are to be monitored meaningfully it is clearly of primary importance that appropriate financial statements are prepared.

Looking at industrialized countries, the provision of consolidated group accounts is required in both the UK and US, for example, although details of requirements on the presentation of subsidiary accounts differ. As an instance, in the UK, separate accounts for each 'class of business' are required in addition, but the definition of this is left to managerial discretion. The definition in the US is clearer; any activity comprising above ten percent of turnover is to be independently reported. EC directives on this issue are also being formulated; the concern here is the separation of activities in the EC and its member states from other overseas operations.

An important additional issue with regard to financial regulation is the relation between the holding company, its subsidiaries and the banking system. Some large holdings may include banks in their portfolio, which could then conceivably become captive or preferential sources of credit. Whether this is likely to happen also depends also on the overall discipline of the financial system towards public enterprises. In many developing countries, public enterprises, whether or not under holding companies, have the implicit guarantee of the state and have large outstanding debts to government-owned banks. If public enterprises can continue to access unlimited credit from the banking system by exercising implicit state guarantees, the holding company would have failed to fulfil the function of imposing
financial discipline in the form of a binding budget constraint.

There are significant differences in this regard between different countries’ holding companies and the enterprises below them. In the case of Italy, it is true that the government’s share in bank ownership has been high, and both banks and industries have in some instances belonged to the same holding group, but these were not captive banks, and the proportion of their business which came from enterprises in the same group was not high. The public enterprises, in turn, frequently used several banks each, not necessarily in the public sector. There have also been strict regulations against the direct ownership by banks of industrial enterprises. By contrast, in Egypt, public enterprises have been the largest clients of large public sector banks, which effectively provided credit to them with few constraints. The banks’ activities too were highly regulated, for example in terms of interest rates, with subsidized rates for public enterprises. Although direct government subsidies to public enterprises have been increasingly limited since 1987, indirect subsidies in the form of easy credit through the banking system continued. In 1991, new regulations were introduced to restrict such credit. In Algeria, there was a major problem of excessive public enterprise indebtedness to the banking system and a high proportion of non-performing loans. Algeria is now attempting to recapitalize its banks and sterilize them against the public enterprises. The new holding companies however hold shares in not only the banks but also, frequently, in the enterprises which are their major clients, and in practice these are the sole banks for these enterprises. This could weaken their capacity to safeguard the financial interests of both the enterprises and the banks.

2.5 Structure: Vertical Linkages, Monitoring and Accountability

The nature of the links of a holding company to the government will in large measure determine the extent of its independence and authority. A large range of forms exist. In the case of a single holding company, this could come directly under a single specialized ministry, jointly under two or three ministries, or be directly answerable to parliament or the head of government. In the case of multiple holding companies, all the above are possible; in addition, particularly if organized along sectoral lines, they may each be answerable to a different ministry.

Parallel to this structure are regulations concerning (i) the reporting requirements, (ii) decision-making authority, and (iii) appointment of the holding company Board. Clearly an emphasis on routine reporting requirements to one or more ministries (such as quarterly reports on production) would tend to reduce a holding company to becoming 'just another layer'. The level of decisions for which government approval is required is also an issue; is this required only for decisions such as major investments, mergers, liquidations, or capital issues, or is it also necessary for changes in product mix? In terms of the composition of the Board, are they civil servants or experienced professionals from outside the public sector? By whom are they appointed? What associations do they have with political parties? Are Board members full time or part time, and what is the length of their term? Experience would suggest that professional Boards, appointed by the highest levels of government, independent of both the civil service and the political system, with outside experience, appointed for terms long enough to permit them to accomplish major tasks, but without the possibility of unlimited renewal, are desirable. In terms of composition, many countries allocate Board positions to special interest groups, particularly labor (eg. Egypt) and the consequences of this require examination. Equally, the presence or absence of non-executive external Board members requires assessment.
The links between the holding company or companies and its/their subsidiary holdings, or operating companies, can also range from extreme control to total delegation. Should the holding company, in its capacity as owner, be able to appoint the boards of lower level holdings and should these in turn appoint those of operating companies? If a holding company is to exert authority, such rights are required, especially if the alternative is direct ministerial appointments of lower level directors. At the same time, the authority of the operating companies could be undermined, if for example, the power to alter such appointments is unlimited. Thus in holding company models where the chairman or directors of the holding company are executive chairmen on the boards of their subsidiaries, the chief executive of the operating company has a limited role. Similarly, it is evident that direct links between the government and subsidiary companies make the holding structure ineffective and redundant. This is frequent and systems which permit it are not equipped to draw significant benefits of ‘decentralization’ from the state holding company structure.

The desirability per se of more than one level of holding also requires examination. In countries where the entire public sector is organized under holding companies, this usually permits the existence of a conglomerate style superholding with sectorally organized subholdings. The advantage is that interface with the government is restricted to one point, and that lower level holdings or operating companies are closer to an independent private environment. However, these advantages will not be apparent if a hands-off approach is not adopted; in circumstances where lower levels have relatively little independence this may also add to the layers of decision making. For reporting requirements and decision-making authority, similar considerations apply as between the holding company and the government.

The framework of accountability set up for the holding company requires scrutiny. Many mixed economies have special auditing procedures for government enterprises (e.g. India) and sometimes the holding company is subject to the same procedure as its subsidiaries. Provided, however, that an adequate framework of independent external audits exist in the private sector, these could also be used for public enterprises under the holding company. The reason for separate audits is usually that these firms may be subject to different criteria or have special obligations, which are not likely to make for efficiency.

A question which may be asked in this context is, to whom should the holding company itself be accountable? In a state holding company, the answer is usually the government. However, this is not evident, as the interests of the enterprises’ creditors, and the general public also require protection. If private participation is permitted, the more general issue of accountability to shareholders arises, in particular of minority shareholders, if privatization is gradual. Auditing or monitoring the holding company itself may require more rigorous procedures, particularly where the company is accorded reasonable independence. In some countries special parliamentary standing committees have been set up to monitor the holding company. Whether this is an effective device for ultimate accountability in combination with adequate day to day freedom requires examination. Multiple auditing and monitoring procedures exist in some countries (e.g., India).

2.6 Portfolio: Share Ownership Distribution

In the state holding companies of the 1970s and early 1980s, the holding company, or a group of sectoral holding companies, would usually hold a hundred percent of the shares of their subsidiary operating companies. However, in some cases, this shareholding may be diluted, and some part of the
shares may be held by either domestic private individuals or companies, overseas individuals or corporations, by other, parallel holding companies or by different organs of the government. The dilution of ownership may be historical (government joint ventures with the domestic or overseas private sector subsequently transferred to holdings) or deliberate. Deliberate dilutions could be part of a government plan to either dilute the power of a given holding company over an enterprise by bringing in multiple owners (the Algerian model) or, to gradually privatize enterprises by diluting aggregate public shareholding, or merely to raise additional equity capital from the market without the principal intention of divesting control.

More recent state holding groups have deliberately attempted to reduce the share of a given holding company in any specific enterprise, to reduce the possibility of excessive dominance of the enterprise. Conceptually, at the other extreme of a continuum, which begins with the wholly-owned subsidiary, is the 'asset-management' company, which has a very limited share in a large number of enterprises, over which it has limited control. It can still however increase its own revenues by trading shares to improve the expected income of its portfolio. Such mutual fund type of holdings, until recently, were rare in liberalizing developing countries (probably in part because the constraints on share trading) but are now appearing in transforming economies trying to undergo rapid privatization. The advantage of this form of distribution lies in the dilution of the power that can be exerted on it by a single owner. The drawback may be that highly dispersed ownership, particularly in the absence of an active stock market and the threat of mergers or takeovers may fail to discipline enterprise performance and in particular may give undue power to managers.

Holding companies close to the wholly owned model would gain some advantages from portfolios of groups of similar enterprises, in the same sector, asset management type holdings with small shares in their enterprises would be able to reduce their risks with more diversified portfolios. ‘Sectoral’ holding companies need not imply a monopoly situation, provided there are sufficient additional enterprises in the sector outside the holdings in either public or private hands. Frequently, however, the presence of import controls and trade barriers lead to this result. If departures from the hundred percent ownership pattern by a single government holding company are permitted, there are two possibilities; a dilution among different government agents, or a dilution directly with private shareholders. Examples of the former are the institutional ownership of German firms by government and private financial institutions, or the dispersal of shares among different holding companies (Algeria, Poland), or different regional governments (Nigeria, and proposals for China). Examples of partial holdings by private shareholders have in the past been the result of historical circumstance; typically, nationalization with less than a hundred percent government takeover (Egypt, Zambia). However, deliberate divestiture to the

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28/ In this sense, no fundamental distinction is drawn in the present study between 'holdings' and 'investment funds'. Taken in their broadest sense, these are both forms of indirect state ownership, with varying degrees of shareholding in the enterprises below them. As the proportional share of a holding in its enterprises is reduced, it moves from the classic 'holding' to the classic 'asset management' models. However, there are no absolute dividing lines and the distinction between a majority and minority shareholder, though significant, is not determinate, as far as the role of the holding is concerned. The role adopted will also depend on the distribution of the balance of the shares. A minority but 'core' shareholder with 30 percent of the shares in an enterprise, where the rest of the shares are widely dispersed, may have greater powers than a 40 percent shareholder if there are two other shareholders with, say, 30 percent each.

private sector is now increasingly frequent (Italy). Distribution of shares among different government agents would signal a reluctance on the part of the government to allow its public enterprises to operate independently, and is probably less desirable, in terms of promoting efficiency, than dilution with private shareholders. It may however be the only political possibility in some circumstances. For the reasons described above, there may also sometimes be a case for limiting the dispersal of shares, to maintain enterprise discipline, whether among private or public shareholders.

Examples of the vertical structure and portfolio distribution of state shareholding corporations in some selected countries are given in Figures 2.1 - 2.5, which illustrate the considerable flexibility and variety in these patterns. The Italian case, which is illustrated in Figure 2.1, illustrates a number of the points raised above. First, at the level of the government, there have clearly been an excessive number of layers, with two interministerial committees, over a special Ministry for State Holdings. However, the holding structure itself is multi-tiered, with powerful apex institutions, which provide a direct, and sole, interface with the government. The subholdings below it are traditionally sectoral, and tend to hold the bulk of the shares of the enterprises below them. However, there are some remarkable elements of flexibility. First, the allocation of ownership in operating enterprises to the private sector is possible, and the percentage holding of the private sector may vary. The private sector may also hold shares directly in the sectoral subholdings. There is a similar flexibility in terms of ownership by level of holding. If the apex company considers an enterprise particularly important, it may hold shares directly in it. Some cross-ownership of shares among different sectoral subholdings is also possible, though rare, and usually the outcome of the breakup of older structures. It is also possible for an operating enterprise to set up its own holding structure, if it chooses to do so, for managerial reasons. The fluidity of the structure is therefore significant.

The case of Egypt, in Figure 2.2, has by contrast been extremely rigid. From 1983 to 1991, virtually all its state enterprises were allocated among thirty eight sectoral holding companies. There was no apex holding institution, and the holding companies were assigned to sectoral ministries in the government. All the shares in each enterprise were held directly and entirely by the holding company to which it was assigned. There was no possibility of share transfer among holdings, or between these public enterprises and the private sector. In 1991, Egypt introduced a new public enterprise law, which altered the vertical structure of its public enterprise holdings. Holdings were no longer required to be sectoral, and they no longer answer to line ministries. A new Public Enterprise Office has been created, below the office of the Prime Minister, which is the apex institution above the new holdings. Other legal and managerial changes have been introduced at the same time. Shares in companies are at present still entirely assigned to a single holding company. However, trade in the shares of these enterprises through the stock exchange is to be permitted. Changes in the composition of the Boards of enterprises introduced in parallel will also reduce the possibility of government intervention in the operations of these enterprises.

Algeria (Figure 2.3) represents the first example of significant portfolio diversification. Although the eight holding Funds in Algeria, set up in 1988, are sectoral in character, they do not hold all the shares of the enterprises in their sectors. The largest single shareholding in each enterprise is allocated to its sectoral fund, and this is the ‘dominant’ shareholding. The dominant shareholder thus has a primary interest in the doings of the enterprise. However, the dominant holder is not a majority holder and the dominant share is between 35 and 40 per cent. This was a deliberate attempt to limit the power

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30/ A ministry could have one or more holding companies in its charge. There were six holding groups below the Ministry of Industry, for example.
that could be exercised over the enterprises by their dominant funds. The remaining 60 to 65 per cent of the shares are distributed between two or three other funds, with fairly large shares going to each. Thus two minority shareholders could in principle block the decisions of the dominant shareholder.

This model also represents an attempt at portfolio diversification, as each fund holds minority shares in a number of sectorally varied enterprises, and is expected to try to earn returns on its portfolio. Trade in shares is technically feasible, among holdings, or among public enterprises (though not with the private sector), but in practice share transfer is severely constrained by difficult legal requirements for such transactions. The Algerian model is thus a hybrid, which attempts to be an interventionist holding at the same time as a hands-off portfolio manager.

The similarity of some of the new holding Funds appearing in East European countries today to these earlier examples is evident from the illustrations of Poland and Romania. Poland (Figure 2.4) proposes the establishment of National Investment Funds which share many similarities with the Algerian pattern. In both cases, the dominant, but not majority, shareholding in an enterprise goes to a single fund, and residual shares are distributed among several other funds. However in Poland the role of the dominant fund, for a given enterprise, is stronger, as the residual shares are fragmented among all remaining fifteen to twenty proposed funds. However in this case too, the funds are required to take on the dual functions of asset managers (of the very diverse small shareholdings in their portfolios) and of enterprise managers, in those enterprises where they have a large stake.

There are two other interesting features of the Polish case, from this perspective. First, the government continues to maintain a significant residual shareholding, almost as large as that of the dominant fund. How the government chooses to exercise ownership rights in its fund is therefore significant. At present, it is debating the transfer of these shares to a 'sleepy' institutional shareholder, such as the social security or pension fund. Shares have also been distributed to employees. The second significant feature is that the National Investment Funds themselves are not held by the government, but by private individuals, through vouchers, to be distributed to all adults, in all funds. Individuals will then be able to trade shares in the Funds through these vouchers, when they become practically transferable. However, despite the real long run significance of this private ownership, these highly dispersed private owners today are no more able to exercise control functions than the owners of a large joint-stock corporation (and without the existence of the managerial or capital markets that enable these to function). For the present, it is still the government which defines the system of operation of the new funds.

The case of Romania is also illustrated (Figure 2.5). The private ownership here operates in a fashion similar to Poland, but the five private ownership funds here do not have 'dominant' and 'minority' enterprises. Seventy per cent of the shares of all public enterprises are still to be retained by the state, and the remaining thirty per cent are entirely allocated to a single fund. Given the maintenance of control by the government and the large number of enterprises per fund (around eight hundred), these funds too may emphasize portfolio management functions.
Figure 2.1  Italian State Holdings: Ownership and Vertical Structure

Government → CIPE → CII

Government → [Ministry of State Holdings]

Apex Holding Companies (IRI, ENI, EFIM)

Sectoral Subholding 1
- Enterprise 1

Sectoral Subholding 2
- Enterprise 2

Sectoral Subholding 3
- Enterprise 3 (2nd level subholding)

Sectoral Subholding n
- Enterprise j

CIPI Interministerial Committee for Industrial Programming
CIPE Interministerial Committee for Economic Programming

Enterprise Ownership:
- Government, through sectoral subholding company 1
- Private ownership (also possible in subholding)
- Shares held by subholding of another sector; subholding 3
- Direct apex holding company ownership
Figure 2.2  Egypt: State Holdings under Laws 97 and 203

A. Law 97 (1983)

- Government
- Ministry 1
- Ministry 2...
- Ministry n

- Sectoral Holding 1
- Sectoral Holding 2
- Sectoral Holding 3
- Sectoral Holding 38

- Enterprises 1 - i of Holding 1

B. Law 203 (1991)

- Government
- Public Enterprise Office

- Holding 1
- Holding 2
- Holding 3
- Holding 20 (approx)

- Enterprises 1 - x of Holding 1
- Enterprises 1 - y of Holding 20
Figure 2.3 Algerian State Holdings: Structure and Portfolio Distribution

[Diagram showing the structure and portfolio distribution of Algerian State Holdings, with lines indicating the flow from the Government to Shareholder's Assembly of Participating Funds (Ministers or Ministerial Level), and details on sectoral funds and enterprises with percentage holdings.]
Figure 2.4  Poland: Proposed Portfolio Distribution of Investment Funds

Private Individuals

Government

Employees

Funds

National Investment Fund 1

National Investment Fund 2

National Investment Fund 3

National Investment Fund n

(n=15 to 20)

27% distributed among all other Funds

Enterprise 1

Enterprise 2

Enterprise 3

Enterprise 4

Enterprise j

30% 10% 33%
(Core enterprise)

30% 10%

30% 10%

30% 10%

30% 10%

30% 10%

(To govt. financial or social security institution)
Figure 2.5  Romania: Private Ownership Funds and the State Ownership Fund

Private Ownership Funds and the State Ownership Fund

Individuals

Government Fund (State Ownership Fund)

POF 1  POF 2  POF 3  POF 4  POF 5

Enterprise 1 →
70% 30%

Enterprise 2 →
70% 30%

Enterprise 3 →
70% 30%

Enterprise 4 →
70% 30%

Enterprise j →
30%

POF 1  POF 2  POF 3  POF 4  POF 5
Part III. Holding Company Performance: Criteria for Assessment

The question of how holding company 'performance' is to be assessed poses some difficulties. The most usual measures of improved performance would be some index or indices of efficiency such as increases in output, productivity, improved financial performance, or, with greater difficulty, improvements in allocative efficiency such as increased returns on new investments. However, as described above, additional responsibilities have been given to holding companies in economies attempting to bring about major reforms in their economic systems with the aim of increasing the role of market forces. These specific responsibilities include the creation of a new class of effective managers, the reorientation and restructuring, if necessary, of poorly performing enterprises, the stimulation of capital markets through trade in shares of the enterprises of the holding company, the introduction of greater financial discipline on enterprises, their insulation from the financial system, and a reduction in the state transfers they receive. While 'good performance' in these areas should translate into increased efficiency as measured by the indices described above, this is a composite index which does not reflect other special roles accorded to the holding group. The direct assessment of the achievements in the specific areas of concern to governments in transition is of intrinsic value. Indices of performance, relevant to the evaluation of holding companies in countries attempting to move towards the greater use of market forces are discussed below.

3.1 Financial Performance and Financial Role

While the financial performance of state holding companies must be examined, it must be remembered that these financial results alone are not an adequate index of performance. The relative financial performance ascribed to the holding structure cannot be easily isolated through time series data on financial results of public enterprises before and after the establishment of holding companies in a given country, if these exist on a major scale, due to the considerable influence of other macroeconomic variables. Policy differences across countries would make cross-country data equally difficult to handle, and the explanatory power of the holding company variable would probably be dwarfed by other factors. Cross-section comparisons (the performance of private versus public enterprises in a given country) will be biased by invariable differences in respective sectoral composition. Besides, these can only be used in economies which have significant private sectors already. The analysis of the financial statements of the holding companies nevertheless has intrinsic value, as it throws up interesting and relevant information on the difficulties of financial accountability which may arise with such holding groups as well as the procedures of financial management adopted by different holdings.\textsuperscript{31}

A holding company may also adopt other financial responsibilities vis-a-vis its subsidiaries, in particular, it may raise loans on their behalf, getting better terms on the financial markets than some of its subsidiaries. It could also give guarantees on loans engaged in directly by its subsidiaries. If used with discretion, this may help subsidiary companies, particularly those embarking upon new or high risk

\textsuperscript{31} One case which has been examined in detail, where it was possible to associate financial performance and holding company structure, however, was Egypt, where there were significant shifts in the structural form of the holding companies examined over the period considered. Even in this case, changes in other major policy and regulatory variables obscure the cause of shifts in financial performance.
projects. However automatic guarantees, or the implicit guarantee of the government, will be detrimental to the long run efficiency of subsidiary companies. The extent to which a holding company is permitted to exercise these functions, and is then able to responsibly execute them, would be an element in its evaluation.

3.2 Non-Financial Obligations: Insulation from the State

Public enterprises are frequently used by governments to achieve non-pecuniary objectives. Strong and direct governmental control makes it difficult for enterprises to resist such pressures. If holding companies help achieve ‘decentralized’ management of public enterprises, such pressures should either be reduced, or at least be made more transparent and subject to negotiation. Such non-financial objectives typically include the provision of social amenities or services to large groups of persons, the maintenance of employment even when it can be shown that this is uneconomic, or the development of economically backward regions. In more extreme cases it could also refer to personal rather than social ends, such as the special use of influence to appoint key personnel or the provision or maintenance of special perquisites to government officials. The issue to be examined is the extent to which such non-financial obligations to the state or its representatives exist, and whether, if they do, are they subject to dialogue, discussion and compensation.

3.3 Enterprise Restructuring

The ability to carry out effective restructuring is of special interest in the context of economies which are going through a major process of transformation. Rapid changes in the operating framework and rules necessarily imply that enterprises which may have been considered successful in the former system will run into difficulties in an altered regime. As a result, these enterprises may require a change in output mix or the overall orientation of their activities. They may also require a modification in their production techniques or distribution networks and systems. The enterprises themselves lack the experience to undertake such a reorientation, which is rendered more difficult by their unfamiliarity with operations in a market economy. External assistance is required for this orientation, and this is where a government may create a holding company and entrust the enterprises to its charge for the duration of this process or for a longer period.

The advantage of the holding group, it may be argued, is to coordinate the process of restructuring of large numbers of enterprises, particularly if these are in the same sector. Qualified personnel are typically scarce and these may be spread over a large number of enterprises. In other words, scale economies apply. Even if external or overseas consultants are brought in to work out the details of restructuring, a national entity is still required to coordinate and oversee their work. Thus the Treuhand of Germany is assuming some of the responsibilities of restructuring, in particular to ensure that certain national objectives, such as avoiding mass layoffs, are respected. The holding companies of Algeria have also been entrusted with the restructuring of certain categories of state enterprises.

The creation of state holding companies for the restructuring of enterprises is not new and need not be restricted to public enterprises. IRI of Italy was established to restructure enterprises which had failed, and whose assets were, through a complex process, acquired by IRI. The purpose of the GEPI
of Italy is to acquire private enterprises which are performing poorly, to restructure them and improve their performance, and then eventually to restore them to private hands. The extent to which restructuring will be an objective of some of the new holding entities in East Europe, particularly those holding large blocks of shares, is still to be determined.

3.4 Share Trade and Transfer: Capital Market Stimulation

Have the state holding groups concerned been able to sell or transfer shares? This depends first on the degree of flexibility permitted to the holding companies to undertake this. Frequently, changes in the initial ownership pattern are not possible, or are possible only with considerable legal difficulty. If share transfer is possible, has the holding group been able to make use of this to stimulate the capital market? In practice, the development of an active investor’s market among public holding companies, or even exclusively among public entities has not occurred in any of the countries examined. If sales of shares to private entities is permitted, this will still depend on the methods used for divestiture. Greater use may be made of the stock market for investment funds through the issue of new equity, or through sales of existing shares. If companies are sold through public offerings rather than private placements, this could contribute to the achievement of this objective. In Italy, new offerings by IRI enterprises, intended to raise capital greatly increased the activity of the Milan stock exchange from 1985 to 1987. However, enterprise sales undertaken by the Treuhand of Germany were mostly by private placement.

3.5 Divestiture and Privatization

As described in the first section, in many cases, particularly in the new state holding institutions in East Europe, privatization is a key objective. The issues to be examined in this context are, first, the extent to which significant privatization has indeed been achieved, for the enterprises under a state holding group. Even if sales of shares to the private sector are permitted, this may be restricted to 49 percent. Alternatively, share transfer or a dilution of the government’s shares may be possible, but with restrictions on the voting rights of the new owners. A reluctance of the government to relinquish controlling rights will not inspire confidence in the prospective new owners and apart from lowering the share value, will also have a lesser impact in terms of the outside discipline brought to bear on the enterprise. The greater the flexibility provided for in share transfer, the greater the capacity to discipline the enterprises.

Second, even if privatization has been achieved, has the holding company had a significant role in this process? In some cases, this has provided the raison d’être for the holding group, for example with the Treuhand of Germany. In other cases this is a secondary objective. Even where the objective is considered important, the role of the holding company may be subordinated to another agency. In cases where significant privatization has been achieved, the real contribution of the holding company to the process of privatization still requires separate assessment.
3.6 Financial Transfers to and from the State

A holding company may or may not be expected to earn a certain dividend on its portfolio. The extent to which there are provisions for a rational process of decision making on this transfer, which permits the holding company to evaluate the requirements for reinvestment in its enterprises must also be examined. While on the one hand the government would be expected to earn an income on its assets, on the other, the holding company should have the flexibility and independence to increase or reduce its retention. In cases where this flexibility is limited, and dividends have to be paid at all costs, enterprises may gradually become undercapitalized for lack of reinvestment. This also illustrates the distinction between a more active or interventionist holding company and a sleepy holding institution playing a more perfunctory role.32/

Are there any reverse financial flows, or transfers from the government to holding companies or their subsidiaries, and what form do these take? The first question in this context is, has the holding company been able to impose financial discipline on the public enterprises it holds, and limit such transfers? If there are routine transfers for injections of new capital, particularly where this is to cover current or accumulated operational losses, it implies that the holding company structure has not assisted the imposition of a ‘hard budget constraint’ on its enterprises.

The second issue in this regard is, if transfers continue, what is the form of these transfers? Assessing this is sometimes difficult because transfers need not be transparent. The forms adopted by such transfers may include preferential access to various special funds, extraordinary or earmarked transfers, assistance with loan servicing even when funds are borrowed from external sources, etc (Italy). Even if transfers continue, the extent to which the holding company has a role in their negotiation, and is a direct conduit for their distribution, is of significance. It can be argued that direct and transparent budgetary transfers going through a single conduit are superior to a series of indirect and opaque transfers, for example through price support schemes or through the banking system. In the case of direct transfers, there may be a role for an active holding company as the sole negotiator on behalf of its enterprises. If transfers are indirect, the holding company becomes a structure of less relevance.

3.7 An Empirical Analysis

A detailed examination of the holding company structure of three countries was undertaken, using the framework of characteristics and performance criteria described here. The results are summarized in the following table, which illustrates the extreme diversity in characteristics, and considerable variation in performance, of holding companies in three cases; Italy, Egypt and Algeria. Holding structures in other countries, including developing countries and the newly emerging economies of some east European countries, have also been examined. Can any general conclusions be drawn from these results? The answer is that some consistent patterns do emerge, which are discussed in the following section.

Table 3.1  A Comparison of Holding Companies: Italy, Egypt and Algeria

<table>
<thead>
<tr>
<th>Italy</th>
<th>Egypt</th>
<th>Algeria</th>
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<tbody>
<tr>
<td>1. Basic Objectives of the Holding Company(ies) and public affiliated enterprises.</td>
<td>i. Original objective: Takeover and restructuring of loss-making enterprises, restoring these to private ownership. ii. Undertaking investments in areas where the state has an advantage due to large size or high risk.</td>
<td>i. General Organizations: Facilitate management of nationalized and newly established state enterprises. ii. Public Sector Authorities: Increased autonomy to public enterprises, under the aegis of line ministries. iii. Holding Companies and affiliated companies - Further increase in autonomy and separation from line ministries</td>
</tr>
<tr>
<td>2. Legal Code for Holding Company and affiliated public enterprises.</td>
<td>i. Affiliated companies operate under standard private commercial law. ii. Special charter for apex holding companies which makes them Autonomous Management Agencies directly under a special ministry, cabinet committees and parliament.</td>
<td>i. Under PSAs: Public enterprises were corporate entities under a special law; Law 97, wholly owned by the government. ii. Under HCs: Both the enterprises and new holding companies are corporate joint stock companies under a new special law; Law 203, and are required to be quoted on the stock exchange. The PEO above the HCs is a government office under the Prime Minister. Law 203 only specifies certain particular provisions for ACs; the law for private enterprises Law 159, applies in other cases. EPEs and the Participating Funds are both joint stock companies of a specific form (société par action) and subject to special laws (Laws 88-01 to 88-06).</td>
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<tr>
<td>3. Policy Framework</td>
<td>i. Basically a liberal market economy, but with residual price controls affecting PEs, as well as anti-competitive restrictions particularly in the financial sector, which are now being reduced.</td>
<td>Highly regulated environment in the 1970s and early 1980s. Substantial liberalization now under way and already achieved in areas such as prices, foreign exchange etc. Marked move from central planning towards a market economy since 1986 in many areas of the economy, in parallel with enterprise autonomy and fund creation.</td>
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<tr>
<td>4. Vertical Links</td>
<td>Italy</td>
<td>Egypt</td>
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<tr>
<td>1. Multiple layers. Two cabinet committees and a parliamentary committee over an apex holding company with subholding companies and affiliated companies below this.</td>
<td>i. Under Law 97: (a) Three layers - line ministries in the government, PSAs and PEs. Vertical responsibilities confused - chairman of Board of subsidiary PE also on board of PSA.</td>
<td>i. Two layers; the EPEs and the Funds. Over the Funds there is a body vested with the authority of a shareholders' assembly, which has so far consisted mostly of ministers.</td>
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<tr>
<td>ii. Clear, if cumbersome, allocation of responsibilities between layers; reasonable autonomy to lower level companies.</td>
<td>(b) Range of functions accorded to PSAs was supervisory rather than executive.</td>
<td>ii. The state reserves the right to have direct links with enterprises through the PMTE and through EPE Board nominations.</td>
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<td>iii. Single point of contact with government. No direct government links to enterprises.</td>
<td>(c) Direct links between government and operating PEs through ministerial representation on PE Assembly and ministerial nomination of PE Board.</td>
<td>iii. Two workers representatives on EPE Board.</td>
</tr>
<tr>
<td>iv. Clearly political appointment of heads of HCs but some insulation of apex holding from government through technical experts on its Board, who are also on the Chairman's Board.</td>
<td>(d) Board drawn from inside enterprise. External professionals, if appointed had no voting rights. Labor representatives make up half the Board.</td>
<td>iv. Restrictions against private Board members for EPEs, though no restrictions against EPE employees.</td>
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<tr>
<td>v. High degree of stability in chief executives.</td>
<td>(e) Extensive reporting require -ments of PEs to both PSAs and line ministries. Need for multiple points of government approval for decisions on prices, investments, imports, etc.</td>
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<td>vi. Remuneration to operating company Board members stand- ardized on size of company.</td>
<td>ii. Under Law 203: (a) Three layers - the PEO, HCs and ACs. No direct contact with line ministries. Also no direct contacts of ministries/government with enterprises.</td>
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<td>vii. Staff salaries of lower level companies are freely negotiable, with performance - linked incentives.</td>
<td>(b) PEO has a monitoring and strategy setting role, with special executive powers to set up the HCs and to undertake privatization.</td>
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<td>(c) HC Board does not include chairman of subsidiary enterprises. But external professionals now are part-time only.</td>
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<td></td>
<td>(d) AC Board now nominated by HC Board. Still includes 2-4 workers representatives.</td>
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<tr>
<td>Monitoring and Auditing</td>
<td>Egypt</td>
<td>Algeria</td>
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<tr>
<td>i. IRI itself has a Board of Auditors which includes persons from the civil service and representatives from the State Court of Accounts who attend all IRI Board meetings. Annual auditor's report on IRI is presented to parliament.</td>
<td>i. Audits of public enterprises have been undertaken by the Central Audit Office and this system will continue. Efficient private audit services exist and can be undertaken for the new HCs and ACs but in addition to and not in lieu of the government audit.</td>
<td>i. External auditors appointed for EPEs and Funds. However, audit profession is just beginning to develop in Algeria.</td>
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<tr>
<td>ii. Private audit of affiliated companies. Restrictions on renewals of auditors' appointments. Boards of operating enterprises include auditors.</td>
<td>ii. An auditor from the Central Audit Office is required to be present at the HC General Assembly meeting.</td>
<td>ii. Enterprises have also been asked to tighten up their 'internal audits'</td>
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<thead>
<tr>
<th>Accounting Practices</th>
<th>Egypt</th>
<th>Algeria</th>
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<tr>
<td>i. Consolidated accounts + HC's own accounts routinely maintained. Some differences compared to a standard civil balance sheet, on the treatment of capital gains and subsidiaries' losses are now being eliminated.</td>
<td>i. Egypt's PSAs produced aggregated (though not consolidated) financial statements for all their companies.</td>
<td>i. Algeria's Funds produce the holding company's own financial statements only. Losses of subsidiary companies are not reflected.</td>
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<tr>
<th>Financial Obligations and Responsibilities; Links to the Financial Sector</th>
<th>Egypt</th>
<th>Algeria</th>
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<tbody>
<tr>
<td>i. Apex HCs can raise loans for the subsidiary HCs or operating companies, or, more commonly, provide guarantees for these loans.</td>
<td>i. PSAs could give state guarantees for loans, but these were implicitly present in any case.</td>
<td>i. The Funds can give all necessary guarantees and provide caution money on behalf of their enterprises, and are encouraged to do so for restructuring purposes.</td>
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<tr>
<td>ii. Direct explicit government guarantees also exist, with government undertakings to repay some or all of special EIB loans.</td>
<td>ii. Under the new Law 203, HC guarantees may not be given except in special cases with permission from the Ministry of Finance and a 5 percent cautionary deposit.</td>
<td>ii. All banks are government owned. Shares in banks are distributed across the Funds who also hold shares in EPEs. Funds can and do hold shares in both the enterprises and</td>
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<tr>
<td>7. Financial Obligations and Responsibilities; Links to the Financial Sector (contd.)</td>
<td>Italy</td>
<td>Egypt</td>
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<td>iii. State ownership of many banks and apex NC ownership of substantial shares in commercial banks. These banks in turn hold large shares in term lending credit institutions. But banks are not allowed to hold shares in industrial enterprises.</td>
<td>iii. State ownership of four largest commercial banks, which account for 80% of commercial bank assets. These four banks hold large shares in many other commercial banks. Public enterprises are the principal clients of the four large banks.</td>
<td>iii. In the past, PEs had automatic access to bank credit for Plan-approved projects. Now lending is at banks' discretion, but problem of arrears of doubtful past debts remains. Enterprise and bank recapitalization program now under way.</td>
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<td>iv. No evidence of preferential treatment of HC-owned subsidiaries by HC-owned banks. Internal lending limits imposed by Central Bank, which is also represented on the Board of the apex NC, may assist to reinforce discipline.</td>
<td>iv. PE relations with banks have been direct and independent of PSAs. Clear that today much of the bank’s PE portfolio is doubtful, but so far this has not been dealt with. Indirect state transfers to PEs through banking system.</td>
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<tr>
<td>v. New banking regulations now being introduced which, inter alia, further clarify the separation of industry and banking.</td>
<td>v. No preferential terms of credit or explicit/implicit guarantees for public enterprises under new system, but banking sector's ability to impose a hard budget constraint is not clear.</td>
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<tr>
<th>8. Share Distribution and Share Transfer</th>
<th>Italy</th>
<th>Egypt</th>
<th>Algeria</th>
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<tbody>
<tr>
<td>i. Broadly subsectoral structure of separate apex holding. Multiple layers of subholdings also exist.</td>
<td>i. Under Law 97: Exclusively subsectoral structure of subholdings, with usually 100% of the shares held by a given PSA. Some rare cases of small private shareholdings, due to historic circumstances of nationalization. Negligible significance.</td>
<td>i. Combination of large holdings in a given EPE by a 'dominant' Fund, and a dispersal of the remainder of the shares between other Funds. Usually 3-4 Funds per enterprise.</td>
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<td>ii. Flexible and variable pattern of share distribution across levels and entities. The apex NC may directly hold shares in a lower level subsidiary company, the subholding company may itself be an operating company. Cross-holdings also exist but are rare.</td>
<td>ii. Under Law 203: (a) Smaller number of NCs envisaged, relative to old PSAs, with 'diversified portfolios'. However, process of organizing this, entrusted to PEO, has not begun. (b) All ACs will be quoted on stock exchange and share sales to public or private entities is permitted. (c) If AC shares are sold to another public entity, the government will decree to which NC the AC will be affiliated. (d) It is implied that voting rights for different public owners may not be strictly proportional to their holdings)</td>
<td>ii. Initial limits on maximum and minimum shares held by a given Fund, of 40% and 10%, which have since been lifted.</td>
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<td>iii. Partially private share ownership in some subsidiaries. Until recently only up to 49% but now greater transfers to private owners are beginning.</td>
<td>iii. Broadly sectoral allocation of enterprises to 'dominant' funds; dispersal of remaining shares among 2-3 other Funds.</td>
<td>iii. Broadly sectoral allocation of enterprises to 'dominant' funds; dispersal of remaining shares among 2-3 other Funds.</td>
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<tr>
<td>iv. Share transfer possible up to limits set by prevailing government policy, through private placements, sales on the stock exchange for quoted companies, etc, to public or private entities.</td>
<td>iv. Share transfer/transferlegally possible between Funds and between EPEs, but not to private persons or entities.</td>
<td>iv. Share transfer in practice difficult due to restrictions on form of enterprise, lack of appropriate asset valuation and requirement that trade occur at nominal value, etc.</td>
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<tr>
<td>8. Share Distribution and Share Transfer (contd.)</td>
<td>Italy</td>
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<td>9. Privatization and Liquidation</td>
<td>i. No real legal obstacles to share transfer to the private sector. However, periodic political decisions on privatization which implicitly set limits on this. Active role taken by NC in the privatization process. Significant dilution of public ownership in mid-1980s mostly through new share issue, and issue of convertible bonds/warrants, as well as some sales of existing shares. However, only up to 49%. Some HC privatization initiatives curbed by government. Some HC privatization initiatives curbed by government.</td>
<td>(d) Trading of the capital of the HCs is only possible among public entities.</td>
<td>i. Privatization is a part of the overall policy change agenda which introduced the new HCs. Once ACs are quoted on stock exchange, sales to private buyers will be eased for firms formerly under Law 97. Meanwhile, plans for direct sales/divestiture of government holdings of other public or (especially small enterprises) are being implemented.</td>
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<td>ii. Assistance to development of capital market through new listings.</td>
<td>ii. Asset sales of public enterprises to private buyers are permitted and liquidation is possible with the agreement of the Shareholders Assembly (extraordinary meeting). Such a meeting must be convened when losses amount to half the paid-up capital of the enterprise.</td>
<td>i. Privatization was not on the reform agenda. Asset sales to private entities only possible in discrete lots (an entire production line cannot be sold) and if the machine is no longer useful. Share sales to private individuals or entities are not permitted. Liquidation is theoretically permitted but the state has the power to stop this if special circumstances justify this.</td>
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<td>iii. New wave of privatization from 1990-1991, of up to 100% divestiture.</td>
<td>iii. New wave of privatization when losses amount to half the paid-up capital of the enterprise.</td>
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<tr>
<td>10. Restructuring</td>
<td>i. Active and apparently successful role in enterprise/subsector restructuring.</td>
<td>i. Very little evidence of any role taken by PSAs or new HCs in the restructuring of their enterprises. Many enterprises appear profitable due to old and fully depreciated equipment which will however require rationalization.</td>
<td>i. Considerable attention to financial restructuring of PEs before and after their passage to autonomy. The process has however been organized mainly through an independent agency, the COREP, and later by the National Planning Council.</td>
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<td>ii. Greatly assisted in this process by continuous government modifications of labor laws to give greater flexibility on labor transfer/redeployment, and to directly reduce the costs of this by financial support for labor redundancy payment schemes. Unusual and effective labor restructuring scheme - the CIG.</td>
<td>ii. A major difficulty faced by firms wishing to rationalize/restructure is the labor legislation which does not provide for dismissal/redeployment on economic grounds and makes the process of labor force reduction very difficult. There is no legislation on severance pay, and there are several legal obstacles to the stoppage of production. Strong labor representation on PE Boards reinforces this.</td>
<td>ii. The preparation of plans for the physical restructuring of large loss-making enterprises which are not yet autonomous has also begun, again under the Planning Council. Restructuring options are limited by constraints on asset sales and enterprise closure.</td>
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<td>11. Government Obligations and Transfers</td>
<td>Italy</td>
<td>Egypt</td>
<td>Algeria</td>
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<td>I. Special government obligations for regional development, additional employment creation, etc., have been imposed. The costs of these, however, are now estimated by the HC and appropriate compensation is received.</td>
<td>I. General government objectives of developing basic industry, creating employment, defending the rights of labor, etc.; implicitly imposed on PEs. Gradual shift to profit orientation from 1980s (Law 97) and especially now (Law 203).</td>
<td>I. PEs expected in the past to be primary vehicles for realizing government economic and social objectives.</td>
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<td>II. Enterprises under state holding companies have not paid any dividends to the government.</td>
<td>II. Some payment of dividends by PEs to state, following agreed guidelines.</td>
<td>II. Subsidized finance for PEs provided indirectly by the government in the past mostly through the public banking system, although some direct budgetary transfers also occurred.</td>
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<tr>
<td>III. Transfers from the government to the government go directly and only to the apex holding company, which had a major role in this process.</td>
<td>III. Transfer of explicit subsidies from the government to public enterprises in parallel, mainly as compensations for price controls. Recent market decline.</td>
<td>III. Negligible if any dividend payments by the PEs to the government.</td>
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<td>IV. These transfers in the past were transparent and budgetary. Since the mid-1980s other forms of transfers have grown important such as government - guaranteed bonds or loans from the EIB where the government also undertakes some or all of the repayment. All these too have been funnelled through the holding company.</td>
<td>IV. Implicit subsidies/transfers through the banking system.</td>
<td>IV. With the establishment of the Funds and EPEs and other reforms, government support through the banking system is also to cease and banks and enterprises are being recapitalized to compensate for arrears of past debt.</td>
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<td>V. Total transfers however in all forms which were substantial in the early 1980s have now declined sharply.</td>
<td>V. The PSAs had no role in this process in the past and no such role is anticipated for the new HCs. The overall significance of such transfers however is expected to continue to decline.</td>
<td>V. Large budgetary and extra-budgetary transfers are now planned specifically for restructuring/recapitalization and associated costs. It is hoped that these will not continue, as successful restructuring is achieved.</td>
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12. Financial Performance

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<tr>
<th>Italy</th>
<th>Egypt</th>
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<tr>
<td>Variable. Successful turnaround of originally acquired enterprises in 1930s. Reasonable performance subsequently until sharp deterioration in 1970s. Revival in mid-80s. Much of the performance variation is due to external factors not linked directly to holding structure.</td>
<td>Poor performance of PEs in 1970s and mediocre in 1980s. However, considerably influenced by presence or absence of external factors such as price controls, etc.</td>
<td>Large losses in many PEs, but largest loss-makers have not yet been transferred to autonomy. This situation cannot be associated with the newly established Funds, as this is the result of other policy variables.</td>
</tr>
</tbody>
</table>
Part IV. Results and Recommendations

The combination of holding company characteristics and indices of holding company performance provide a framework which has been, and can be, applied to the evaluation of the state holding companies in specific countries. However, as a caveat, it should be pointed out that the factors described above may change over time. In some cases, the rationale for the company itself may alter or disappear. Thus if a holding company which is set up to pioneer development in certain areas, or restructure and privatize enterprises, is successful in achieving these objectives, it should itself dissolve, or at least change form. It could conceivably move from a more interventionist form with large proportional ownership, towards the asset management type model, gradually disengaging itself from an active role in the affairs of its enterprises, diluting its ownership and reserving its interests for the returns on its portfolio. Such cases are rare but not unknown. Conceivably the role of state holding corporations in an economy may also change with its level of development, or with an increase its exposure to market forces. More mature market economies may have lesser needs for direct state intervention in industrial development as savings increase, financial markets develop, and the role of the private sector strengthens. Depending on the pace of economic transformation and the degree of political will, the state holding corporations may themselves gradually divest or dissolve.

The following sections first summarize the findings of three detailed case studies on the state holdings of Italy, Egypt and Algeria. Next (section 4.2), general conclusions are drawn from these case studies, on the performance of holding companies as institutions. Implications of these for the formation of new holding institutions are pointed out in section 4.3.

4.1 Results from Country Studies

Italy

The examination of the holding company experience of the Italian ‘imprese’ shows that if the aims of the government are greater decentralization of the management of its public enterprises through a holding company structure, the eventual privatization of some of these enterprises, and the restructuring of others, through the same structure, these aims can be, and have been (albeit partially) realized. At least where they faced competitive product markets, the behavior and performance of many IRI companies was comparable to those in the private sector.

Success at restructuring had also been achieved by IRI, both in its early days in the 1930s, and again recently, for example in the case of the steel industry, as well as with other, smaller enterprises. However, this required considerable legal and financial support from the government. The value of the apex holding in this case was that it played the role of a coordinating unit for the drawing up of restructuring plans, it provided for some real transfer of jobs within the group, and it provided an

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Ayub and Hegstad (1986). On a more theoretical basis, it has been argued that maintaining public control may reduce the costs of government intervention (Sappington and Stiglitz, 1987). Indirect intervention may be even more difficult in countries with thin or poorly developed markets.
IRI also provides an example of a flexible route towards ownership diversification and increased private participation. The latter was successfully combined in some cases with the raising of new capital for enterprises to support investment or strengthen their equity structure. The apex holding organization certainly took a lead role in the implementation of this, adopting a flexible, case-by-case approach and working out the details of each. The registering of new companies on the stock exchange and the flotation of new stock added some stimulus to the stock market, although this could not be on a scale sufficient to overcome other constraints faced by the capital market in its development, some of which are now being addressed. There were few direct cases of outright privatization through transfers of ownership, until very recently. The Italian experience emphasizes that the extent of privatization depends essentially on prevailing government policies, which may be based on both macroeconomic and political considerations. An effective implementation agency can at best reinforce a government decision to move in this direction.

However, the Italian experience also illustrates the difficulties of achieving real financial independence from the state, through a holding company arrangement. This was clearly not achieved by IRI over most of its years, although there was a very significant decline in such transfers. It also suggests that overall financial performance of public enterprises under state holding companies depended more significantly on the general economic situation, and the particularities of the market structure faced by their operating companies, than on their form of organization. The significant swings over time in the state holding companies' performance clearly illustrates this.

Both positive and negative elements on holding company structure and performance emerge from this case, and are summarized below. Not all these element are adaptable to other contexts. On the positive side, it must be noted that:

- First, operating companies under the state holding companies were under private commercial law. This common legal framework for private and public enterprises is rare, as the other cases examined here illustrate. More typically, some form of public enterprise law remains, and with it, limitations on the real transfer of state control.

- Second, for many industrial enterprises, there was significant competition from the domestic private sector, as well as, for tradable goods, from other European and overseas producers.

- Third, at the level of operating companies, there was a fairly flexible ownership interface with the private sector. There are many companies in the group which have some private shareholding, and both sales and acquisitions of smaller companies have occurred frequently. At least for minority shareholdings, there were no major legal impediments to share trade or asset sale.

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34/ It should not however be forgotten that this support was also made available to the private sector, which also made use of it. It is interesting that the most important private restructuring undertaken in the 1980s was that of Fiat, also organized under a private holding; the Agnelli group. This may suggest the advantages of a large and powerful centralized corporate control structure in undertaking such drastic actions.
Fourth, there was also flexibility in the forms that lower levels could take in the vertical structure. These could include subholdings or operating companies. Direct investment by the apex institution in a particular enterprise was also possible if this was considered important for financial or technical reasons. Although cross-holdings were not common, these were certainly possible.

Fifth, at the head of the apex institution, the non-government 'executive committee' below the Board was useful for insulation against the government. The relative stability of the chief executive was notable. There was little scope for the significant representation of special interest groups within the enterprises on the IRI Board, or on the boards of lower level holdings or enterprises, through a predetermined seat allocation\(^{35}\).

Sixth, there were provisions for merit-based salaries at the apex institutions and for the delinking of employment in operating companies from civil service terms and conditions. These permitted greater performance motivation to staff.

The superstructure of IRI had a clearly defined role to play in the organization, in terms of its contribution to risk-bearing, its strategic decision taking, its emphasis, particularly recently, on greater direct involvement with activities involved with innovation or research. In addition, the apex played the role of sharing, or lowering, financial costs, through its guarantees (or through special government guarantees), or the channeling of low-cost funds. These are the classic 'value-added' features of a holding group in market economies\(^{36}\).

There is no evidence of abuse of the intricate indirect interlinkages which exist between public enterprises and the banking system. This appears to be due to careful regulation of direct links, as well as due to the relatively strong role of the central bank, and the internal limits set on intra-group loans. Achieving this elsewhere may require a prior examination of the central bank’s regulatory capacity in this regard, as well as the framework of regulations for commercial bank lending to industry.

On the negative side, however, it must be pointed out that

In areas where competition is limited, the performance of the holding company and its operating affiliates remained vulnerable to the direction of government regulations. This is illustrated by the variability in the application of price regulations, which have influenced the results of IRI both positively and negatively in the past. It also shows the government’s difficulty in permitting greater price flexibility in industries which have developed as natural monopolies.

\(^{35}\) In contrast to Egypt, for example, as the next chapter shows, where a special number of seats are assigned to labor representatives. However this does not preclude political influence, as discussed below.

\(^{36}\) Or the group of the apex office of an ‘M-firm’, or managerial conglomerate, which is characterized by a head office endowed with these functions (see Chapter 1, and Williamson (1970)).
A top heavy decision making and reporting structure above the apex holding company can delay decision-making. While audit and accountability provisions are essential, the need for the various cabinet and parliamentary committees in addition to a specialized ministry was difficult to understand. The elimination of this superstructure under the new government, and with the transfer of the former state holding companies to the Treasury is appropriate.

The achievement of insulation from the political process is difficult, if not impossible. This may well be a basic vulnerability of such a state-owned holding structure which will be difficult to overcome in many countries.

Substantial additional government assistance was required to achieve the restructuring undertaken by IRI. This took the form of direct support in the form of cash grants, debt absorption or through transfers from special funds. It also took the form of indirect legislative support through modifications in labor legislation to ease the restructuring process.

Finally, the state holding companies, for the most part, were not able to do without government transfers. At IRI, there was a reduction of such transfers from the mid-1980s, but they did not entirely cease. For the most part, transfers were transparent and easy to account for, although some recent arrangements for assistance with debt amortization or servicing are more opaque. However, hidden transfers through the banking system, which operated in the other countries examined in this study, have not taken place. The Italian experience clearly illustrates the difficulties of achieving real financial independence in decentralized, but still for the most part publicly owned, enterprises, under a state holding company.

Egypt

The Egyptian experience clearly illustrates the limitations of certain holding company forms (the Public Sector Authorities of Law 97) in aiding the move towards a market-based economic system, but also shows how some of these limitations may be detected and rectified (under the new Law 203). This case also emphasizes that it is difficult for a holding institution in isolation to promote decentralized market management if the key parameters of its economic environment are still regulated. The present trend towards economic liberalization has reinforced the greater decentralization and autonomy of public enterprises within the new holding company structure.

The multiplicity of legal frameworks for its companies is a first notable feature of the Egyptian system. There have been a succession of special laws over time, each covering different groups of companies, with different implications for share or asset transfer or trade, foreign investment and taxation. Public enterprises have been and are still subject to a special law, although the present Law 203 specifically provides that the law for private enterprises will apply unless otherwise specified. There are multiple laws for private enterprises as well.

The government has proposed the introduction of a new Unified Law, which will eventually iron out these differences.
• The share distribution structure adopted by the former Public Sector Authorities was strongly conducive to the reinforcement of the lack of market competition. This was first because of the hundred percent allocation of all the shares in a given enterprise to a single Public Sector Authority; second, the sectoral structure of the Public Sector Authorities, and third, the complete inflexibility of the share structure in terms of the possibility of share transfer or trade. Today, the sectoral share distribution pattern has been made more flexible but the hundred percent allocation of shares of each public enterprise to a given holding company remains the same.

• The vertical structure of the former Public Sector Authorities permitted too much ministerial influence. There has been a significant move away from this in the new holding companies. In the new structure, a relatively powerful but professional Public Enterprise Office, which retains its distance from the affiliated companies may de facto assume the role of an apex holding company. The role of the actual holding companies may well, in this case, become rather weak.

• The possible financial contribution of a holding company as a means of reducing costs of funds through guarantees was not necessary in the past, due to generous credit allocation to public enterprises. This role has also been made difficult in the new structure. The need to guard against unwise decisions by making this legislatively difficult suggests that, at least for the present, holding companies' powers are to be carefully kept in check.

• A related point is that public enterprises' links with the banking system had been a major source of indirect government support in the past, and there clearly had been no binding constraints on this. As a result the holding company was effectively bypassed as a means of financial discipline. Although there were increasingly limited direct transfers or supports from the government to public enterprises from the mid 1980s, there is evidence of enormous indirect transfers through the banking system.

• There is little evidence of any restructuring efforts undertaken by the holding companies under Law 97. This was not perceived to be a major role. The principal role of these holding groups was to facilitate administration of a planned system, for example through foreign exchange allocation, or coordination of the setting of appropriate price subsidies. Restructuring efforts may also have been constrained by the lack of legal flexibility to undertake the actions required for this.

• Finally, privatization of public enterprises was not permitted under Law 97, for the Public Sector Authorities. Today, under Law 203, this is permitted, and significant moves in this direction have begun. At present however the focus is on joint venture

38/ While it is true that the eventual aim of the government is to privatize most of these enterprises, some gradual increase in ownership diversification could be attempted in parallel, as the privatization program is spread over many years. Such gradual diversification would include the possibility of share transfer among holding companies, or even cross-holdings between enterprises. In addition, a gradual dilution of ownership with the private sector could be attempted (for example by floating new share issues to raise capital) even before full divestiture. An increase in the flexibility of share transfer is also essential if the new holding companies are to act as portfolio managers.
firms in the first place, although the preparation of public enterprises for this has also begun. However the principal coordinative role for this has been adopted by the Public Enterprise Office.

Algeria

A key feature of the Algerian holding company experience, compared to the cases of Italy and Egypt, is the relatively rapid and radical change in the public enterprise framework that the new framework has required. Although there have been delays in the implementation of the reform program, and often a gap between de jure and de facto change, the overall magnitude of change is nevertheless greater, and more compressed in terms of time, than the reforms of the other two countries examined. The initial position, of a highly centralized planned economy, was also more severe in terms of controls and further removed from a market economy than in the preceding cases. Some of the difficulties faced by the Algerian Funds however may have been alleviated if greater attention had been paid to their design. Comments on their structure and performance are offered below:

- First of all, the Algerian Funds were faced with a multiplicity of objectives, sometimes conflicting, and rarely spelled out clearly. The objectives of greater decentralization and an increase in the autonomy of public enterprises were enunciated at the time of the creation of the holding companies, although the primacy of this objective was somewhat obscured by several caveats on residual rights of state intervention.

- Second, the vertical links between the Funds and the government were too close to insulate the Funds from the possibility of government influence. Changes in the 'shareholders' assembly' of the Funds with each change in government, and the frequent changes in the Boards of the Funds that this has led to, were unsettling. On the other hand, the vertical links between Funds and their enterprises have been weak. With the virtual disappearance of the five-year planning framework in which the system was conceived, the original role envisaged for the Funds has also gone, and a new role is in the process of being defined.

- The share distribution pattern and horizontal links between holding companies in the Algerian model reflect a deliberate attempt at ownership dispersal, without however relinquishing the concept of a controlling interest. The resulting Funds therefore share the features of both a majority holding company and a portfolio management company. To the extent that Funds are expected to take an active interest in the restructuring of their companies, however, there are still too many companies per portfolio to make this manageable. Share distribution patterns with large blocks of holdings without a majority holder will weaken the control of the 'dominant' shareholder. If the Funds are indeed active, this could lead to uneasy situations of deadlock, as two minority holders collude against the dominant Fund. If share trade was eased, there would probably be a tendency towards concentration of ownership in a smaller number of companies.

- The sectoral concentration of ownership is a source of concern in the present share distribution pattern (which could be exacerbated by share trade, however desirable this may be from other points of view). This could lead to the exercise of monopoly or oligopoly powers by the Funds or their enterprises. De facto monopoly power exists today and price setting tends to be collusive through force of habit and the slow
development of a new competitive ethic. Guarding against monopolistic behavior through the explicit encouragement of competition will be necessary in the future.

- Links between industrial enterprises, the Funds and the banking sector could be too close, due to the simultaneous holdings of Funds in enterprises and their banks. The conflict of interest that this could lead to is obvious and a clearer separation of the two would be desirable. In contrast to the Algerian system, banks in Italy, may not hold shares in enterprises. While the holding company IRI can hold shares in both, they are still under separate sectoral subholdings. In Egypt, banks are not forbidden to hold shares in enterprises, but there are no holding companies which today hold shares in both.

- The development of trade in shares is hampered by significant legal barriers. Similarly, there are barriers to sales of assets, or lines of production. The realization of the aims of increasing share trade, restructuring or privatization are at present greatly hampered by the lack of enabling legislation for these actions.

- The financial structure of the Funds is too weak to permit them to bear risks on their own account. If the Funds give guarantees, these will implicitly be state guarantees, which will continue to insulate enterprises from financial discipline. This is due to their very small capital relative to their shareholdings, although they are authorized to give such guarantees. Second, the Fund’s income is low, relative to their shareholdings, and Fund operating costs are high, relative to their income. Third, the income and capital grants received have not been productively used. At present these are allowed to remain as short-term bank deposits. If this persists, it will lead to a real erosion of Fund capital as a result of inflation.

- The accounting systems followed by the Funds at present will not permit this erosion to be reflected in the Funds’ financial statements. More serious, losses made by subsidiary companies and the impact they have on the values of shares held are not reflected. Consolidated balance sheets are not produced, not even for all dominant or major holdings. Financial statements do not incorporate any procedure for revaluation of the shares held by Funds in their enterprises. The granting of guarantees by Funds, until their capital base is fortified, may also be a dangerous privilege. If continued, an explicit ‘lender of last resort’ to the Funds should also be appointed.

- Finally, enterprises cannot be said to be financially independent of the government until the process of recapitalization of the enterprises and the treatment of their past debt is complete. One difficulty here is the tendency towards too many successive rounds of recapitalization, which in turn are a consequence of minimum rather than adequate recapitalization in the previous rounds. There are indications that the Algerian

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39/ For example all four major cement companies have the same prices, although these are separate public enterprises.

40/ The government has indicated (September 1992) that it may in future permit private participation in enterprises, and ease provisions on share transfer to achieve this. Details of the process have not yet been enunciated.
government may be lured into this route, which must be guarded against. The real test
of the new system will be its ability to stand on its own, once the present round of
recapitalization is complete.

4.2 General Findings

Can the individual country studies permit us to draw some general conclusions about the
effectiveness of these institutions? Have they been able to achieve the objectives required to assist
transition towards a more market-based economic system, and can they be useful interim instruments in
aiding this process? The first general conclusion of this study is that, under appropriate circumstanc-
es, such holding groups can achieve, and have achieved, some of these objectives. However, special
conditions are required, and usually, special and continuing government support.

These conditions refer first of all to the general economic environment. 'Policy matters', and
this can dominate changes in organizational form. If the policy environment is of rapid economic
movement toward a liberal and market economy, and if this occurs in conditions of relative stability, this
will go a long way towards creating an environment conducive to the economic efficiency of public
enterprises. Another way of looking at the same result is that no government-spawned institution can
normally be expected to rise above the parameters provided by that government. If the government
chooses to slow down the movement towards a market economy, the state holding company cannot leap
ahead. Indeed, in cases where a state holding group may have tried to go faster than the government (as
in the IRI privatizations of the late 1980s), it has been reined in.41

Second, policy features which affect market competition appear to have a particularly acute
impact on financial performance. The application and removal of selective price controls in Italy, and
the levels at which they were set, affected the IRI group's performance even when there were no
structural shifts in holding organization. The removal of price controls (in a situation of limited
competition) in Egypt was also associated with improved profits. Macroeconomic policy shifts in Italy,
such as the credit squeeze of the early 1980s, affected all large enterprises, public and private, to an
extent that a differential response based on organizational structure would be hard to capture.

Looking at other objectives with which state holding companies are set up in transitional
economies, however, corporate form has a more significant role. For the achievement of restructuring
of chronic loss-making enterprises, which require drastic changes in orientation to achieve a
turnaround, large centralized holding companies have been clearly successful. IRI was an early
example; the Treuhand is a recent one. These structures also appear to be appropriate vehicles of
'managed' case-by-case privatization. In these cases, the holding company did provide the strategic
orientation as well as the strong decision-making which these tasks require. The success of these
particular structures in achieving these objectives suggests that holding companies which are relatively
centralized, with a strong apex, are better able to succeed than more decentralized structures. One of the
critical features of these structures, in this context, is the composition of top management, and the ability
to introduce professional experts outside the government among the top executives. Direct ministerial

41/ There were instances when IRI attempted to go ahead with the privatization of enterprises in the cement
industry (under CEMENTIR) and the food industry (under SME), but the government, at that time, held
back these initiatives.
nominations of Board members has proved stifling, but the vulnerability of holding structures to political influence remains. The small executive board of IRI provided the role of a moderately independent professional executive and the executive board of the Treuhand had a similar role. The trimming of additional layers between the corporate headquarter and the government on the one hand, and the enterprises on the other, is also clearly advisable. The removal by Treuhand of the originally proposed three-tier structure increased the contact of the center with major enterprises. The Treuhand has also been remarkably free, in practice, of layers above it, which had by contrast hampered IRI.

In holding company structures where this strong apex organization has been absent, the undertaking of structural or financial transformations of enterprises has been transferred to external agencies. In Algeria, for example, these tasks were entrusted to the COREP initially, for the financial reconstruction of the balance sheets of enterprises. Later, the National Planning Council took a lead role in enterprise restructuring. There are now signs that responsibility for this may shift back to the Ministry of Industry within the Government.

Such structures are more likely to realize their objectives if they are kept relatively simple. Thus the Treuhand, relative to IRI, was able to distance itself from regional development objectives, which weighed heavily on IRI. In contrast to other new East European institutions, the THA has also separated itself from the achievement of distributional objectives. This does not imply that these objectives need be neglected; it merely points out that multiple objectives for a single instrument, or institution, make all of them more difficult to achieve. Other institutions or instruments can be devised for these purposes.

Continued support from the government in other forms has nevertheless been necessary, even with these relatively powerful holding structures. It must not be forgotten that in both Italy and Germany, the passage of additional enabling legislation to assist the holding companies with their tasks had been undertaken frequently, and government support had been offered with the bearing of costs associated with restructuring.

Can these structures permit, or facilitate, the process of eventual privatization? The extent to which privatization is permitted is clearly primarily a political decision, and not a decision of the holding group, which can only be an executing agency. Thus is Egypt, the political will for privatization now appears to be present, but the government is still proceeding slowly with former Law 97 companies. Besides, even if a decision to privatize has been undertaken, the primary responsibility may be given to an agency outside the holding companies (as in Pakistan's recent attempts at privatization), or a coordination of the holding company and another agency may be required (as in Egypt, where the Public Enterprise Office will take a lead role in the process). This appears to be particularly true of cases where there is no apex holding unit.

In the case of Italy, the decision to 'privatize' in the mid-1980s was born from a financial decision to turn to the capital markets for funds, rather than from an ideological aim to privatize. During this era, the apex holding group was able to 'privatize' with fair efficiency, and there were even instances where, left to itself, it may have gone further and undertaken some privatization to rationalize its business activities. Today the government has more commitment to privatization, for budgetary reasons. There is no reason why, with appropriate political support, strong holding groups should not be able to undertake this.

At the opposite extreme, the raison d'être of the Treuhand of Germany was privatization. To
an impressive extent this aim has been realized, although the problem of undervaluation of assets, and underestimation of the real costs involved, has probably been far more acute in this case. It is clear that privatizations which are primarily ideologically motivated may not be economically efficient in terms of budgetary impact. The other danger here is that the most successful enterprises may be sold off first, leaving the holding agency or group (or the government itself), with the problem cases - a situation which has been referred to as 'lemon socialism'.

To what extent can new holding institutions successfully engage in active portfolio management? Since most of the holding institutions which have been given this function have been very recently established, or have not even begun to function, the conclusions on this are tentative and are based on one example only; Algeria. Evidence here suggest that share trade does not begin easily and that new government holding structures find it difficult to take on portfolio management functions. Initially, there may be legal difficulties due to inappropriate forms of registration of shares or companies, and the lack of appropriate market structures for such trade. While these can be addressed, the gaps in the legislation are usually discovered on an iterative basis and tightening up the legislation may take a very long time. Egypt, and even Italy, have notoriously limited trade on their stock markets. New fledgling institutions in emerging market economies cannot realistically do much better. The difficulty here is not only the lack of a market framework but also the inexperience, and therefore caution, of managers of new funds.

It has been suggested that if domestic investment fund managers are inexperienced, outsiders may be brought in, with experience in other countries. The likelihood of principal-agent problems arising in such situations is high, and such experiments may prove costly. Besides, the external experience of such persons would have to be balanced against their more limited familiarity with the country and the enterprises concerned. There is a danger of holding institutions in such countries, which have a primary focus on asset management, becoming either the sleepy asset managers of the Algerian Participation Funds, or becoming maximizers of managerial objectives, possibly at the cost of shareholders. If the state detaches itself from the exercise of ownership functions in such institutions at the present stage, and leaves them to their highly dispersed public ownership, this could lead to the classic problem of separation of ownership and control which had disturbed Berle and Means in 1932. In a market economy, it was subsequently demonstrated that balance could be restored through the existence of multiple regulatory markets, which discipline the enterprise. Financial discipline is provided by the banking system, through restrictions on credit. Managerial discipline is imposed through the threats of takeover, or managerial replacement. But in semi-market or transforming economies, such markets do not exist, or are just beginning to emerge. The present structures (in Poland especially, and also potentially in Romania) fall between two stools; they are set up and organized by the state, but for the present, the general public's ability to exercise ownership functions is limited. Yet the superstructure of accountability of these new, and fairly autonomous, institutions to the state and the public is ill-defined. At least at present it is difficult to see how portfolio value maximization, in the style of investment funds of industrialized countries, could rapidly develop. The greatest hope in this respect is probably Czechoslovakia, whose funds have not been detailed here, because they are private and voluntary and there are fewer restrictions on transfer of shares or rights to buy them than in Poland or Romania. Yet in this case too it has been shown that the new asset managers need not act in the best interest of their shareholders and have, in some cases, exploited their credulity. One lesson from this experience is that if the state relinquishes ownership rights in such institutions, it has to rapidly take on regulatory functions instead, and should plan to do so early.

Another finding from the case studies is that 'combination' holding companies do not appear
successful. In Algeria, for example, the Funds are intended to take on both restructuring functions and portfolio management functions. Some combination of these functions is also envisaged in Poland. However, the skills and staff requirements of the two are very different, and so are the prescribed links between the enterprises and the holding company. The overall number of companies which require to be supervised, or at least observed, also grows large and unwieldy. In practice, as in Algeria, one function will probably dominate the other. In Algeria, the restructuring function appears to be dominating, and funds have expressed their desire to rid themselves of a large number of small shareholdings. To the extent that the development of the portfolio management function is limited by the factors described above, in terms of an appropriate market infrastructure, it is likely that the new institutions of other countries will also develop in this direction.

It follows from this that the introduction of holding structures, even on an all-industry scale, will not, in itself, rapidly lead to the development of a stock market. The extent to which share trade is stimulated will depend on the flexibility permitted for such trade, which has frequently been restricted, in the case of public enterprises under holding companies. Frequently, changes in the initial ownership pattern are not permitted, or they may be possible but with considerable legal difficulty. In Egypt, under Law 97 of 1983, holding companies were joint stock enterprises, but trade in their shares was not permitted. With reforms introduced with Law 203 of 1991, the sale of enterprises to the private sector is permitted, and all enterprises are to be listed on the stock exchange. However, provisions for plural public ownership (the transfer of shares in an enterprise to other public holding companies) have not been made. In the case of Algeria, share transfer is nominally permitted, for public enterprises held under holding companies, but this is only permitted between public enterprises and not to private entities. There are also numerous restrictions on such share transfer which make it extremely difficult to implement.

If a stock market exists already, the flotation of new share issues, or the use of the stock market to sell existing shares, can certainly add to market capitalization. But as the Italian and Egyptian examples show, the real growth of such a market depends on other factors; both regulatory factors specific to the stock market, such as tax advantages of holding shares, costs of registration and share issue, protection afforded to minority shareholders, disclosure requirements, and so forth, and, as in Italy, also on the relative attractiveness of government paper. If savings in these new markets are constrained, and if these limited savings are drawn off into government bonds, this will have a greater negative effect on the stimulation of the stock market than the positive effect of the creation of the new investment funds.

Have state holding companies affected market structure by increasing sectoral concentration ratios? Despite attempts to diversify shareholdings, it would seem, from the Algerian case, that a sectoral pattern tends to creep back, as the holding groups decide to concentrate their activities in particular fields. Moreover, old patterns of collusion, which were formerly 'coordination' under planned regimes, die hard. However, this need not be a major concern, to the extent that there is sufficient external competition from either the domestic private sector, or from foreign firms. In Italy, there were sectoral subholdings below IRI, but in many areas of industry, these competed against other Italian, and in some cases other European firms. In emerging transforming economies, encouraging the parallel growth of private

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Under the form of incorporation permitted to Algerian public enterprises under holding funds, the shares held by the funds are registered shares, under the name of a specific entity, and not bearer shares. Moreover, the shareholders' names are inscribed in the statutes of the enterprises, instead of only being inscribed in a shareholders' registry. A change of ownership therefore requires an amendment to these statutes.
enterprise, and permitting some external competition, would therefore be a necessary adjunct to the setting up of such institutions.

Can holding companies resist government pressures to be used as instruments of non-economic objectives? Evidence suggests that insulation from other governmental objectives which need not imply profit maximization is difficult. In Italy, IRI fought a long battle against this and eventually settled on an agreement to at least calculate the burden of such government-imposed objectives, and to later be compensated for them. The extent to which this was followed in practice has been erratic. Even the Treuhandanstalt of Germany put employment and investment objectives high on its lists, and indeed it concern with its own profitability or the immediate profitability of its enterprises low. (However, this may also imply a more long term view of the origins of profit).

Can the government be expected to increase its return on its equity in public enterprises organized under holding companies? In some countries (e.g., Egypt) the government has rigorously extracted dividends from its profit-making public enterprises, in some cases using a pre-determined formula which leaves very little discretion with the holding company, and has also led to the physical depreciation and undercapitalization of these companies. In others countries, dividends are routinely retained at the level of the holding company and in practice the government does not expect to receive any income from them (Algeria, Italy). Receipt of dividends therefore appears variable, but less frequent.

Probably the most difficult objective for the state holding corporations to achieve is independence from the government in terms of net financial transfers. The tendency for continued support, explicit or implicit, to continue, has been observed in all the cases examined. A distinction can nevertheless be made where such transfers are transparent and directly payable through the budget, and cases where transfers are implicit. In Egypt, although the government received positive dividend payments from its public enterprises, many of these benefitted from price support schemes or from indirect support through the banking system. The extent of indirect support through the banking system through doubtful loans has not been calculated but is estimated to be large. Clearly a system of transparent, and limited, transfers, is relatively more desirable. It must be cautioned, however, that the Italian experience suggests that there is some tendency for explicit transfers, such as budgetary allocations to the holding companies’ capital, to gradually to slip towards implicit transfers. In the case of Italy, these took the form of government-serviced debts or government backed loan guarantees.

4.3 Recommendations on the Design of State Holding Institutions

State holding institutions are still being set up, on an interim or longer term basis, to aid countries in transition with the decentralized management of their public enterprises. The findings of this study can provide some further guidelines on their establishment, based on the discussion in the preceding sections.

Legal Code

Next, the legal code of both the holding companies and their operating enterprises must be examined. If indeed the aim of the system is the simulation of private sector behavior by public enterprises, the operating enterprises under the holding should be subject to private commercial law. In practice, this is rare. In the three detailed case studies presented here, Italy is the only country where
this occurred. What is more usual is the Egyptian or Algerian pattern of a special public law for such enterprises, which usually permits the enterprises to be incorporated, often as joint stock companies.

These cases clearly show the danger of regarding ‘corporatization’, in itself, as significant progress towards moving public enterprises towards a private environment. There are many degrees of progress possible in this process and the character of the corporate status conferred on the newly joint stock companies must be closely examined. In Algeria, the forms of incorporation permitted were extremely limited and did not, for example, provide for bearer shares. In Egypt, even under Law 97, public enterprises were incorporated, but this did not permit them to set their own wages or prices, determine the disposal of their profits, to transfer ownership or to liquidate. Today, another special public enterprise law has been introduced. The new law specifies that provisions of private law apply unless specific provisions to the contrary exist. However, this is still not the same as a single code for enterprises in each sector of activity. A broadening of the framework of private commercial law may also be required, to include the introduction of legislation on concomitant enabling conditions, for example with regard to share trade, asset sales and disposal, enterprise liquidation, etc.

Vertical Structure

First, if the holding company is required to take an active role in the affairs of its enterprises, for example in their physical restructuring or case-by-case privatization, it will have to have strong authority to do so. This suggests the need for an apex organization. This need not be an additional holding company (as in IRI), the possibility of a single strong holding company (as in the THA) can also be envisaged. The case of Italy also clearly illustrate the difficulties that can arise from an excessive superstructure between the holding group and the government, and trimming this to a minimum in terms of vertical layers (again as in Germany), is advisable. In the German example, explicit steps were taken to remove a superfluous third layer between the holding company and its enterprises.

If decentralization is to be promoted, a general reduction in the number of points of contact between enterprises and the government is desirable. The former Egyptian pattern under Law 97 illustrated the difficulties of a system of multiple points of contact with different ministries. The holding company should therefore answer to a single ministry (or possibly a single parliamentary committee) within the government, and there should not be any occasion for direct contact between the enterprises below the holding company, and different organs of government. Such a structure would also have the advantage of increasing the transparency of government-holding company links. Placing the office directly under the prime minister (as in Egypt) has the disadvantage that the prime minister is unlikely to be able to devote much personal attention to the structure, which will then be as good as its secretariat. If made up of competent professionals and specialists, this may be effective. If there is a specialized or particularly competent department in the government, there may also be a candidate, for example the Treasury in Italy, to which the holding companies were transferred in July 1992.

The responsibilities to be given to the government office at this level clearly vary inversely with the degree of responsibility given to the holding company itself. In Italy, the principal role given to the Ministry of State Holdings is to examine specific areas of special concern to the government, in particular, issues with budgetary implications, in particular the use of the lump sum capital grants ('fondi di dotazioni') from the government to the apex holding institutions, requirements for the CIG,

43/ There are no direct transfers from the government to subholdings or operating enterprises. The apex holding institution is thus effectively the sole interface of these enterprises with the government.
and labor and employment implications of investment decisions). In Germany, the Treuhand is nominally under the Ministry of Finance, which does not have any significant role in its functioning. Conversely, with the weaker multiple holding groups of Algeria, the responsibilities for the restructuring of particularly problematic enterprises are still with organs of the government.

A point of significance to be raised in this context is that in some of the new holding structures emerging today the accountability of the holding company is extremely ill-defined. Since shares in these investment funds are ultimately to be held by the public, the government has absolved itself of the responsibilities of oversight. Yet, private owners are not in a position to exercise these powers due to their inexperience, the dispersal of shareholdings, and in some cases, continuing restrictions on the extent to which they can exercise these rights. Some of these new institutions may have a disproportional amount of autonomy, relative to their accountability. In these cases, the government must better define the framework of links between itself and the new holding institutions.

Equally, what responsibilities are given to the holding companies and enterprises, vis-a-vis each other, and the government? A clear demarcation for each level is desirable. The division of technical and financial decision-making functions between enterprises and holdings in the Italian model is fairly clear-cut. Thus the apex holding or subholding concerns itself with major financial decisions, while technical decisions are left to operating enterprises. In principle, the same division prevails in Algeria, where owners are implicated in any financial decision which may alter the financial structure of the enterprise. While in principle, the role of the holding should emphasize strategic intervention in broad direction, assistance with financial decisions and sources and risk sharing functions, it may be difficult to maintain this demarcation in practice.

An associated question is the extent to which monitoring functions are ascribed to higher levels in the structure, and the associated reporting requirements. It is easy (as in Egypt under Law 97) for an otherwise toothless holding to assert itself through large data reporting requirements. The value added of such a structure then becomes negative. One general principle is that each level should ask only for the volume of information required for the decisions it has to make.

Clearly, the responsibilities of the holding company will also depend on its proportional shareholding. As the shareholding diminishes, the responsibilities will diminish proportionately, and when these proportions are low, the responsibility of the enterprise to its shareholder will be the presentation of accounts, and an invitation to its annual shareholder’s meeting.

Within a given holding structure, who appoints the persons at each level, and who are these persons? First, conferring the authority to appoint such persons in a way that bypasses the structure is clearly undesirable (such as in Egypt, Law 97, where board members of operating enterprises were appointed by the concerned ministry, bypassing the holding authority). At the highest level, the extent to which appointments are politically affected is problematic. Some political influence at the top is inevitable, but the extent to which this percolates down is controllable. Although the heads of the state participation firms in Italy were clearly political appointees, their long term of appointment (with only

44/ A special fund for financing retrenchments of labor from enterprises or industries undergoing restructuring.

45/ The level is determined by the importance of the decision. For example a decision to float new shares would be taken at the apex holding level, while a large investment decision may go to the subholding in question.
Finding appropriate top executives and board members is not easy, particularly in economies going through general transformations, where there is a shortage of experienced personnel, and the tendency to introduce civil servants or political appointees instead of technical persons is widespread. One useful structure in this regard, for the top level, is the 'Chairman's Board', of IRI, Italy, where the three technical specialists on its twelve member board are the only whole time board members, and who also form a part of a smaller select executive board in the Chairman’s office. In the case of the Treuhand, the composition of the executive and supervisory boards of the Treuhand itself, and the supervisory boards of its companies, has clearly helped the institution achieve its objectives. Drawing skilled executives, as well as former representatives of federal or local government, and in particular, representatives of banks and the local financial community, has aided decision-making vis-a-vis the enterprises and has also helped integrate the enterprises in their new economic framework.

Finally, are there any special interest groups on the boards of either the holdings or the enterprises below them? One example of this is the appointment of labor representatives to the boards of the enterprises, which is the case in both Egypt and Algeria (half the board in the first case, and up to a quarter in the second). In the case of Egypt, major representation of certain special interest groups has paralyzed the decision-making ability of these structures. In some East European countries such as Poland and Hungary, the role of worker’s councils has also been extremely problematic and is today retarding the process of decision making regarding the fate of these enterprises. These cases would suggest that the restriction of such special interest groups is advisable. It must however be admitted that German regulations, which also require a high proportion of labor representation (variable with the size of the company) on their enterprises' boards, has not led to the same difficulties. The reasons for these differences require further analysis. One possibility may be that in the German case, there are adequate and attractive provisions for workers affected by structural changes at the enterprise, which may not be the case elsewhere. This question remains open for the present.

Accounting and Auditing

Auditing arrangements for holding groups and the enterprises below them need not be the same. Some additional oversight procedure for the holding would be desirable. In Algeria, the Funds are meant to present an annual report on their activities to their 'assembly', but so far, these have taken the form of accounts only. In Italy, IRI has an independent Board of Auditors, who also attend its board meetings. The annual report of the auditors is presented to the parliament. At the level of the enterprise, private external auditors may be used (as in Italy, with suitable restrictions on the renewals of their terms), but a complication in many transforming economies (for example, Algeria) is the frequent absence of a private audit profession. Developing this rapidly is an essential part of enterprise reform. In Algeria the government is assisting its formation through the establishment of an institute which will undertake audits with the assistance of overseas auditors, on a pilot basis. Egypt illustrates something else, a country which does have a well-developed private audit profession, but which still requires government audits for its public enterprises. Private audits can be undertaken in addition to but not in lieu of the government audit. This incongruity is an example of the difficulties of accepting a change in system.

The accounting system to be adopted in a holding framework is a clearly a point of potential
weakness. First, there is a frequent lack of a consolidated balance sheet of all the subsidiaries of a given holding. To the extent that the shares held by the holding group are a large proportion of the shares of the company concerned, this would normally be expected. This is certainly the case if it is a majority owner, but is also desirable where the holding or funds' share is 'dominant' or controlling. Although in Italy, the state holding companies do produce consolidated sets of financial statements, this is not the case in Egypt and Algeria. While Egypt attempts to produce at least an aggregated, if not consolidated statement, Algeria does not go even this far. Second, there is a tendency to permit special accounting traditions to evolve for state holding institutions. The special definitions used for the treatment of 'equity' in the Italian case are a clear example. Derogations from standard accounting procedures are likely to arise, if appropriate precautions against these are not taken.

More serious is the issue of the accounting for losses. Apart from the consolidated balance sheet of all the enterprises in which it holds shares, a holding group would also prepare its own financial statements of its profits and losses. In the case of an 'asset management' type of holding, where the proportional shareholding of any fund or holding group is small, these may well be, justifiably, the only financial statements produced. In the present examples, while dividends received from profitable enterprises in the group appear as profits on the holding group's own financial statements, losses made by companies in which the holdings have shares are not reflected, in Egypt or Algeria. These losses affect the total capital value of the portfolio of the holding group, which needs appropriate adjustment. However, these appear frequently to not be undertaken. There may be many difficulties with this. In the case of Algeria, the initial valuation of capital is itself dubious, so that adjustments may have little meaning. Even without this difficulty, evaluating the extent of the downward adjustment required on the share value as a result of the losses may be complicated by the absence of market, as there may be no trade in shares, or such a thinly traded market that these prices have little relevance. If no reasonable proxy for market value can be found, the book value adjustment by the amount of losses can be used (or, following the principle of conservatism in accounting, whichever of these is lower). A failure to introduce some such adjustment would imply in the medium term that the holding groups' own accounts become increasingly incapable of reflecting portfolio's performance. This problem is likely to be relatively more acute in holding company models with widely dispersed shareholdings, where such a 'holding balance sheet' may be all that the fund or holding is required to produce. In the new East European holding companies of Poland and Romania, and in the investment funds of Czechoslovakia, particular precautions must be taken against this.

Financial Responsibilities

The significance of this issue increases with the proportion of shareholding held by the holding group, and with the extent to which it plans to play an active, 'interventionist' role in the affairs of its enterprises. Raising loans, giving guarantees, or providing caution money are theoretically among the more important contributions of a holding company structure. If these are permitted, and if the permission is responsibly exercised, it clearly enhances the role of the holding group. Particularly in large and diversified holding groups, such as IRI, the holding may be able to raise financing on more favorable terms than some of its subsidiaries. Extensive and virtually unlimited guarantees were extended by the Treuhand of Germany to its enterprises, in their first few months after acquisition, although constraints have now been placed on these. However, the examples of the preceding sections also show that in some cases the authority to give guarantees, which are explicitly or implicitly government-backed,

46/ Loans incurred on the financial market but serviced by the government were included in the definition of equity.
may be construed as an alternative channel for government transfers to enterprises. In Algeria, a resolution adopted by the 'assembly' of the Funds, which encourages the Funds to provide guarantees, may suggest that the government is prepared to bail out the funds, if required. In Egypt, on the other hand, the government is reluctant to vest this authority in the holding companies, possibly for fear that it will not be responsibly exercised.

To what extent is a holding company able to dispose of its profits in a discretionary way? The existence of 'formulae' on dividend distribution clearly curbs the initiative of the owner(s) in this direction. Egypt had such a system under Law 97, which appears to be dropped under the new law. If holdings are to be responsible and 'active', they should have full discretion over the disposal of profits. In the case of minority holdings, this is not an important issue, as the owners will not be in a position to recommend dividend distribution. The treatment of proceeds from the sales of assets, or shares, is a related issue. If enterprises are autonomous, proceeds from their sales should accrue to them, or to their holding group. However, government budgetary requirements may dictate that these are to be handed directly to the government, as Egypt plans to do. This necessarily limits the authority granted to the holding company. In Germany, the Treuhand retains the proceeds from the sales of its assets and uses these to pay off enterprise debts, provide workers' compensation, or other purposes associated with restructuring.

Links with the Banking System

If there are government-owned banks which are not, themselves, subject to external discipline, and public enterprises who deal with these directly and whose loans are implicitly guaranteed by the government (as in Egypt under Law 97), the holding authorities' role in enforcing a 'hard budget constraint' is irrelevant. If however the banks too have passed to indirect ownership and are also supposedly subject to financial discipline, there may still be an issue if the same holding company has shares in both (as in both Algeria and Italy). In Algeria the potential problems of this are more grave because of the sectoral concentration of lending activities of the banks, which coincide with the sectoral activities of their owners. Some precautions against any resulting problems have been introduced in the Italian case and could usefully be considered elsewhere. These include the setting of limits by the Central Bank on the lending by these commercial banks to enterprises in the same group, and the recently extended limits to the proportion of the industrial ownership links to enterprises in the same holding. In addition, there is the fact that these particular banks deal only with short-term credit, and finally, the presence of a Central Bank representative on the Board of IRI. In Germany, despite the severe pressures to which the Treuhand has been subjected, banks did not extend credits to East German enterprises without explicit government-backed guarantees.

Another issue which so far has not arisen in any of the cases described here is but is of potential significance in both Algeria and Egypt, is the holding of shares in enterprises by banks, within or outside the same holding groups. This is being contemplated as one of the possible solutions to the large debts in public enterprises currently held by the banks in both these countries; their conversion to bank-held equity. This is a major issue which requires further study; certainly this has not, in itself, been a source of indiscipline in all other countries. However, in the present cases, if such equity is acquired as the end result of debt-equity conversions of non-performing loans to unprofitable enterprises, the banks' original basis of acquiring such shares is weak, and is more dangerous than a situation where a bank has made an equity investment in a financially sound enterprise with good prospects. If this were to occur, it would certainly weaken the position of the holding group, particularly in the cases where the group holds shares in both the banks and the enterprises concerned.
The Share Distribution Pattern

One of the most important elements in the holding group structure is the share distribution pattern adopted. As described at the outset, two extremes can be conceived of, the case in which a hundred percent of the shares of a given enterprise are held by a single holding company, and the case in which shares are widely dispersed among a number of different agents, and the proportion of share in any one company held by a single holding is small. Many variant are possible, with shares being diluted among different public entities or sold to the private sector. The grouping of shares in a given fund or holding may be sectoral or deliberately diversified. Egypt began as an example of a ‘hundred percent holding’, with a rigid and static structure. The Italian case has also been closer to the ‘hundred percent’ model, but the pattern was more fluid, and over the last five years particularly, vigorous dilutions, recently even involving a transfer of control, have begun. Algeria aimed deliberately for a ‘blend’ model, with the intention of bringing in multiple, but not too many, public owners. This is the model adopted in Poland as well, although the lead role of the dominant fund in the Polish case is clearer. At the same time, two new agencies in East Europe, the Treuhand, and the Hungarian State Property Agency, follow the hundred percent model.

As observed above, the greater the stake a holding company has in one of its subsidiaries, other things being equal, the greater its authority and incentive to significantly influence major managerial decisions, regarding, for example, restructuring, asset sales, selective closure of certain operations, mergers, etc. Thus a holding company which is expected to have an interventionist role and bear major responsibilities for the restructuring of its enterprises, or otherwise significantly improving their performance, should accordingly have a substantial share in these enterprises. The disadvantage is that the holding may curb the independence of the enterprises’ management. In Italy, the large holdings certainly did have a major role to play in restructurings, and in Algeria, where it seems that the importance of this function is increasingly apparent, the Funds expressed an interest in increasing their holdings above the originally imposed 40 percent limit, to help them with this, and to also further increase their sectoral specialization. It does not seem coincidental that high concentrations of ownership are observed with high degrees of sectoral concentration of portfolios. If the managers of the holding are expected to take an active interest in the businesses of their companies, knowledge of the business is desirable and sectoral synergies would be expected. Thus in Italy the conglomerate ‘superholding’ is followed by subholdings with sectoral specializations.

In the other extreme variant, the asset management or mutual fund type of holding, the holding cannot be expected to have a large say in the structural reform of its firms, as its holding in each would be typically small. Rather, immediate financial returns are the aim, and could be achieved presumably though share trade. This however presupposes the active existence of such a market, and this is one of the weak points of the asset management type model. If there is already a perceived problem in asset valuation, and difficulties in reflecting the true worth of such a fund in its financial statements, the extent to which ‘market discipline’ can function is questionable. Besides, the concomitant legislative and infrastructural requirements for this are high. They involve the setting up of capital markets, including, preferably, stock markets, devising appropriate regulation and supervision for these markets, and including enough successful companies in the funds concerned to make shareholding and share trade attractive to investors. Given the slow takeoff of the stock markets in not only Egypt but also Italy, it is difficult to assume that all this can be rapidly accomplished. Exclusive reliance on the ‘asset management’ type of holding as a means of simulating market forces, particularly in situations where a large number of the companies concerned are in poor financial shape, and in the absence of such market structures, appears premature.
The importance of the policy environment also highlights the difficulty of the problems of transition, even in countries which are committed to change. These problems are clearly illustrated in the cases of Egypt and Algeria, and particularly the latter. Without the introduction of all the complementary changes required to permit greater enterprise autonomy to become a reality, it will be easy to misjudge the performance of any new corporate structures. The general issue of the sequencing of reforms is beyond the scope of this study. In the present context it appears that a high degree of simultaneity is desirable, but it is equally clear that the enormous practical difficulties associated with this inevitably mean that it will probably be years rather than months before any new structures take root.

4.4 Conclusions

A ‘summarized conclusion’ of the preceding observations would be that holding structures can be useful structures, for the achievement of specific objectives related to the movement towards a market economy, provided they have the backing of the government, and at some cost. The most effective structures seem to be the ones with a strong apex unit which provides strategic functions, and relative freedom in achieving their goals. The goals they have been best suited to achieving have been those requiring strong decision-making functions, such as enterprise restructuring, and they are likely to successfully undertake case by case privatization. However, even in these cases, continued government support is necessary, insulation against other government demands is difficult, and some financial assistance from the government tends to continue. Holding companies do not seem to be a major factor in the improvement of financial results in rapidly liberalizing economies, as, particularly in environments undergoing decontrol and policy shifts in many other directions, such other factors are likely to be of much greater significance for average industrial performance than changes in corporate structure for public enterprises, or even corporate ownership.

Holding companies with mixed active and passive roles of ‘enterprise management’ and ‘asset management’ are likely to find it difficult to achieve the latter role and will move towards the former. Holding companies set up entirely along the lines of portfolio management groups will find it difficult to achieve this for some time, until appropriate market conditions, and appropriate regulations, develop. Meanwhile, today some of the new holding structures of East Europe, (as in Poland or Romania) which are now nominally private lack an appropriate framework of accountability to any owners, which has not yet been substituted for by appropriate regulation. The use of holding companies as ‘interim institutions’ may do less to raise financial returns, develop capital markets or manage assets, than they could do, with proper legislative and financial support, to aid financial or physical restructuring, or speed privatization. And in these cases, they may well remain a burden on the government.

To conclude, the state holding group is a flexible organizational form with many variants, which has appeared in the past, and is continuing to appear today, in a variety of guises. One of the principal reasons for its establishment today is as an interim vehicle for the decentralized management of public enterprises, to aid them in the process of transition towards a market economy. Such institutions, if appropriately designed, can help to achieve some of the several objectives associated with transition, although there are other objectives where expectations on their achievements may be too high. The present study has attempted to sift through these objectives to see which ones can generally be achieved, and under what circumstances. The achievement of some of these objectives is related to concomitant external support from the government, others are critically affected by the internal structure of the holding institution.
The impact of external government policies however remains important, in terms of concomitant changes introduced in other parts of the policy environment is evident. The overall degree of competition in the enterprise sector, in terms of freedom of entry and exit, the existence of price controls, sectoral concentration and the role of the private sector, and the degree of openness of the economy, may well do more to affect the profitability of public enterprises than their form of corporate structure. The extent to which and pace at which an economy attempts to liberalize or privatize is also a policy decision, and a holding institution cannot lift itself outside this framework. With regard to the attainment of specific government objectives, as well, direct government support with legislative changes and financial flows that facilitate the realization of these objectives has been observed.

There is clearly a need for further research efforts on interim institutional forms. There are several possible interim stages between state and private ownership which require evaluation, once again because, as in the case of holding companies, these are inevitably going to be used during the long and protracted process of transition. One such arrangement is the ownership, or partial ownership, of public enterprises by financial institutions, such as banks. Other interim arrangements to be explored are management contracts, subcontracting to the private sector, leasing, and management or employee buy-outs. Other forms of institutional ownership could also be considered. An effort must be made to better understand the different forms of, and options between, public and private ownership, to evaluate the circumstances under which they may be used, and to better predict their effects.
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