IPPRED-9

The Interdepartmental Action Programme on Privatization, Restructuring and Economic Democracy

Privatization of two state enterprises in the Lao People's Democratic Republic

M. Allal and F. Bonnet

International Labour Office - Geneva - February 1998

ISBN 92-2-111002-8

First published 1998

Printed by the International Labour Office, Geneva, Switzerland

Contents

Preface

This paper is part of a series of working papers published under the ILO's Action Programme on Privatization, Restructuring and Economic Democracy for use by governments, workers' organizations, employers organizations, development assistance agencies, consultants, academics and managers. The ILO is particularly interested in the social aspects of privatization, structural adjustment and economic transformation. However, it is also concerned with helping all stakeholders to better manage the overall process of privatization. Experience has indicated that, in the areas of privatization and economic transformation, countries that manage privatizations strategically and participatively are more successful.

This paper describes two cases in which the ILO first assisted the Government of the LAO People's Democratic Republic in establishing two state enterprises: an industrial tannery and an integrated textile tannery — between 1982 and 1990 — and subsequently assisted the Government in its decision to privatize them. In 1993, the Government requested ILO and UNDP assistance in the privatization of the LAO industrial tannery (LIT) and the Lao women textile centre (LWTC). The privatization of these two enterprises involved a number of stages: assessment of various privatization options, identification of potential foreign partners; negotiations with a selected number of such partners; and formulation and approval of joint venture agreements. The two enterprises have been successfully privatized and the terms of the Joint Venture Agreements were favourable to the Government. The privatization process was probably one of the most extensive and transparent ever used in the LAO People's Democratic Republic since the start of the privatization of state enterprises.

The effects of the privatization of the LIT contributed to achieving a number of development objectives of particular interest to the Lao Government and the ILO: employment generation; creation of quality jobs; improvement of working conditions; payment of some of the highest skilled and unskilled workers wages in The Lao People's Democratic Republic; increase in productivity levels; respect for international labour standards; and increased private sector privatization in decision-making. These objectives have been fully or partly achieved as a result of the privatization of LIT. During the privatization process it became clear that there was also a need to strengthen the capacity of the national agency responsible for the privatization of state enterprises.

These two case studies of ILO-assisted privatization show that such assistance can benefit other countries in the same situation. Early in the process some countries lack the technical capacity that would allow them to negotiate on an equal footing with foreign partners more knowledgeable in business matters. In view of the results achieved, the ILO assistance was altogether fairly successful. Moreover, the difficulties encountered in the privatization of the textile centre showed that it is essential for governments to create a climate of trust and to strictly adhere to contractual terms if they wish to attract larger numbers of foreign investors. Any future involvement of the ILO will further focus on the above interlinked issues.

Max Iacono
Action Programme Coordinator for Privatization,
Restructuring and Economic Democracy
International Labour Office, Geneva

Executive summary

The ILO assisted the Government of the Lao People's Democratic Republic in establishing two state enterprises: an industrial tannery (the first in the country) and an integrated textile centre. These two projects were implemented over a period of eight years, from 1982 to 1990. At the end of the project, it became clear that, while the staff had acquired the necessary technical skills, there was a real danger that the two projects may fail in view of the absence of managerial and marketing skills (in addition to constraining bureaucratic procedures). At the same period, the Lao Government initiated and applied various policies intended to promote free market mechanisms and privatization policies with a view to generating employment opportunities and foreign exchange, attracting foreign investors and reducing government subsidies to state enterprises which face difficulties in achieving an acceptable level of economic efficiency. Some of the measures adopted by the Government include trade liberalization policies; easing of foreign exchange regulations; adoption of a foreign investment law which should be attractive to foreign investors; and privatization of a number of state enterprises under various forms. The Government was seeking foreign partners for the privatization of these enterprises.

The decision to privatize the Lao women textile centre (LWTC) and the Lao industrial tannery (LIT) was in line with the Government's privatization and free market policies. Furthermore, privatization was the only option for overcoming the management, marketing and financial problems faced by these two enterprises.

In 1993, the Government requested ILO and UNDP assistance in the privatization of these two state enterprises in order to ensure that such privatization will be based on attractive terms for the Government. The previous privatization of other state enterprises presented many weaknesses due to the lack of government capacity for negotiating privatization contracts with foreign partners under more favourable terms. Thus, the financial benefits were much lower than expected and the workers of the state enterprises lost some of their social benefits. Altogether, privatization did little to improve the country's long-term development objectives. The selection of the wrong foreign partners was a further aggravating factor.

Under these circumstances, the request for ILO assistance in privatizing the LWTC and the LIT was made in order to ensure that the privatization process will be carried out under the most favourable terms for the Government and the country as a whole.

The privatization of these two enterprises involved a number of stages: assessment of various privatization options; identification of potential foreign partners; negotiations with a selected number of such partners; and formulation and approval of joint venture agreements. These stages are further discussed below.

The ILO reviewed and assessed a number of privatization options on the basis of various criteria of direct interest for the Government: maintaining the original development objectives of the LWTC and the LIT; creating new jobs; increasing foreign exchange earnings; and expanding and diversifying production. These options (lease contract, joint venture agreement, marketing contract, management contract, full divestiture and a combination of the latter options) were presented to the Government for consideration. The joint venture option, recommended by the ILO, was adopted. This option required, furthermore, the leasing of the existing facilities since the Government did not wish to sell the land.

Following this decision to seek joint ventures for the LWTC and the LIT, the ILO prepared brochures on these two enterprises and sent them to over 400 firms worldwide specializing in textile production and leather products, respectively. A number of firms were preselected for further negotiations between the Lao Government and representatives of these firms. The ILO and UNDP offered their assistance in such negotiations. The latter ended with the signature of Joint Venture Agreements with the selected foreign partners: Simon & Associates and IBC in relation to the LIT, and Société Anonyme Lereport and three other minority shareholders in

relation to the LWTC. In both cases, the Joint Venture Agreements were drafted in such a way as to secure attractive benefits and guarantees for the Lao Government.

The two enterprises have been successfully privatized and the terms of the Joint Venture Agreements were particularly favourable to the Government.

In 1994, the Government and UNDP were interested in having a post-evaluation of the privatization process and requested the ILO to carry out such evaluation. A post-evaluation mission took place in April 1994. The results and recommendations of the mission are presented in Part V of this report.

The above privatization process was probably the most extensive and transparent process ever used in the Lao PDR since the start of privatization of state enterprises.

Concerning the ***tannery***, the Joint Venture Agreement was signed in June 1993 with the formal estblishment of Simon Lao Ltd. The Lao and foreign partners acted swiftly and were able to start up production and export processed hides by the end of October 1993. One of the foreign partners (Simon & Associations, Bangkok) had to make substantial additional investments (over US$800,000) from its own resources as a loan to Simon Lao in order to acquire additional equipment, and for the required working capital. Without such contribution, it would not have been possible to go into production promptly after the signing of the Joint Venture Agreement. Thanks to the high qualifications and motivation of the Lao and foreign staff of the tannery, production and sales increased steadily and the number of workers more than doubled, increasing from 43 workers in 1994 to over 100 workers in mid-1996. Substantial foreign exchange revenues were generated, mostly through sales of finished leather to Simon & Associates (Bangkok) which used the leather for furniture and car upholstery. Estimated revenues and employment levels for future years were particularly promising.

In 1996, Simon & Associates discontinued its leather processing business in Thailand and sold its shares of Simon Lao to another foreign partner. At the same time, the LIT started producing dog chews (pet food made up of the inner lining of the hide) in addition to leather. This proved to be a very profitable business, contributing to a substantial share of the profits made by the firm. Since the production of dog chews is fairly labour-intensive, the number of workers increased to close to 300 by 1997. It may be noted that the production of dog chews was actually initiated on the basis of ILO advice, and the carrying out of a technical and feasibility study funded out of remaining funds in the original ILO/UNDP project.

The effects of the privatization of the LIT contributed to achieving a number of development objectives of particular interest to the Lao Government and the ILO: employment generation; creation of quality jobs; improvement of working conditions; payment of some of the highest skilled and unskilled workers' wages in the Lao PDR; increase in productivity levels; respect for international labour standards; and increased private sector participation in decision-making. These objectives have been fully or partly achieved as a result of privatization of the LIT.

The Joint Venture Agreement for the ***Lao Women Textile Centre*** was signed in October 1993, leading to the establishment of Lao Cotton. However, in 1994, Lao Cotton continued to operate as in the past, and the new production lines specified in the business plan had not yet been implemented. Nevertheless, after the post-evaluation mission in 1994, the prospects and potential socio-economic benefits were very promising. In particular, the foreign partners started establishing commercial linkages with a number of importers in Europe and Asia, designs were improved and production streamlined and rationalized.

In terms of employment, and if the business plan were to be fully implemented, 176 permanent jobs at the Lao Cotton plant, 300 jobs for home-based women weavers and 800 to 900 jobs for home-based women embroiderers should have been created by the end of June 1998. Furthermore, Lao Cotton started subcontracting private farmers for the production of cotton which would help reduce the import of cotton. Over 4,000 new jobs were to be created in cotton production within four years, excluding additional jobs associated with the growing of cotton

(over 1,000 ha should have been put into production within two years). Other benefits were also forecast within three to four years, namely:

— foreign exchange earnings exceeding US$4 million per year; and
— government revenues (in the form of a lease payment and the sharing of profits (49 per cent for the Government)) exceeding US$1 million per year by the end of third or fourth year of the joint venture.

The only potential problem identified in 1994 by the mission concerned the management of Lao Cotton. There were no permanent qualified Lao or foreign staff responsible for the effective technical, administrative and financial management of Lao Cotton. The foreign partners had provided ad hoc management services, but this was not sufficient and did not constitute a long-term solution to this problem. Nevertheless, production and sales increased, and Lao Cotton was able to cover its variable costs and started generating some profits. Cotton production was also initiated, covering most of the needs of Lao Cotton. Additional industrial weaving equipment was also installed by the foreign partners with a view to starting production of a profitable line of new goods, namely bed linen and tablecloths.

Relations between the Government and the foreign partners started deteriorating in 1995. By mid-1996, the Joint Venture Agreement was arbitrarily cancelled by the Government. It is suspected that the Lao Women Union, which operated the LWTC before privatization, was eager to keep the profits for itself rather than sharing them with the foreign partners. Some conflicts between the latter did not facilitate also matters. By the time this report was being finalized, it was not clear whether the foreign partners have received compensation from the Lao Government or whether this matter were to be brought to the local or international courts of justice.

The latest information collected on Lao Cotton indicates that production is falling. This was to be expected since the same weaknesses present before privatization reappeared (i.e. lack of managerial and marketing skills on the part of the management staff of the Lao Women Union). While the same privatization process was used for both the tannery and the textile centre, the different outcomes of these two privatizations were mostly the result of differences between the two local partners involved in the Joint Venture Agreements: the Lao Women Union for the textile centre and the Municipality of Vientiane for the tannery. The union had only one enterprise among its assets (the textile centre). It did not have to bother about the reaction of potential foreign investors to the arbitrary cancellation of the Joint Venture Agreement. On the other hand, the municipality was in the process of privatizing a large number of enterprises it owned in the Vientiane Province. It could not afford to break arbitrarily a contract since this would have frightened off potential foreign partners interested in establishing Joint Venture Agreements with the municipality.

During the above privatization process, it became clear that there was a need to strengthen the capacity of the national agency responsible for the privatization of state enterprises. Such strengthening would ensure that future privatization projects will be negotiated under the most favourable terms for the Government and will maximize benefits for the country. Furthermore, various measures could be implemented in order to attract a large number of foreign investors in economic sectors which are not yet sufficiently developed. Under these circumstances, the ILO included in its post-evaluation report a section intended for the Government where various suggestions are made for improving the capacity of the agency responsible for negotiating privatization arrangements. It is the view of the author of this evaluation that the problems encountered in relation to the privatization of the textile centre could have been avoided if a more effective and better structured agency had been put in place early enough during the privatization of process. It is not clear whether all or some of the ILO recommendations have been adopted by the Government.

These two case-studies of ILO-assisted privatization of state enterprises clearly show that such assistance could benefit many other countries in the same situation. These countries often lack the technical capacity that would allow them to negotiate on an equal footing with foreign

partners more knowledgeable in business matters. However, the failed privatization of the textile centre also shows that it is essential for governments to create a climate of trust and strictly to adhere to contractual terms if they wish to attract larger numbers of foreign investors. Therefore, any future involvement of the ILO in this area should focus on the above interlinked issues.

This direct ILO involvement in the privatization of state enterprises is the only instance known to the author. It was a learning experience for the ILO since it did not have any previous experience in this domain: assessment of privatization options; selecting foreign partners; covering the legal aspects of Joint Venture Agreements; etc. In view of the results achieved, the ILO assistance was altogether fairly successful. The premature termination of the Agreement on the textile centre was not the result of weaknesses in the elaboration of the Agreement: it was mostly due to the country's weak legal system. The issue now is whether the ILO should use the experience acquired in future projects involving the privatization of state enterprises. Should it be directly involved in such privatizations as in Lao PDR? If not, should it limit its assistance to making the tools and instruments prepared for Laos to government agencies in other countries responsible for the privatization of state enterprises? Should the ILO also be involved in the training of the staff for these agencies? These and other questions would need to be answered in the context of this action programme on privatization, taking into consideration important policy and legal considerations.

Introduction

The Lao People's Democratic Republic is a landlocked country. In 1994, its population was about 4,7 million. Its economy is still at an early stage of development and, again in 1994, the estimated per capita income was less than US$320.[1]

Over the past six years, the Lao Government initiated and applied various policies intended to promote free market mechanisms and privatization policies with a view to generating employment opportunities and foreign exchange, attracting foreign investors and reducing government subsidies to state enterprises which face difficulties in achieving an acceptable level of economic efficiency. Some of the measures adopted by the Government include trade liberalization policies; easing of foreign exchange regulations; ***adoption of a foreign investment law*** which should be attractive to foreign investors; and privatization of a number of state enterprises under various forms. Once the Government of the Lao People's Democratic Republic adopted free market mechanisms and decided to privatize publicly owned enterprises, it put machinery in place to assess and approve privatization proposals. In addition, the Government adopted foreign investment polices which were promulgated into a law on foreign investment in 1989. Since then, the law has been reviewed and a new "Law on the promotion and management of foreign investments in The Lao People's Democratic Republic" has been recently adopted (1994). Foreign investors can now request the Government to apply the current law to previous privatizations negotiated under the terms of the 1989 law, or decide to have such privatizations implemented under the previous law.

Two institutions play a leading role in managing foreign investment for the Lao People's Democratic Republic Government: the Foreign Investment Management Committee (FIMC) and a professional body playing the role of a secretariat to the FIMC, the Permanent Office of the Management Committee. The Government's Foreign Investment Management System, still in its formative stage, is rapidly maturing.

In 1993, the Government requested ILO and UNDP assistance in the privatization of two state enterprises established with UNDP funding and ILO technical assistance: the Lao women textile centre (LWTC) and the Lao industrial tannery (LIT).

Additional financial assistance was provided, in the case of the LWTC, by the Australian, Belgian, German and French Governments and by UNCDF. In the case of the LIT, part of the equipment was funded through a local bank (BCEL) loan to the Municipality of Vientiane.

A. Brief history of the two projects

1. The tannery

In 1987, the ILO undertook, at the request of the Government, a UNDP-funded consultancy in order to assess the potential of processing hides and skins which were otherwise exported salted to Thailand or consumed locally. The consultant recommended to improve the collection and salt preservation of most hides for export, while keeping a small fraction of the hides for local processing on a pilot basis. He proposed to establish a small vegetable tanning unit for the processing of a few hides a day, using simple equipment and tools and local tanning products. The processed hides will then be used locally for the production of leather goods. The Municipality of Vientiane (MOV) was the project counterpart agency.

Approval of the project document and the recruitment of the expert took over two years. By the time the expert arrived in Vientiane, he found out that the MOV had acquired over US$300,000 worth of tanning equipment and drums from a Thai dealer. It was estimated that this equipment could process over 200 hides per day, using a chromium-based tanning process. The

[1] World Bank, *Report on the development in the world, 1996.*

MOV secured a loan from BCEL in order to acquire the above equipment, and wished production to start as soon as possible in order to be able to repay the loan according to the terms and schedule agreed upon with BCEL.

Under these circumstances, it became necessary to review the whole project design and implementation since industrial tanning on this scale required a much larger building than that provided by the MOV; the securing of much larger volumes of hides on a daily basis; substantial working capital; more intensive training of the tannery staff; and, most importantly, the installation of an effluent treatment plant costing as much or more than the imported equipment. The establishment of an industrial tannery and of an effluent treatment plant will also require much more time, and, consequently, a rescheduling of the payment of the loan to BCEL.

After further negotiations between the MOV, BCEL, the Ministries of Planning and Finance, UNDP and the ILO, it was decided that:

— the MOV will provide an appropriate plot of land along the Mekong River, and part of the funds required for the construction of the tannery buildings;
— the UNDP will provide additional resources for the design, procurement and installation of an effective effluent treatment plant in order to prevent pollution;
— payment of the BCEL loan will be rescheduled, taking into consideration the time required before production can start;
— the supply of raw hides will have to be investigated, and measures will need to be implemented in order to prevent their export to Thailand as salted hides; and
— the project duration should be extended in view of its complexity and the time needed for the various project stages.

It took over three years before the tannery started production at a fairly low capacity level in view of the many problems encountered. Towards the end of the project, in 1992, the Government requested UNDP and ILO assistance for the privatization of the tannery. Reasons behind this decision are provided later.

2. The Lao women textile centre

The Lao women textile centre (LWTC) started as a modest, UNDP-funded and ILO-executed project in 1983. The counterpart agency of this project was the Lao Women Union (LWU). The original development objectives of this project included: income-generating activities for home-based weavers in the Vientiane Province; the development of Lao hand-woven textiles; and the generation of foreign exchange through export and sale to tourists of hand-woven goods. The main activities of the project included training of trainers at the LWTC and of home-based weavers; development of new products and designs; and the marketing of the LWTC output.

However, thanks to the dynamism of the Chief Technical Adviser (Mr. J. Heuchenne), the active financial support of UNDP, UNCDF and the Australian, German and Belgian Governments, as well as the full and continuous support of the Lao Women Union, the objectives, scope and content of the project reached quickly new and much more important dimensions, and resulted in the establishment of a fully integrated textile centre which makes use of mostly local inputs for its operations (i.e. Lao Cotton).

Expansion of the original objectives and scope of the project were justified by the following:

— First, the production of hand-woven textiles required reliable supplies of good quality yarn of specific characteristics and at affordable prices. Import of yarn from Thailand did not often fulfil these requirements, and would have prevented a regular production of quality hand-woven textiles on a profitable basis.
— Second, the continuous import of yarn would have considerably reduced net foreign exchange earnings, while local cotton was becoming available for yarn production. The

export of raw Lao cotton reduced its value as a foreign exchange earner, and it was therefore fully justified to transform it locally into yarn.

— Finally, the production of hand-woven cloth for sale reduced marketing prospects. Therefore, it was necessary to transform the cloth into garments, home-furnishing goods and other products such as leather goods made up partly with the hand-woven cloth.

B. Privatization of the two enterprises

The decision to privatize the LWTC and the LIT was in line with the Government's privatization and free market policies. Furthermore, management, marketing, technical and financial problems and constraints justified this decision. Privatization was the only option for overcoming the above problems and constraints.

The Government's request to UNDP and ILO for assistance in the privatization of these two enterprises was made in order to ensure that such privatization will be based on attractive terms for the Government, and that the right partners will be selected. Subsequently, the ILO initiated the privatization process. Privatization of these two enterprises involved a number of stages. First, an assessment of various privatization options was made by the ILO. The latter reviewed and assessed a number of such options on the basis of various criteria of direct interest for the Government: maintaining the original development objectives of the LWTC and the LIT; creating new jobs; increasing foreign exchange earnings; expanding and diversifying production and so on. The joint venture option, recommended by the ILO, was adopted by the Government. Second, the ILO identified a large number of potential foreign partners which could be interested in establishing a business in the Lao People's Democratic Republic. Third, it actively participated in negotiations with a selected number of such partners. Finally, it helped formulate the Joint Venture Agreements with the selected partners. The joint venture contracts were signed in June 1993 for the tannery and in October for the textile centre.

Following the privatization of these two state enterprises, the Government and UNDP requested the ILO to undertake a post-evaluation intended to determine the impact of these privatizations on the local economy as well as to assess the effectiveness of the privatization process adopted by the ILO. A post evaluation mission, which took place in April and May 1994, noted that some minor changes were made in the original Joint Venture Agreements. It also identified several potential and actual problems in the implementation of the two agreements. However, at the time of the evaluation, it seemed that the two privatizations should succeed in achieving their original objectives once these problems had been resolved. The evaluation report included a number of recommendations for addressing these problems as well as for strengthening the Government's capacity to successfully negotiate future privatization contracts.

The different stages of this privatization process, from the situation prior to the privatization to the latest developments, will be reviewed in this report. First, the situation and characteristics of the two enterprises prior to privatization will allow to assess their potential and to identify the problems that led to the decision to privatize them. The reasons for and objectives of privatization are based on the in-depth analysis of potentials and problems described in this part of the report. Part II of the report identifies and assesses various privatization options, taking into consideration the objectives they were supposed to achieve. The actual implementation of the selected privatization option (combination of a lease and joint venture agreements) is presented in Part III. Part IV summarizes the terms of these agreements. Some changes in these Agreements were introduced late, prior to the post-evaluation. They are presented in Part V. The latest developments on these two privatizations are presented in Part VI. Lessons learnt regarding joint venture agreements in the Lao People's Democratic Republic are presented in Part VII.

During the above process, it became clear that there was a need to strengthen the capacity of the national agency responsible for the privatization of state enterprises. Such strengthening would ensure that future privatization projects will be negotiated under the most favourable terms

for the Government and will maximize benefits for the country. Furthermore, various measures could be implemented in order to attract a large number of foreign investors in economic sectors which are not yet sufficiently developed. Experience gained during this privatization process could be used by the Government of the Lao People's Democratic Republic for improving its current privatization procedures and the monitoring of privatization agreements. Therefore, some time was spent during the evaluation for assessing this issue. The evaluation report contains a number of recommendations intended to strengthen the capacity of the government agency responsible for the privatization of state enterprises.

Part I. Characteristics of the two state enterprises prior to privatization

A. The tannery

1. Available infrastructure and equipment

Prior to the start of the project, the Municipality of Vientiane acquired US$350,000 worth of industrial tanning equipment from a Thai supplier, with a loan from BCEL. The tannery has been established on a large piece of land along the Mekong River, near the Pepsi Cola factory. Sufficient land was available for an eventual extension of the tannery. The tannery equipment was housed in a large, well-designed building where the various tanning processes could be carried out in an efficient manner. Offices were located in the same building. The effluent treatment plant (a series of concrete basins and drying beds) was located between the building and the Mekong River. The effluent treatment technology was designed by a Dutch firm (TNO).

2. Type of leather produced

The tannery was equipped with the full range of tanning equipment required for the production of **wet-blue leather** (fleshing machine, splitting machine, sammying machine and eight tanning drums). Additional equipment was also available for the production of **crust and finished leather**, but such equipment was not sufficient for the production of these two types of leather on an industrial basis.

3. Treatment of the effluent

The effluent treatment plant was fully equipped for the processing of the effluents from the tannery and for recovering the chromium which is then used again for the tanning of additional batches of hides. The design of the effluent treatment plant had to ensure a full and effective protection of the environment, including, in particular, the Mekong River water. Foreign specialists who visited the tannery agree that the effluent treatment plant is the most modern and effective in the whole of developing Asia. An article in the *Bangkok Post* provided a very positive coverage of the effluent treatment plant, especially since no or much less effective plants are currently operating in the Asian region. The multinational company, IKEA, which is supplied with leather furniture made up of leather produced by the tannery, would have refused such supplies in the absence of a proper effluent treatment plant.

4. Previous and potential production capacity

4.1 Production capacity in 1992

The capacity of the tannery in 1992 was approximately ***7.5 tonnes of wet-blue hides per week*** intended for the export market, mostly in Thailand (i.e. 360 hides per week). The number, size and structure of the tanning drums were the main factors which limited the production capacity. With some small adjustments in the process and the drums' configuration (change of gear boxes), the capacity could be quickly increased to between 10 and 15 tonnes per week (i.e. 400 to 600 hides per week).

The other pieces of equipment used for the production of wet-blue leather (splitting, fleshing and sammying machines) had a much higher capacity and could process over 200 hides per day, if necessary.

A number of pieces of equipment were also available for the production of ***crust or finished leather*** (e.g. a shaving machine, a stacking machine and a toggle dryer), although some additional pieces of equipment were required to complete the leather finishing processes (e.g.

setting machine). The effluent treatment plant could handle a total capacity of 600 hides per day, and could allow a substantial expansion of the tanning department of the tannery.

It will be shown later that this production capacity, available prior to privatization, was very far from being achieved by the local management staff of the tannery.

4.2 Potential capacity

Limited investments for the acquisition of additional tanning drums, and for the extension of the building, could ***increase the plant capacity to 30 tonnes of wet-blue hides per week***, four times more than the capacity in 1992.

The wet-blue hides could also be processed to the crust or finished stages with some limited additional investment for leather-finishing equipment (e.g. setting machine, dyeing equipment). Splits produced from the hides could also be processed and either exported or used locally.

5. Profitability of the tannery

The tannery should have started generating a profit once a capacity of approximately 10 tonnes of wet-blue hides a week had been reached. The break-even point — namely the point at which the tannery would be able to cover all its variables and fixed costs, including the depreciation of equipment and buildings — is a function of a number of variables, including the price of raw materials, the market price of wet-blue hides, the mix of cow and buffalo hides processed by the tannery, the interest rates charged on current loans or used for estimating depreciation costs, and so on. Normally, there were no reasons that should have prevented the tannery from operating in a profitable manner, since it was technically viable and there was a good market for wet-blue hides.

To summarize:

Prior to privatization, plant capacity was 7.5 tonnes of wet-blue hides per week. Potential plant capacity was 30 tonnes of wet-blue hides per week. The break-even-point was 10 tonnes of wet-blue hides per week.

6. Technical, marketing and managerial skills

6.1 Technical skills

The ILO has trained a number of staff members from the Municipality of Vientiane in the following areas:

- main tanning processes, from liming to the production of wet-blue and crust leather;
- maintenance of equipment;
- operation and maintenance of the effluent treatment plant;
- operation of a laboratory for quality control and analysis of the tannery effluents;
- marketing of processed hides;
- collection and flaying of hides;
- accounting, including use of a computerized accounting system; and
- general tannery management.

The technical staff had been trained to the point where it could run a number of standard tanning processes. However, it had not acquired sufficient experience for solving various technical problems that could arise in relation to variations in the quality of the raw hides or chemicals, or for adjusting the process to the intended output. One of the main problems faced in the training of the staff was the fact that production had not yet reached a sufficient capacity, and was often discontinued when it was not possible to secure sufficient quantities of hides. Additional training was also required in relation to the use of the splitting machine and for undertaking various laboratory analyses.

More importantly, the tannery needed a technical director who could supervise all technical activities, programme correct maintenance and repair operations, and so on.

To summarize:

The technical staff was capable, with some additional training, of carrying out all the tannery operations, from the sorting of raw hides to the production of wet-blue and crust leather. Such training could not be completed until the tannery had reached a steady and sufficient production capacity over a sufficiently long period. Additional training was needed in the form of on-the-job training and of fellowships for some of the staff members.

6.2 Marketing skills

There was no local staff with basic qualifications capable of being trained in marketing skills: marketing of the tannery output or in the acquisition of hides, chemicals and spare parts. It was not clear whether it would have been possible to locate somebody with the right qualifications in the Lao People's Democratic Republic, or to have this person trained by the project. Thus, prior to privatization, there were no qualified and trained staff members capable of carrying out the various marketing activities.

6.3 Managerial skills

The tannery needed a full-time, experienced managing director and a qualified accountant. In general, the tannery problems were attributed, to a large extent, to poor overall management. One example which may illustrate the lack of proper management relates to the use made of US$30,000 for the acquisition of a stock of hides and the starting of commercial production. The quality of the processed hides was such that it was difficult to find a buyer who would agree to pay the world market prices for wet-blue leather. Thus, the processed hides could not generate more than US$20,000 (less than the cost of raw hides). Furthermore, delays in finding a buyer and reaching a deal had prevented the tannery from operating in a continuous manner. Political problems, and the scarcity of local people with management experience, forced the project to depend on a staff member of the Municipality of Vientiane with no management skills. He also failed to collaborate with the international experts hired by the project, and established poor working relations with the local tannery staff.

7. Market outlets and marketing

The tannery could, in 1992, produce various types of leather:

- wet-blue leather;
- crust leather, using a manual setting process since there was no setting machine;
- finished leather;
- splits for making industrial gloves and other soft leather products;
- dog chews (a new product with some good marketing prospects, not considered for production at the time the tannery was established); and
- a limited range of finished leather.

7.1 Wet-blue leather

All available studies indicated that there was a good market for wet-blue leather. The latter were the easiest to market since they were standard intermediate products which were less difficult to produce than finished leather which had to conform to the exact specifications of the client. Furthermore, demand for wet-blue leather was very high and it was only necessary to tap into the right marketing channels. Specialists agreed that demand for leather exceeded supply. This was particularly true of Thailand, where tanners were forced to look for sources of supply from neighbouring countries.

7.2 Crust leather

Foreign demand for crust leather should be less than for wet-blue leather because tanners generally prefer to work with wet-blue rather than crust leather for the production of finished leather. On the other hand, there could be a small market for crust leather in the Lao People's Democratic Republic for the production of leather goods. However, demand was very low, and only absorbed a very small fraction of the total output.

7.3 Finished leather

The market for finished leather is an extremely difficult one. It requires a well-equipped leather-finishing department and very close relations with potential clients. Usually, the clients (leather goods and footwear manufacturers) get their supplies from tanneries established in the same country, or have their own tanneries. The Vientiane tannery would have faced great difficulties in exporting finished leather, even if it were to acquire the missing finishing equipment. At best, exports would be limited to standard black or brown leather, which does not require specialized finishing.

Buffalo hides are thick and must be split before sale. The splits could be used for the production of industrial gloves or for other purposes. An export market exists for splits, but these must be of good quality. Alternatively, splits could be processed locally by a foreign partner specialized in the production of industrial gloves.

7.4 Dog chews

There is a good market for dog chews, and first splits could be used for this purpose. Production of dog chews is fairly labour-intensive and does not require a heavy investment in equipment. However, marketing of dog chews required good marketing skills not available prior to privatization, as well as rigorous quality control.

The marketing of splits and dog chews should further improve the profitability of the tannery and lower the break-even capacity utilization. Following privatization, the ILO discussed with the foreign partners the possibility to produce dog chews, a production line these partners were not aware of. Subsequently, the ILO used some remaining funds in the project for the purpose of undertaking a full technical, financial and marketing feasibility study of dog chews production. The study indicated that substantial profits could be generated through such production. Soon after privatization, the foreign partners started producing dog chews. As expected from the feasibility study, most of the profits of the tannery were generated through this additional production line.

8. The BCEL loan

The Municipality of Vientiane had borrowed over US$300,000 from BCEL for the acquisition of some of the tanning equipment from the Lai Lai firm (Thailand). With accumulated interest, the debt had quickly reached US$400,000. The rest of the equipment and part of the building costs had been provided in the form of a grant by UNDP. The Municipality of Vientiane also needed to subsidize the tannery since the latter was not in a position to cover even its variable costs.

9. The legal status of the tannery

The tannery was a project of the Municipality of Vientiane. As such, it had to conform to government procedures in terms of the hiring of staff, the determination of staff salaries, etc. This situation explains to some extent the problems faced by the tannery. The ILO prepared draft legal statutes which would have attributed to the tannery the status of a parastatal organization enjoying extensive managerial and financial autonomy. In 1992, these statutes had not been approved by the Government. Therefore, it had not been possible to test the effectiveness of such a parastatal

structure. It is the opinion of the ILO that, **had such a structure been officially adopted, and had UNDP and the ILO been allowed to help** with the recruitment of staff at all levels at an early date (e.g. late in 1990 or early 1991), limited UNDP resources could have been used in such a way as to ensure a steady and profit-making operation of the tannery.

B. The Lao women textile centre[1]

1. Product line

The centre produced three main types of goods:

- fabrics: the centre produced five qualities of fabrics which were categorized by end use and production method;
- garments: men's and ladies shirts, kimonos and finished home furnishing goods, such as curtains, tablecloths, cushion covers, etc.;
- sundry items: items partly made up of leather including leather-bound notebooks, key cases, picture frames, etc. The leather was imported and sewn at the centre.

2. Production activities

2.1 Spinning

In the spinning department, there were two spinners, each one being used to spin a different size of yarn. Spinner No. 1 was producing 120 kilos of size 16/1 weft yarn and was operating at near maximum capacity on one shift. Spinner No. 2 was operating at two shifts per day, producing 53 kilos of yarn. The spinning department used fairly modern equipment from Germany. This department operated as a modern industry.

2.2 Dyeing

The dyeing department was dyeing hanks only. The dyeing tank could handle washing, bleaching and dyeing in one production run. It also used fairly modern equipment.

2.3 Weaving

The centre had 215 hand looms of which about 200 were being used. About 15 of the looms were used within the centre while the rest were distributed among women weavers working in their home. Each weaver could produce 3 to 4 metres per day, depending on the difficulty of the design.

The original plan for the centre was to employ about 300 weavers. To make this possible, additional hand looms would have to be purchased at a cost of around US$2,500 each, in addition to the additional capital investment required to increase yarn production.

Home weavers were located in 28 villages divided in five areas, with one extension agent assigned to each area. Each agent visited the villages she was responsible for on a daily basis. She completed a production report which was submitted to the production planner who coordinated orders and the various production units.

2.4 Garment production

The garment department produced shirts, special order garments and accessories like kimonos, slippers, curtains and cushion covers, bed and tablecloths for hotels and restaurants, etc. There were, in April 1991, 29 employees in the garment sewing section. They operated 23 sewing machines, as well as cutting and pressing equipment.

[1] Situation in April 1991.

2.5 Leather products

A small department produced goods made up partly from leather, such as paper folders, key cases and picture frames. Five persons were employed in this department. The products appeared to be popular.

2.6 Exports

Packaging and shipping of goods to foreign clients was handled by two shipping companies. There were two main constraints on expanding exports: the high transport cost resulting from the "landlocked" position of the Lao People's Democratic Republic; and the lack of marketing skills.

3. Employment

In 1991, there were about 180 salaried employees and 18 temporary employees who were considered to be "salaried" employees. Weaving was carried out by 180 home-based women weavers who were paid on a piece-rate basis. They were monitored and trained by 28 extension agents.

Salaries for the centre's permanent employees were paid partly through government subsidies. They were based on a salary index set up by the Ministry of Finance. The index specified that salaries should be equivalent to the cost of 4 kilos of rice per month. The centre supplemented the government subsidies by ensuring that each employee received at least the equivalent of US$1 per day. This resulted in a salary range of US$30 to US$50 per month according to the skills of the employee.

All the home weavers were paid directly by the centre according to their output of fabric. Depending on the complexity of the design, weavers earned between US$1 and US$2 per day, and produced 3-4 metres of cloth on average.

4. Market outlets: Design, marketing and sales

4.1 Marketing

Historically, the centre has done little to market its products. Most sales were the result of walk-in clients at the retail shops. The centre participated in a trade promotion fair in Europe which generated some sales. However, the absence of an assistant director in this area did not lead to follow up sales.

In 1991, about half of the centre's weaving production was for special orders while the other half was for the showroom. Selling prices were based on the cost of production plus an arbitrary 15 per cent mark-up. The pricing process was production-driven and did not take the pricing of competitive products into account. There was no ongoing market research efforts. Furthermore, the centre did not attempt to engage in market promotion activities, such as advertising, production of catalogues or organization of special marketing events.

4.2 Distribution and sales

There was no formal distribution system for export sales. Most of these sales had been the result of visits to the retail shops by foreign buyers.

The centre operated two retail shops, one within the premises of the centre and another located in town close to the tourist district. Both of them had on display a variety of items classified as fabrics, garments and leather sundry items. The products were of high quality and contemporary in nature and design when compared with items available in the other stores of Vientiane. However, because of the relatively high cost of the centre's products, most of the goods were purchased by foreign tourists, local expatriates and businesses serving expatriates.

5. Origin of raw materials

The centre utilized two types of cotton: short staple Lao cotton and medium staple imported cotton. Short staple Laotian cotton (1.5 to 1.8 cm) was being used for the production of weft yarn. Taking into account the rate of production, around 5,000 kilos of Laotian cotton were required per month bringing the total yearly requirements to 60,000 kilos. The centre was able to purchase its existing requirements by contracting in advance for cotton through marketing cooperatives within the Lao People's Democratic Republic. The production of Laotian cotton was sufficient to supply the existing raw cotton needs of the centre. However, if the centre were to increase its output of weft yarn, additional quantities would have to be imported.

Medium staple Cameroon cotton (2.2 to 2.8 cm) used for the production of warp yarn was being purchased on the open market. Production required 20,000 kilos a year at a cost of US$1.9 per kilo. Additional medium staple cotton could be purchased on the open market as required.

Thread for the garment and sundry operations as well as leather and other accessories were all imported. Dyes were of the "reactive" type in order to improve colour fastness. They were imported from Germany.

6. Legal structure

The centre did not have a formal legal structure. Most decisions, including many minor decisions normally under the responsibility of management, required the joint approval of the UNDP, LWU and the Ministry. Prior to privatization, the LWU "monitored" the operations of the centre with the assistance of the project experts. Efforts were made to have the centre become an autonomous parastatal enterprise, and draft legal statutes were prepared by the project. However, this attempt did not lead to concrete results.

C. Specific problems leading to privatization

1. The tannery's specific problems

Soon after the tannery was established, a number of problems were encountered which prevented it from achieving the minimum production levels for a profitable operation. These problems are briefly described below.

1.1 Supply of hides

The only reliable supply of hides was, at the time, the Vientiane abattoir. Backyard slaughtering of cattle was taking place in many areas of the country. However, the collection of hides from these areas, while feasible, would have been extremely difficult. In any case, it would have required a project of its own over a number of years: feasibility study on the availability of hides; establishment of hides collection centres; training of extension agents for the proper flaying and salting of hides; and organizing the transport of the latter.

Therefore, the tannery management tried to secure most of the hides produced each day by the abattoir (estimated at 70-90 hides). This number was not sufficient for a fully profitable operation of the tannery, but would have at least covered all the variable costs and some of the fixed costs. However, it became quickly clear that the securing of these hides would require substantial working capital in order to release the Lao hide dealers from their indebtedness towards Thai hide merchants. In view of the lack of financial guarantees, the local banks were not inclined to provide loans for working capital. Furthermore, the hides trade is fairly complex, and the availability of such working capital might not have been sufficient to secure the hides produced by the abattoir.

Under these circumstances, the tannery was only able to process small volumes of hides on an ad hoc basis, and was prevented from achieving minimum levels of profitability. Thus, it continued to rely on subsidies from the Municipality of Vientiane (MOV) for its operations.

1.2 Reimbursement of the BCEL loan

In view of all the above problems, the tannery could not start repayment of the loan, or even the interest accrued. Thus, the MOV was facing a situation of a constantly increasing debt without any real prospects for starting reimbursement. In the long term, this would have completely crippled the already poor financial situation of the tannery, and would have forced the MOV to declare itself insolvent vis-à-vis the bank.

2. The textile centre's specific problems

The textile centre presented a number of specific weaknesses.

2.1 An uncertain supply of local raw materials

Production of locally grown short staple cotton was quite small and has not always been available to the centre. If production of weft yarn was increased, short staple cotton would have to be imported. There was no local supply of middle or long cotton staples. Thus, the centre was forced to purchase these from world markets.

2.2 Low labour productivity

Though the daily labour wage was low, productivity was also quite low. This was due to the fact that the fabrics were produced by traditional, hand-woven methods; production runs were short and training had been minimal.

2.3 Small sizes of the industrial spinning and dyeing units

The spinning and dyeing units were too small for an economically competitive operation, when compared to the much larger units established in other countries. They did not allow for economies of scale.

D. Problems common to the tannery and the textile centre

Both the tannery and the Lao women textile centre encountered a number of common problems:

- marketing problems;
- lack of funds for additional investments and working capital;
- management problems; and
- technical problems.

These problems led to the decision to privatize these two enterprises. They are further discussed below.

1. Marketing problems

The tannery

Two main problems were encountered in the marketing area. First, it was difficult to seriously engage in marketing activities in view of the very low number of hides that could be processed, and the market requirements for large volumes of hides to be exported on a regular basis. Therefore, marketing activities could be only carried out on an ad hoc basis, without much success.

Second, the management staff of the tannery did not include a staff member qualified in international marketing. It had little knowledge of potential clients, marketing procedures, and so on. Thus, even if the supply of hides had increased significantly, the tannery management would have faced difficulties in identifying profitable markets and in applying the relevant

marketing procedures. Almost no exports were realized, and the tannery accumulated a stock of processed hides (wet-blue), which was quickly deteriorating and may never be exported or used.

The textile centre

The following problems were encountered soon after the LWTC started operations and partly explain the decision to privatize it. The export of garments and home-furnishing goods produced with hand-woven cloth is a very complex operation which requires very good marketing skills and an in-depth knowledge of international markets. The garment and home-furnishing markets are very competitive in nature, in view of the large number of producers in the Asian region. Fashions change constantly, and it is therefore important to adjust production to such changes. Active participation in international fairs is also a prerequisite for effective marketing.

Unfortunately, the required marketing skills were not available at the LWTC. When foreign advisers were still working at the centre, it was possible to identify a number of foreign clients and to maintain some level of exports. Subsequently, the local LWTC marketing staff was not able to maintain the past level of exports, and most sales were made in the Lao People's Democratic Republic to tourists, hotels, restaurants and some local people. This situation explains, to a large extent, the low level of sales of LWTC at the time it was privatized.

2. Lack of funds for additional investments and working capital

The tannery

Additional financial resources were needed for working capital since revenues could not be generated without the production of a sufficient stock of processed hides. Working capital for hides, chemicals, labour, etc., was required for approximately a four-month production period, estimated at a few hundred thousand dollars (US). Furthermore, there was a need to acquire some additional equipment, improve some of the existing equipment and extend the buildings for a more efficient operation of the tannery. The required additional funding was estimated at over US$100,000.

The MOV could not provide the required financial resources, and the local banks also declined to provide loans in view of the estimated risks. Consequently, the tannery could only produce very small volumes of processed hides with its limited resources.

The textile centre

Prior to privatization, the LWTC required urgently additional funds for the following purposes:

- expanding the capacity of the spinning department in order to increase output, while at the same time reducing unit production costs. Such an expansion would have been justified, even in the absence of sufficient markets for hand-woven cloth, since there was a good local demand for yarn;
- expanding the capacity of the dyeing department since it constituted a bottleneck to any further expansion of the production of hand-woven cloth. The dyeing process needs also to be relocated, and a pollution control system installed; and
- working capital for the maintenance of sufficient stocks of cotton and the production of sufficient volumes of finished goods for the local and export markets.

UNDP could not provide the required additional funds, nor were local banks inclined to provide the necessary loans in view of the estimated risks. Thus, the financial situation of the LWTC did not allow it to expand production according to market requirements, should market prospects have been improved.

3. Management problems and constraining bureaucratic problems

The tannery

The efficient operation of any enterprise requires quick decision-making and the hiring and retaining of qualified staff who must be offered attractive salaries. Since the tannery belonged to a government agency, rules and procedures applying to such agencies must also apply, to a large extent, to the management of the tannery. These rules and procedures did not allow for efficient management although the Municipality of Vientiane did its best to give some degree of freedom to the management staff. It was also possible to attract a few qualified staff members in the area of processing. However, UNDP funding was necessary for retaining a key qualified staff member, trained by the project (the tannery supervisor), by offering him a higher salary from the project budget.

The management staff did not have the right qualifications for the effective management of a fairly complex operation. Furthermore, being government officials handling secured jobs, it was not sufficiently concerned of the need to reduce costs and generate profits.

Under these circumstances, the problems mentioned earlier were compounded by the lack of efficient management and further reduced prospects for a profitable operation of the tannery.

The textile centre

The LWTC is a complex enterprise requiring skilled management. Without the latter, it could not achieve the level of expected profitability. Unfortunately, the local management, although it showed great motivation, did not have the necessary management skills required for such a complex enterprise. Consequently, constant management problems considerably reduced the effectiveness required for the profitable operation of the LWTC.

The LWTC was established under the aegis of the Lao Women Union and operated as a publicly owned enterprise. Thus, it was submitted to the usual bureaucratic constraints which created a number of management and other problems. For example, it was difficult to attract and/or retain qualified staff. Furthermore, the Lao Women Union could not put at the disposal of the centre a permanent representative with a signature authority. Most decisions had to be approved by the Lao Women Union, leading to delays in decision-making. A solution to this problem was considered, and would have transformed the LWTC into a semi-private body enjoying wide management and financial autonomy. However, the late adoption of this solution did not significantly improve the overall management of the centre for reasons provided earlier.

4. Technical skills

The tannery

A few technical problems were encountered soon after the start of production: limited water supply, badly designed tanning drums, etc. These problems required additional financial resources in order to resolve them. As mentioned earlier, these were not available. Thus, even if more hides would have become available, production would not have reached full capacity unless these problems were first resolved.

The textile centre

While under the project a number of staff members received intensive training for running the various technical departments, and although most staff members acquired substantial technical skills, the overall capacity of the technical staff to run effectively the whole production process was still lacking. Thus, frequent breakdowns due to insufficient preventive maintenance and planning at times reduced the centre's production capacity.

E. Decision to privatize the Lao industrial tannery and the Lao women textile centre

The above problems, and the absence of feasible solutions to resolve them, took place at a time when the Government was pursuing free market mechanisms and privatization policies.

Under these circumstances, it was first envisaged to transform the tannery into a semi-private body, enjoying full managerial and financial autonomy. The ILO provided assistance in preparing the legal and institutional framework for such a body, and the latter was finally established in 1992. However, the above problems remained, and little change took place in relation to the tannery management. Consequently, it became clear that the only solution was to privatize the tannery. This decision was fully in line with government policies and was adopted by the authorities concerned in 1993. The Government requested the ILO to provide assistance for a successful privatization. The current privatization of the tannery was the result of this request.

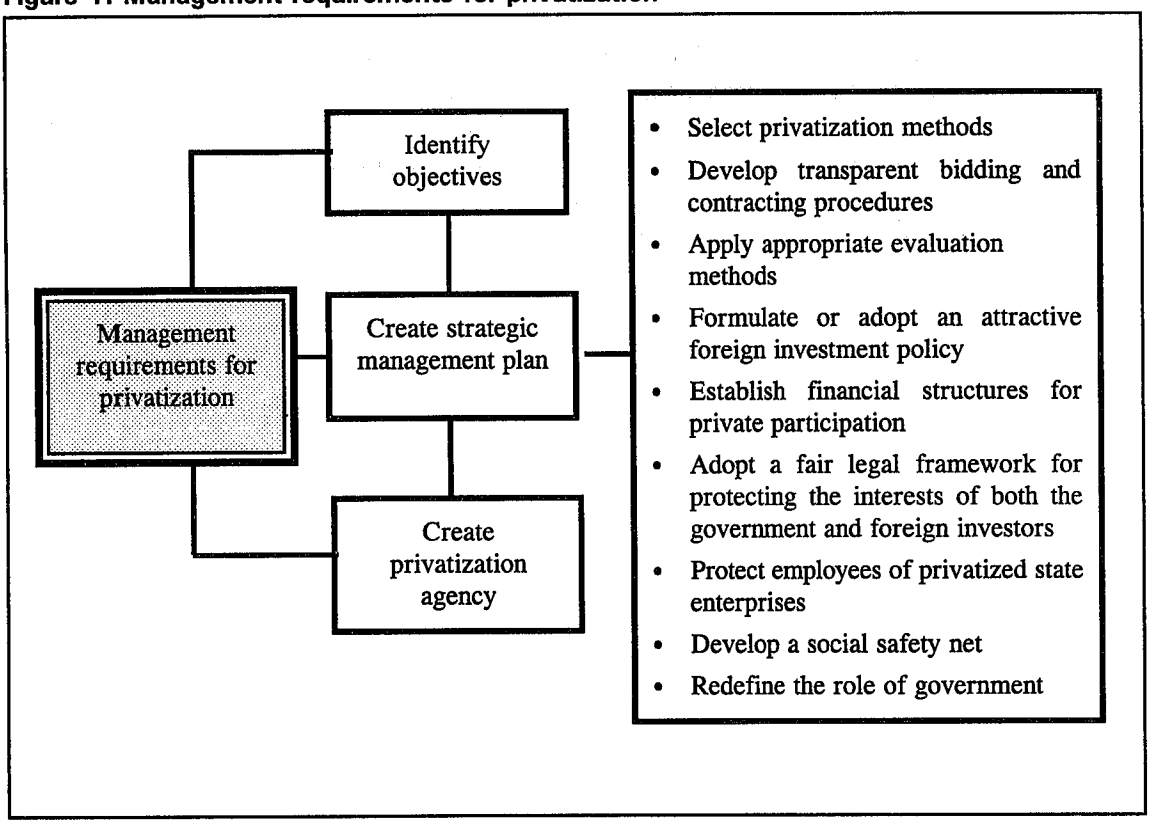
At the same time, the LWTC also became a candidate for privatization, after a number of other options had been reviewed and rejected. Consequently, the Government requested UNDP and ILO assistance for an effective and profitable privatization of the centre. The current privatization of the LWTC is a result of this request. Negotiations started in early 1993 and the Joint Venture Agreement was finally signed in October 1993, and amended in February 1994 in view of the addition of other foreign shareholders.

Part II. Objectives and procedures for privatization

A. Overall objectives and procedures for privatization

Managing the privatization process is a complex undertaking. Figure 1 shows a set of important management principles that governments must take to manage privatization effectively. Taken together, these actions form a management framework for planning, implementing and managing the privatization process.

Figure 1. Management requirements for privatization



Identifying the objectives and principles of privatization

Setting realistic priorities and goals is essential to developing appropriate processes and procedures for privatization.

Creating an effective privatization agency

Privatization is a complicated process that requires an agency or organization that has the resources, authority, and skilled personnel to implement the process professionally and with a minimum of bureaucratic delay. Governments must carefully consider the most appropriate organizational structure for the privatization agency and the most appropriate set of functions and tasks to assign to it. It is also important to put in place the conditions that will ensure the agency's success in managing the privatization process.

Developing and implementing a strategic management plan

Once goals are established they should be described clearly in privatization plans: annual privatization plans, multi-year plans or master plans for privatization. The type of plan that is selected depends on the economic circumstances in the country, the degree to which the government is able to predict in advance which companies can be offered for privatization, its capacity to offer state-owned enterprises for sale or transformation, and the ability of investors to respond quickly. The strategic management plan should offer a set of guidelines providing overall directions for privatization that can be adjusted regularly as government gains more experience and learns more about the complexities and opportunities.

These include the identification and evaluation of various options of privatization and the selection of one method or combination of privatization methods; the development of transparent bidding and contracting procedures; the application of appropriate evaluation methods; the formulation and adoption of an attractive foreign investment policy; the establishment of financial structures for private participation; the adoption of a fair legal framework for protecting the interests of both the government and foreign investors; the protection of employees of privatized state enterprises and the redefinition of the role of the government.

All of these stages will be reviewed in the particular case of the tannery and the textile centre privatizations.

B. Objectives of the privatization of the tannery and of the Lao women textile centre

1. Common objectives

There were a number of reasons which justified the privatization of both the tannery and the Lao women textile centre in one form or another:

- The first and most important reason was that such privatization was in line with the New Economic Mechanism adopted by the Government and applied in most sectors of the Lao economy. The tannery and the textile centre presented all the characteristics that would justify their privatization.
- Secondly, privatization was required in order to establish the necessary marketing channels for the tannery and the Lao women textile centre output. In theory, a well trained local marketing director should have been able to establish such channels. In practice, this was difficult to achieve. Only a foreign privatization partner would have been able to offer the necessary marketing expertise, especially if the partner was directly involved in the marketing of finished or semi-finished leather in the case of the tannery, and of hand-woven goods in the case of the textile centre.
- Thirdly, privatization would provide the necessary managerial and technical skills required for an efficient operation of the tannery and of the textile centre. This reason would have applied only in the case where it was not possible to find local staff with the required qualifications for the positions which were still vacant (e.g. marketing and managerial staff).

2. Specific objectives

2.1 The tannery

- The most important reason was of a financial nature. The MOV was not capable of repaying the BCEL loan. Any privatization solution had to provide the financial resources for this purpose.
- A private partner had to provide sufficient working capital for a full capacity utilization of the tannery. It was estimated that US$100,000 to US$200,000 was required for the acquisition of sufficient supplies of hides and chemicals and for labour costs (three months'

stock of raw hides and chemicals, and the value of two to three months' stock of wet-blue leather (in view of standard payment delays and the need to produce a minimum load of wet-blue leather before shipping).

- Thirdly, a privatization partner had to provide the necessary additional capital in order to ensure a fuller capacity utilization of the tannery. Additional funds were required for the acquisition of larger drums and other miscellaneous equipment. A total of US$100,000 to US$150,000 could be required for this purpose. Indeed, any potential privatization partner would have to take into consideration the need for an additional investment since the current capacity would not ensure an acceptable rate of return.
- Finally, a privatization partner could have been interested in providing the necessary financing and know-how for the establishment of leather goods and/or footwear manufacturing units which would use finished leather produced by the tannery. This was a particularly attractive solution since it could help generate a great deal of employment and foreign exchange.

2.2 The Lao women textile centre

A number of specific objectives justified the privatization of the textile centre. These are:

- ensuring that traditional Lao hand-woven fabrics will continue to be produced by home-based weavers; total production should not be lower than that applying before privatization or should preferably be higher;
- Lao cotton should gradually replace imported cotton;
- produced yarn should be used in priority by the centre for the production of hand-woven fabrics, and only excess production could be sold without further processing; and
- the foreign partners must have the necessary managerial and marketing know-how and sufficient financial means for further fixed investments.

C. Guiding principles for full or partial privatization

A number of reasons have been provided in the previous paragraphs which would justify the privatization of the tannery and of the Lao women textile centre. Such privatization should be based on a number of guiding principles for the choice of the most attractive privatization option, in line with the Government's socio-economic objectives and New Economic Mechanism.

The selected privatization option (presented later) will, by necessity, be a compromise solution between that which would best reflect the country's development objectives and that which would be acceptable to the privatization partner. In the process of negotiating a privatization deal, maximum efforts should be made in order to apply as many as possible of the following guiding principles, or at least the most important ones.

The tannery

- *Guiding principle No. 1*
  Development of the Lao leather sector
- *Guiding principle No. 2*
  Improvement of the balance of payments
- *Guiding principle No. 3*
  Repayment of the BCEL loan, including interest payments
- *Guiding principle No. 4*
  No government subsidies
- *Guiding principle No. 5*
  Generation of government revenues
- *Guiding principle No. 6*
  Preference for a local privatization partner
- *Guiding principle No. 7*
  Protection of the environment and adoption of safe working conditions

The textile centre

- *Guiding principle No. 1*
  Promote native textile handicrafts
- *Guiding principle No. 2*
  Improvement of the balance of payments
- *Guiding principle No. 3*
  Provide income-generating jobs for Lao women
- *Guiding principle No. 4*
  No government subsidies: generate sufficient cash flow to operate without further subsidies
- *Guiding principle No. 5*
  Generation of government revenues
- *Guiding principle No. 6*
  Preference for a local privatization partner
- *Guiding principle No. 7*
  Protection of the environment and adoption of safe working conditions
- *Guiding principle No. 8*
  Use Lao produced cotton to the extent it is available
- *Guiding principle No. 9*
  Generate foreign export income to the extent possible through export sales

Create privatization agency

The above guiding principles would have to be negotiated with potential privatization partners, and the selected partner would have to abide by these principles translated into specific contractual terms. The application of these guiding principles will be a function of the privatization alternative adopted by the Government. Various privatization options are discussed in Part III of this report. Prior to doing so, the privatization policies and institutional mechanisms established by the Government of the Lao People's Democratic Republic for applying these policies are briefly reviewed below.

D. Privatization policies and institutional mechanisms

Once the Government of the Lao People's Democratic Republic adopted free market mechanisms and decided to privatize publicly owned enterprises, it put into place a machinery for assessing privatization proposals and approving the latter. In addition, the Government adopted foreign investment polices which were promulgated into a law on foreign investment in 1989.

1. Role and functions of the Foreign Investment Management Committee (FIMC)

The Foreign Investment Law states that the FIMC is the government agency responsible for the promotion and management of foreign investments in the Lao People's Democratic Republic. The FIMC plays the role of a "one-door" service for foreign investors. It is supposed to issue licences and review and manage privatization proposals, in collaboration with the concerned line ministries and provincial authorities from which the privatization proposals originate.

FIMC reviews applications from foreign partners and evaluates, processes and eventually approves them within 60 days at the latest from the day the application is received. Line ministries and/or provincial authorities are supposed to provide their technical comments to the FIMC within 20 days at the latest from the day they receive requests for such comments from the FIMC. Once a licence has been granted, the foreign partners must register the company and may then start the business. The line ministries or provincial authorities are supposed to manage the foreign investments under their responsibility.

2. Additional information on the role, functions and structure of the FIMC described in the 1989 law and obtained from discussions with FIMC staff members

According to the 1989 Foreign Investment Law, the FIMC must perform the following functions:

- to consider and authorize investments, and approve agreements on contractual businesses, joint ventures and wholly foreign-owned enterprises;
- to inform the foreign partners about the terms and regulations of the Foreign Investment Law;
- to facilitate the preparation and approval of foreign investment agreements by the Lao investors and their foreign partners;
- to monitor foreign investment agreements with a view to ensuring that the partners are adhering to the terms of the agreements and Lao laws and regulations; and
- to review and assess the application of the Lao Foreign Investment Law with a view to advising the Council of Ministers on measures to improve the content and application of the law.

FIMC must approve the privatization proposal and issue the licence to operate. It is supposed to use the services of a professional body which will review the accounts and audit reports, and give its opinion on the implementation of the accounting system used by the privatized company.

In addition to the Privatization Office, it would seem that a separate privatization committee is to be established for each privatization proposal/agreement. The committee is presumably made up of representatives of the Privatization Office (or FIMC) and of the line ministry/ municipality/locality from which the privatization proposal originates. These latter bodies are supposed to provide technical inputs for the assessment of privatization proposals and to monitor privatization agreements in collaboration with members of the Privatization Office or FMIC (e.g. Ministry of Finance for checking the accounting system and financial transactions).

The ILO assessed the above information and made various proposals for adoption by the Government. Altogether, information at hand does not shed sufficient light on the role, functions and structure of the various bodies involved in foreign investments. In the event action is required in order to clarify the latter, such action should be initiated as soon as possible since this is an important issue for the foreign partner. In any case, a clear information brochure on the role, functions, structure and procedures of the various privatization bodies should be prepared for the near future and made available to potential privatization partners.

3. Comparison between the 1989 and the 1994 Foreign Investment Laws

Since then and after the privatization of the tannery and the textile centre, the law has been reviewed and a new "Law on the Promotion and Management of Foreign Investments in the Lao People's Democratic Republic" has been adopted (1994).The main differences between the two laws are summarized and discussed below:

- The new 1994 law covers two types of foreign investments: joint ventures and fully foreign-owned enterprises. The 1989 law includes a third category: business by contract. The latter may include marketing and management contracts whereby the foreign partners offer services to the publicly owned enterprises, while assets of the latter remain the property of the State.
- The 1994 law does not impose any limitations on the duration of fully foreign-owned enterprises (15 years in the case of the 1989 law).
- Foreign staff must pay a 10 per cent income tax instead of 5 to 10 per cent as per the 1989 law.
- Corporate profits are submitted to a 20 per cent tax instead of 20 to 30 per cent in the 1989 law.
- Tax exemptions for a period of two to four years, with a further 50 per cent exemption for some specific types of investments are mentioned in the 1989 law, while such exemption is not clearly spelled out in the new law. This lack of clarity may affect foreign investments negatively. The ILO recommended that this matter should be reviewed by the authorities concerned, and clarified in the near future.
- The 1989 law indicates that taxes will be imposed on all imported inputs according to the Customs Regulations of the Lao People's Democratic Republic, while the 1994 law specifies that a 1 per cent import duty will be levied, while imported inputs for the production of goods for the export market will be exempted from duty. Thus, the 1994 law is more attractive to foreign partners, although special exemptions on imported equipment and materials (the latter for a two to four-year period) have been included in some previous joint venture agreements, under the 1989 law.
- In general, the 1989 law provides much more detail on conditions and terms for foreign investments in the Lao People's Democratic Republic than the 1994 law. While the latter is thus substantially simplified, its implementation may require more negotiations with the foreign partners in order to clarify the application of some of the articles and terms.

Foreign investors can now request the Government to apply the current law to previous privatizations negotiated under the terms of the 1989 law, or decide to have such privatizations implemented under the 1989 law.

4. Privatization procedures used by the FIMC

It is not clear whether well-defined procedures are systematically applied by the staff of the FIMC (or Privatization Office). From discussions with staff members of the FIMC, it would seem that the following stages are used in the privatization of state enterprises.

Stage 1: Receipt of privatization proposals from government agencies and provincial/local authorities.

Stage 2: Evaluation of privatization proposals.

Stage 3: First offer for privatization to the staff of the enterprise to be privatized.

Stage 4: Search for foreign and Lao private partners for privatization.

Stage 5: Call for bids.

Stage 6: Assessment of offers.

Stage 7: Negotiations.

Stage 8: Selection of the local or foreign partner.

Stage 9: Drawing up of privatization contracts.; and

Stage 10: Approval and signature of the contract.

Information obtained on the above in the privatization process was far from being clear. Such process would be confusing to potential foreign investors. The ILO recommended that a more systematic procedure should be urgently established for the benefit of both the Lao and foreign partners.

More detailed information on ILO proposals for improving the evaluation and application of privatization proposals is provided later in this report.

Part III. Privatization process

A. Privatization options

One of the most important tasks in planning and managing privatization is to choose the most appropriate privatization options. Experience with privatization over the past decade has clearly shown that no single method is the most appropriate for divesting of all state-owned enterprises (SOEs) or for eliciting the participation of the private sector in all economic activities. Governments have to choose which option or combinations of options are most appropriate for achieving their objectives. In making the selection, they must consider the conditions of and trends in the sectors or industries in which SOEs operate, and the current organizational forms, financial conditions, records of performance, management capabilities, and assets of the SOEs they wish to privatize.

The situation of both the tannery and the Lao women textile centre and the problems leading to privatization have been presented in Part I and the objectives of privatization in Part II. This chapter reviews the five major options for privatization envisaged in the particular case of the tannery and the Lao women textile centre.

Once the Government of the Lao People's Democratic Republic requested ILO assistance in the privatization of the LIT and the LWTC, the ILO prepared a paper for government consideration, outlining and assessing a number of privatization options. This paper focused mostly on the privatization of the LIT, but its findings and recommendations should apply equally to other privatization agreements.[1] The guiding principles were then used to assess the feasibility and potential benefits of the following five privatization options:

- sale of the buildings and equipment to a local and/or foreign investor (full divestiture option);
- joint venture agreement with Lao and/or foreign partners;
- lease agreement;
- management contract; and
- marketing contract.

These options are further elaborated below.

1. Full divestiture (sale) of facilities

In this strategy, the state enterprise equipment and stocks would be sold to a local or foreign investor, while the buildings and land would be leased for the tannery's total life.

2. Joint venture

There are two types of joint ventures: one where the Government (Municipality of Vientiane (MOV) or the Lao Women Union (LWU)) and a foreign investor would be the joint venture partners, and one where a foreign investor and a Lao investor would be the partners. A third type of joint venture would involve the MOV/LWU and a Lao partner. This implies financial means and technical, managerial and marketing know-how. However, it does not seem that such a partner can be found in Laos. Therefore, this third type of joint venture is not accessed further in this paper.

[1] *Assessment of various options for the privatization of the Municipality of Vientiane tannery*, by M. Allal, Entrepreneurship and Management Development Branch, ILO Geneva, 1992.

3. Management contract

A management contract could take many forms. In principle, it should not involve any financial commitment from the partner in terms of additional investments or the payment of outstanding loans. However, financial inputs could be considered in the form of a reimbursable loan, as long as the duration of the contract would ensure reimbursement of the loan and accumulated interests, and/or the Government can guarantee the reimbursement of the loan in the event the contract must be prematurely terminated. A management contract could also constitute the first stage in a process leading to a joint venture or a full divestiture of the facilities to the contract partner.

A management contract can exhibit one or more of the following characteristics:

(i) the partner only offers its technical, managerial and marketing skills against payment. The latter could be a standard monthly fee, a share of the profits, or both. The contract will determine the respective responsibilities of the MOV/LWU and of the contract partner, as well as an agreed upon level of performance of the latter in terms of plant capacity utilization or level of sales;

(ii) the partner may provide both its know-how and some financial inputs for the working capital and additional investments to increase the plant capacity utilization. These financial inputs would be provided in the form of a loan at an appropriate interest rate (fixed or variable). The partner would probably require guarantees, in one form or another, to ensure that he will recover the loan in the event that the management contract should be prematurely terminated.

Whatever form the management contract would take, the legal status of the enterprise would have to be clearly spelled out and approved by the Government. The potential partners would probably require that the tannery/textile centre enjoys a full managerial and financial autonomy, including both the freedom of hiring new staff and/or replacing current staff in order to achieve the necessary efficiency. The role of the MOV/LWU should be limited to ensuring that the foreign partners apply fully the contractual terms.

The management contract should indicate the services to be rendered by the contract partner. These may include one or more of the following:

- supervision and improvement of all technical processes, including the treatment of the effluent in the case of the tannery, and quality control;
- development of an improved hide flaying and collection system for the tannery and improvement in the procurement of Lao cotton in the case of the textile centre;
- overall management, including financial and personnel management, incentive systems, accounting, etc.; and
- marketing of the wet-blue leather and other tannery products, and of handicrafts and textile products from the textile centre.

4. Lease agreement[1]

A lease agreement is similar, in many ways, to a management contract. The leaseholder provides the required technical and managerial skills. However, he only pays a flat fee to the

[1] As noted in the paragraph on government policies, the new 1994 law covers two types of foreign investments: joint ventures and fully foreign-owned enterprises. Both the 1989 and 1994 laws do not include another option used in past privatization agreements, namely the lease contract. The latter may constitute an attractive option and is generally needed as an addendum to joint venture agreements since the land and buildings owned by the State are often leased to the foreign partners as part of the joint venture agreement. However, it would also seem from discussions with staff members of the FIMC that the foreign investment options considered by the Government include fully foreign-owned investments (including the sale of all the assets of a state enterprise),joint venture agreements, lease agreements, and a combination of both lease and joint venture agreements (this is currently the case for Simon Lao (the tannery) and Lao Cotton (the Lao women textile centre)). On the other hand, management and marketing contracts (i.e. business contracts included as an option in the 1989 Law) are not considered currently by the FIMC.

Government and keeps all the profits. The contract would normally specify the responsibilities of the leaseholder, such as the requirement to maintain the facilities in good working order (including, if necessary, replacement of worn-out equipment) and the need to operate the facilities at a high capacity utilization.

It is unusual for a lease agreement to require the leaseholder to make an initial investment (e.g. for the reimbursement of the BCEL loan for the tannery or for the acquisition of additional equipment). However, this could be considered in the agreement. In this case, payment of a flat fee would be postponed until the leaseholder has been paid back his initial investment plus, eventually, some interest payments.

5. Marketing contract

In a marketing contract, the partner agrees to buy specified volumes of wet-blue leather, splits and other tannery products for either set unit prices or on the basis of world market prices. This type of contract could be of interest under the following conditions:

- the tannery and the textile centre remain a state enterprise, although it should enjoy full managerial and financial autonomy;
- financial resources can be secured for working capital and additional investments for full capacity utilization of the facilities;
- in the specific case of the tannery, the BCEL loan can be renegotiated; and
- qualified and trained technical and managerial staff can be recruited locally.

The above conditions would be extremely difficult to achieve since the current problems faced by the tannery and the textile centre are the result of a lack of funds for working capital, and the absence of qualified managerial and marketing staff. The above problems would have to be solved with, for example, additional technical assistance before a marketing contract could be considered. Under these circumstances, this option was not considered for the privatization of the tannery or the textile centre.

Remarks:

From discussions with staff members of the FIMC, it would seem that the selection of a particular option depends on the type and characteristics of the state enterprise to be privatized. For profit-making enterprises, the Government prefers joint ventures. Enterprises experiencing heavy losses tend to be sold to foreign partners. Lease agreements are used when enterprises face financial problems, cannot borrow funds locally but have, nevertheless, a good growth potential. The FIMC feels that, in general, joint ventures are more difficult to negotiate and monitor than the sale of the enterprise or lease agreements.

B. Overall assessment of the five privatization options

The overall assessment of each option was then carried out on the basis of a ranking of each option vis-a-vis each of the adopted guiding principles: very attractive, attractive and least attractive option. This ranking method resulted in the following ranking of the various privatization options:

- joint venture agreement (JVA): most feasible and attractive option;
- full divestiture option: second best option;
- lease agreement (LA): less attractive in terms of government revenues and achievement of development objectives; and
- management or marketing contract: least advantageous options from most points of view.

The determination of the best privatization strategy from the point of view of the guiding principles spelled out earlier would also depend, to a large extent, on the characteristics of the

potential partners for the planned privatization and on the type of offers they would make to the Government. The ranking was made with respect to each of the guiding principles.

1. Joint venture

A joint venture was the most attractive privatization option since the Government would be in a stronger position to induce the privatization partner to apply some of the important guiding principles, such as the long-term development of the Lao leather sector and the protection of the environment in the case of the tannery, and of the Lao hand-woven fabrics in the case of the textile centre. Furthermore, a larger fraction of the generated foreign exchange should remain in the country, and greater efforts would be made to develop the local management and technical capacity. Concerning the tannery, one disadvantage of this option was that it might not yield a satisfactory solution for the reimbursement of the BCEL loan, unless the privatization partner were to acquire a large majority of the shares. However, it was doubtful that this would happen since, in this case, the joint venture partner would by far prefer to become the sole owner of the tannery if he/she was required to invest heavily in this project.

It was recognized that the search for a partner for a JVA would present some difficulties, especially if the conditions offered by the Government were not very attractive. However, it was supposed that these difficulties could be less important than in the case of a full divestiture option. A number of conditions needed to be fulfilled by the Government before a foreign partner would agree to a JVA. These are:

- guarantees regarding the supply of hides;
- suitable legal framework: the tannery and the textile centre would have to enjoy a full managerial and financial autonomy, and clear legal statutes would have to be formally approved by the Government beforehand; and
- a satisfactory solution concerning the BCEL loan had to be approved by all parties concerned.

The success of a joint venture option required a very careful choice of the joint venture partner. The latter had to have the necessary technical and managerial know-how, good experience with the marketing of leather products (tannery) or hand-woven goods (textile centre), as well as sufficient financial resources. Most importantly, the foreign partner should not be looking for short-term profits. It should consider a long-term relationship with its Lao partner, considering that the full development of the leather or textile sector would take much time to achieve. In particular, many years will be needed in order to develop the supply of local raw materials, such as cotton or hides.

2. Full divestiture option

This privatization option seemed to be a second-best solution when compared to a JVA. It was supposed to be quite attractive in relation to the development of the Lao leather and handicrafts sectors and the generation of foreign exchange. Furthermore, it would not require financial inputs from the Government, and should have provided a satisfactory solution for the reimbursement of the BCEL loan. This latter advantage was particularly important in view of the limited financial capacity of the Municipality of Vientiane. However, this option was less advantageous than a joint venture in relation to the development of a local managerial and technical capacity, the generation of government revenues and the protection of the environment, since the Government would not have been able to control the operation of the tannery or the textile centre on a regular basis.

3. Lease agreement

A lease agreement was less attractive than both a joint venture or a full divestiture option. It provided much less guarantees in relation to the development of the Lao leather, handicrafts and cotton sectors, the generation of foreign exchange and government revenues, and the protection of the environment. It was also doubtful that it could provide a satisfactory solution for the reimbursement of the BCEL loan. In general, a leaseholder would use his/her freedom of action to generate maximum profits without concern for the main guiding principles spelled out earlier. The Government would have lacked the capacity and legal base that would have allowed it to exercise a meaningful control of the tannery and of the textile centre operations. The leaseholder would have probably had a short-term view unless he/she was required to invest substantial sums in the form of working capital and/or additional equipment.

4. Management and marketing contracts

A management or a marketing contract seemed to be the least advantageous privatization option. They had most of the disadvantages of a lease agreement. In addition, it would not have led to a quick and efficient transfer of skills to local staff, since it was in the interest of the contract partner to sell his/her services for as long as possible. A management or a marketing contract should be considered mostly as a stop-gap solution if partners for the other options cannot be found quickly. The partner in a management or marketing contract would have to ensure the operation of the tannery or the textile centre at an acceptable capacity utilization without further government subsidies. This was a minimum requirement.

The ILO paper was studied by the Lao Government which decided to adopt the joint venture option recommended by the ILO, and requested the latter's assistance for implementing this option.

C. Privatization process

1. Preparation of brochures on the LIT and the LWTC

The ILO prepared attractive brochures describing, respectively, the facilities available at the LIT and the LWTC, market prospects, the Lao foreign investment policies, etc. These brochures were then sent to approximately 400 firms (200 firms specialized in textile/garment production, and 200 firms specialized in tanning and leather goods/footwear production) in Asia (Japan, Thailand, Korea, Indonesia, etc.), Australia, and Europe (France, United Kingdom, Italy, Germany, Sweden, Spain, etc.). A letter from the FIMC was attached to these brochures, inviting each firm to send an offer for a joint venture with the Lao Government in relation to the privatization of the LIT and the LWTC. The closing date for the bids was set at three months from the date the letters were sent.

2. Preliminary negotiations with interested private firms

Fifteen to 20 firms indicated their interest in bidding for the joint venture, but requested more information before sending their bids. The ILO provided the additional information requested by these firms. Subsequently, four to five firms submitted formal bids or preliminary indications of their intentions. Other firms indicated that they required more time before they could submit a formal bid. By the time the bidding was closed, there were four serious offers for the LIT (from the United States, Australia, France and Thailand) and two serious offers for the LWTC (one from Italy and Thailand (joint partners) and one from Thailand).

3. Final negotiations with interested bidders and selection of privatization partners

Further meetings were held with two potential partners for the privatization of the LWTC and one potential partner for the LIT in both Vientiane and Bangkok. During these meetings, in which the ILO and UNDP/Vientiane participated along with government representatives and the foreign partners, the offers made by the latter were discussed and assessed in relation to the following:

- financial commitments of the foreign partners;
- the expertise they will bring to the joint venture;
- business plans for developing the lit and the lwtc;
- shares of the lao and foreign partners in each joint venture;
- minimum revenues guaranteed for the Lao Government;
- adherence to the development objectives of the LIT and the LWTC adopted at the time these two enterprises were established. Specific terms for ensuring adherence to these objectives were also discussed (e.g. minimum number of home-based women weavers who will continue to work for the LWTC; use of local raw materials; retaining the staff of the LWTC and the LIT);
- special benefits to be granted by the Government to the foreign partners; and
- other standard terms that should be included in the joint venture agreements.

Following these discussions, during which the potential foreign partners indicated their final plans and conditions, representatives of the FIMC, the ILO and UNDP/Vientiane met in Vientiane in order to review and assess the various offers and to select a partner for, respectively, the privatization of the LIT and the LWTC. Such review and assessment led to the decision to select the following foreign partners:

- Simon & Associates and IBC (both from Thailand) for the privatization of the LIT; and
- Société Lereport (Italy) with three other associated partners from Italy, Thailand and Taiwan, for the privatization of the LWTC.

4. Drawing up of the Joint Venture Agreements

Following the selection of the foreign partners for the privatization of, respectively, the LIT and the LWTC, additional meetings were held with these foreign partners for the drawing up of joint venture agreements. Intensive discussions took place over a number of meetings during which details on the various terms of the agreements were negotiated, with each party attempting to secure the best terms and to obtain the required guarantees. First drafts of the joint venture contracts were finally approved by the parties concerned, and submitted for review and finalization to lawyers hired by the Lao Government and the foreign partners, in order to ensure the legality of the terms and conditions spelled out in these contracts.

5. Signing of the Joint Venture Agreements and the starting of the joint ventures

The two Joint Venture Agreements were signed by the FIMC and the foreign partners in June 1993 for the LIT, and October 1993 for the LWTC (i.e. respectively, six months and nine months since the start of the search for foreign partners).

Following the signature of the Joint Venture Agreements,[1] the FIMC issued licences to the foreign partners allowing them to establish a business in the Lao People's Democratic Republic. Subsequently, Lao Simon Ltd was officially registered and started business immediately after such registration. The registration of Lao Cotton has been delayed for reasons provided in Part V of this report.

The above privatization process was probably one of the most thorough and transparent used in the Lao People's Democratic Republic to date. Very good terms and guarantees were negotiated for the benefit of the Lao Government. Prospects for the future were very good, especially if the Lao and foreign partners were to adhere strictly to the terms of the Joint Venture Agreements. Substantial revenues should be allocated to the Government from these two joint ventures in the future, in addition to the large number of jobs which should be generated in 1994 and thereafter. Experience gained in the privatization of these state enterprises should be used for improving the process and procedures for future privatizations.

[1] The main features of the two Joint Venture Agreements are described in Part II (for the LIT) and Part III (for the LWTC) of the report: *The post-evaluation of the privatization of the Lao industrial tannery and of the Lao textile centre*, ILO, May 1994.

Part IV. Terms of the joint venture contracts

The following table provides full details on the two Joint Venture Agreements.

The tannery	The Lao women textile centre
I. Content of the Joint Venture Agreement	
The Joint Venture Agreement, signed on 15 June 1993 by the Lao People's Democratic Republic Government (GOL) and two foreign partners (Simon & Associates and IBC), includes the core text of the Agreement and five Attachments: — ***Attachment A.*** List of equipment and materials brought in by GOL. — ***Attachment B.*** A business plan prepared by the foreign partners. This plan, prepared before the Joint Venture Agreement was finalized, is only indicative of the expectations of the two joint venture partners. These expectations are not legally binding, since they depend on a number of prerequisites, on evolving market conditions and progress achieved in the tannery operation. — ***Attachment C.*** Articles of Association which define the respective role of each partner, the management structure, conditions for increasing or decreasing the original capital, etc. — ***Attachment D.*** The organization structure of Simon Lao. — ***Attachment E.*** The Lease Agreement covering the land, buildings and equipment leased by GOL to the foreign partners.	The Joint Venture Agreement, signed on 27 October 1993 by the Lao People's Democratic Republic Government (GOL) and the foreign partner (Société Anonyme Lereport), includes the main Joint Venture Agreement and four Attachments: — ***Attachment A.*** List of equipment and materials brought in by GOL, for a total value of US$1,641,500, after deduction of US$375,000 for depreciation of equipment prior to the Joint Venture Agreement. — ***Attachment B.*** List of equipment and value of working capital to be brought into the new company (Lao Cotton) by the foreign partner, with a total value estimated at US$1,708,500. — ***Attachment C.*** A business plan prepared by the foreign partners. This plan, prepared before the Joint Venture Agreement was finalized, is only indicative of the expectations of the two joint venture partners. These expectations are not legally binding, since they depend on a number of prerequisites, on evolving market conditions and progress achieved in the growing of local cotton. — ***Attachment D.*** Articles of Association (by-laws) which define the respective role of each partner, the management structure, conditions for increasing or decreasing the original capital, etc.[1]

[1] Inadvertently, the Joint Venture Agreement did not include two other important Attachments, namely a lease agreement between GOL and the foreign partner (the land and buildings are actually leased rather than sold by GOL to the new company), and the organizational structure of the new company. Consequently, a lease agreement was drafted and approved by the Board of Directors during a board meeting held on 7 May, with the ILO and UNDP participating as observers. During this meeting, it was also decided that GOL and the foreign partner will prepare a formal organization chart for the new company before the end of May 1994.

II. Scope of the Joint Venture Agreement

The foreign partners guarantee that:

- the new company shall process not less than **300 hides** per day by the end of the second full year of operation, and not less than **500 hides** per day by the end of the fifth year of operation; and
- new products, such as dog chews, shoe leather, and cut and sewn hides will be introduced as part of the business of the new company.

In addition, the business plan indicates prospects for modernizing the Vientiane Abattoir, starting meat processing for exports, and promoting improved herding practices. The foreign partners were also considering the establishment of a leather goods production unit.

The foreign partners guarantee to adhere to the original development objectives of the LWTC and to expand and diversify production. They agreed, in particular, upon the following:

- to produce a minimum of 20,000 metres of hand-woven cloth from the start of the third year of the joint venture in order to maintain the jobs generated prior to the joint venture, for home-based women weavers in the Vientiane Province, and to promote traditional hand-woven Lao textiles;
- to use the yarn produced by the spinning unit for achieving first the above output of hand-woven cloth, with the remaining yarn becoming available for other purposes; and
- to use only Lao cotton for the production of yarn as long as the Lao cotton price does not exceed 115 per cent of the international market price for cotton of similar quality, and land is made available by GOL for cotton plantations (initially 300 ha).

In addition, the business plan indicates a diversification of production which includes the production of 1,000 bed and/or table sets, using machine-woven cloth which is then hand-embroidered. This additional production and expansion of the garment unit should generate over 1,000 more new jobs (details are provided in the business plan attached to the Joint Venture Agreement).

III. Financial inputs of the joint venture partners

- The Lao Government brings in the joint venture equipment and materials estimated at US$717,000.
- The land and buildings are leased to the new company. The equipment is also leased up to the time the BCEL loan is fully paid. At that time, the equipment will become the property of the new company.
- The new company will obtain the additional financing required for working capital and new investments from financial institutions. Simon & Associates will also make available its lines of credit, as and when necessary, if funds cannot be secured from financial institutions. In other words, the foreign partners (Simon & Associates and IBC) bring into the joint venture mostly their technical, management and marketing expertise, and additional funding requirements are to be raised through loans to be repaid by the new company once it starts generating profits. These loans will be provided by Lao financial institutions and/or Simon & Associates.

- The Lao Government brings in the joint venture equipment and materials, estimated at US$1,641,500.
- The land and buildings are leased to the new company.
- The new company will bring in the additional financing required for working capital in addition to equipment for the production of machine-woven cloth and other purposes, for a total of US$1,708,500. The value of new equipment (ten mechanical looms, one sizing machine, one warping machine and sewing machines) is estimated at US$1,500,000.

IV. Granting of foreign investment incentives

The establishment of the new company is subject to the new company and its shareholders being granted:

- the maximum Foreign Investment Management Code, particularly Articles 22 and 28, for investments in agro-processing industries; and
- exemption from all duties and taxes on imported raw materials, chemicals, supplies and equipment in accordance with the Lao People's Democratic Republic's tax regulations on re-exports.

The establishment of the new company is subject to the new company and its shareholders being granted:

- the maximum Foreign Investment Management Code, particularly articles 22 and 28, for investments in agro-processing industries; and
- exemption from all duties and taxes on imported raw materials, chemicals, supplies and equipment in accordance with the Lao People's Democratic Republic's tax regulations on re-exports. For the time being, and unless otherwise requested by the foreign partners, the new company will operate under the terms of the 1989 Foreign Investment Law.

V. Distribution of shares

The shares of the new company are distributed as follows:

- Government of the Lao People's Democratic Republic (GOL): 25.1%
- Simon & Associates Ltd. (Simon): 67.4%
- International Business Centre: 7.5%

If new shares are to be issued, every shareholder has the right to purchase a pro rata number of such shares, GOL receiving 25.1 per cent of such new shares at no cost.

The shares of the new company are distributed as follows:

- Government of the Lao People's Democratic Republic: 49%
- Société Anonyme Lereport: 31%
- Mr. D. De Agostini: 5%
- Chai Textile Limited: 10%
- Mr. A. Huang: 5%

If new shares are being issued, every shareholder has the right to purchase a pro rata number of such shares.

VI. Board of Directors

The Board of Directors will consist of no more than nine directors. GOL will nominate one Chairman and one Vice-Chairman; Simon will nominate five directors; and IBC two directors. The authorized directors, who can sign and bind the new company, shall be one director nominated by Simon, who can jointly sign with one director nominated by GOL.

The Board of Directors will consist of no more than five directors. GOL will nominate two members for election to the Board, and the foreign partners will also nominate two members. The four elected Directors of the Board then nominate the fifth Board member. The Chairman of the Board will be designated by the Board, and the foreign partners will designate the Managing Director of the new company.

VII. Distribution of dividends

GOL shall be entitled to a minimum dividend of Kips equivalent to US$50,000 per year, starting after the year the BCEL loan is paid off in full, regardless of the profit generated that year. If the new company is not in a position to do so, Simon and IBC shall lend the amount equivalent to the shortfall of US$50,000 so as to enable the new company to pay the minimum dividend to GOL.

GOL shall be entitled to a 49 per cent dividend. However, it should receive, as from the nineteenth month, a minimum dividend of US$50,000 per year regardless of the profit generated that year. If the new company is not in a position to do so, the foreign partners will transfer some of their shares to GOL for a value equal to the difference between the above guaranteed dividend and the actual dividend generated by the new company.

For a period of four years, starting from the year in which the outstanding loan owed to BCEL has been fully repaid, 50 per cent of the profits in excess of US$200,000 will be used for new investments, while the remaining 50 per cent will be disbursed as dividends to the shareholders. However, this agreement is subject to the new company being exempt from tax on profits, and its shareholders being exempt from tax on dividends received.

In addition, the foreign partners guarantee that, under conditions spelled out in the Joint Venture Agreement, the net profit margin before taxes will not be less than 30 per cent on all costs of the new company, all activities combined.

VIII. Financial requirements

The new company shall use its net profit to repay the loan to BCEL as soon as possible and before the end of the fifth year at the latest. A number of options are considered in the Joint Venture Agreement for the repayment of the loan. The one which has been finally adopted consists of a transfer of the loan from the Municipality of Vientiane to the new company, with a guarantee offered by the latter to BCEL in the form of the tannery assets. Agreement has been reached to repay the loan within three years, at an interest rate of 8 per cent.

The new company will make a quarterly payment of US$4,000 to the LWU as an all-inclusive lump-sum payment in remuneration of services provided by the LWU in the areas of recruitment and training, and to support the LWU's activities in general.

IX. Lease agreement

GOL shall lease the land, factory building and equipment for a period of not less than 25 years. The rent is US$50,000 per year, payable quarterly, and will be increased by 5 per cent per year, compounded, starting the sixth year. The lessee has the option of renewing the lease agreement under the same terms and conditions for any additional period up to 25 years. Upon repayment of the outstanding loan to BCEL, ownership of the equipment and machinery (listed in Attachment A) will be transferred to the new company and excluded from the lease agreement without any reduction in the lease fee.

GOL shall lease the land and factory buildings for a period of not less than 30 years. The rent is US$20,000 per year, payable quarterly, and will be increased by 5 per cent per year after the fifth year. The lessee has the option of renewing the lease agreement under the same terms and conditions. GOL also agrees to lease 300 ha of land for cotton plantation to the new company. The lease fee will be negotiated by the two parties.

X. Termination of agreement

The parties terminating this agreement may request a pro rata transfer of shares held by the other party causing the termination.

The parties terminating this agreement may request a pro rata transfer of shares held by the other party causing the termination.

XI. Environmental concerns

In the area of environmental protection, the new company ensures that its operations will conform with the most advanced international standards in the area of tanning operations.

In the area of environmental protection, the new company ensures that its operations will conform with the most advanced international standards recommended in this area.

XII. Business plan

The equipment and technical know-how will be upgraded over the years, in order to expand the product range to higher value products. The tannery will start producing drum-dyed leather. As soon as full hides can be processed, it will begin producing pearl-crust leathers. Dog chew production will be started as soon as possible, preferably with help from Simon & Associates.

The business plan (Attachment C to the Joint Venture Agreement) covers three phases of, respectively, 18 months (Phase I), 8 months (Phase II), and 22 months (Phase III). Phases II and III must be approved by a 75 per cent vote of the Board of Directors.

The plan will be implemented in five phases.

Phase I: First six months

Production of drum-dyed water buffalo hides, using local hides; recruitment and training of personnel; starting the sourcing of equipment for processing full hides and finishing operations.

Phase II: 6 to 12 months

Establishing an international network of raw material suppliers; assessing the establishment of a seat-covers plant and other investments; starting dog chews production.

Phase III: 12 to 24 months

Installing finishing equipment; producing new products developed during the second phase.

Phase IV: 24 to 36 months

Doubling the throughput; improving the quality of finished leathers; expanding the cut and sewn operations.

Phase V: 36 to 60 months

Consolidating market position for all products; doubling the output of premium grade leathers; seeking ways to lower costs. Exploring peripheral opportunities:

- cut and sewn cover sets: it will be feasible to begin with simple sets within a year of start-up;
- operation of the abattoir: with expertise of Simon & Associates, to add value to output through pet food products;
- herd improvement: Simon can take a lead role in establishing programmes for improvement of cattle herds; and
- operation of abattoir: enhance the viability of the operation, and potentially add value to the output through expertise in development, production and marketing of pet food products.

The plan will be implemented in three phases.

Phase I:

It covers the following output:

- 10,000 metres of hand-woven cloth per month;
- a maximum volume of hand-woven cloth transformed into garments and home-furnishing goods;
- 7,000 to 10,000 metres of machine-woven cotton cloth per month;
- 250 m/day of machine-woven linen cloth for home-furnishing goods to be embroidered locally.

Phase I will use the equipment available prior to the joint venture, plus additional equipment imported by the foreign partner.

Phase II

Additional equipment and buildings will be used for the production of 20,000 kg/month of terry cloth; hand-woven cloth will increase to 15,000 metres/month; linen cloth production will expand for the production of 850 sets of bed sheets and pillow-cases per month (or other home-furnishing goods).

Phase III

Dyeing and bleaching equipment will be added to the current facilities which will yield added value to the produced output at approximately 40 per cent of the wholesale selling price. New buildings will become available for a new dyeing unit and leather goods production.

The employment to be generated by each phase is estimated as follows:

- Phase I: 447 to 547 jobs;
- Phase II: 1,122 to 1,222 jobs;
- Phase III: 1,137 to 1,237 jobs.

In addition, a large number of jobs will be generated through the production of cotton which will cover over 2,000 ha within a few years. Furthermore, the new company agrees to retain the Lao staff employed by the LWTC prior to the joint venture.

XIII. Adherence to The Lao People's Democratic Republic labour laws (applies to both agreements)

The new company shall be managed and operated in accordance with applicable laws and regulations of the Lao People's Democratic Republic, in particular, but not limited to, the laws on foreign investments, the social and labour laws, and laws on the protection of the environment. In addition, the foreign partner agrees the current Lao staff of the tannery.

Part V. Implementation of the Joint Venture Agreements by the Lao and foreign partners

This part of the report provides a brief summary of the situation of both the tannery and the textile centre in 1994, at the time the two projects were evaluated by the ILO. Part VI will review new developments over the past three years which affected the implementation of the two joint ventures, and the situation of the latter by June 1997. Information on these latest developments was obtained through contacts the ILO has maintained with the Government and the foreign partners. The ILO also provided some limited assistance to these projects during the years following the project evaluation.

A. The tannery

The implementation of the Joint Venture Agreement started swiftly and positive results could be seen earlier than expected. While the Joint Venture Agreement was signed in June 1993, it was possible to start production in October of the same year, although new equipment had to be imported and installed, and hides had to be imported from China. The foreign partner should be congratulated for providing funding for additional, unexpected investments, and for its professionalism in the operation of the tannery. The foreign general manager was highly qualified, and was able to make maximum use of the tannery assets. The Lao party contributed as best as it could to the early start of production. The Lao tannery staff has also demonstrated that its skills and productivity compared very favourably with those of similar staff in more advanced countries.

1. New investments

1.1 Capital investments

While there were no plans for additional capital investments in the very early stages of the Joint Venture Agreement, such investments became necessary immediately in view of the deficiency of some of the installed equipment and the lack of sufficient water for the production process. Simon Lao has made additional investments for the improvement of the facilities available prior to the agreement (new drums, water supply, sammying machine, car, etc.). The maximum plant capacity in 1994 was 180 hides per day (this capacity was limited by that of the paddle drums), and may reach a capacity of 320 to 500 hides per day with some additional investments estimated at US$400,000 (in particular, for the acquisition of additional paddle drums, tanning drums and splitting and shaving machines). Simon Lao had already initiated steps in order to reach a higher capacity of 160 hides per day in 1994, should sufficient hides become available. Dog chews production also started in 1994, once some of the old drums had been rebuilt.

The total cost of the above investments amounted to US$180,000 provided by Simon & Associates. Simon Lao was to reimburse this loan once it started generating profits.

Some of the equipment available in the tannery prior to the Joint Venture Agreement could not be used because it did not match the technical requirements or because it was of very poor quality. It was intended, in 1994, to rebuild four of the six tanning drums, at a cost of US$24,000, in order to increase the tannery capacity, using wood with the right characteristics for this purpose.

It may be noted that the above additional investments by the foreign partner ***will not reduce the 25.1 per cent share of profits for the Government.***

1.2 Working capital

Working capital was required to cover the cost of hides, chemicals, labour, electricity, and administrative and management costs. The amount of working capital made available by the foreign partner was approximately equal to US$800,000. Since the output was immediately shipped to the foreign partner who was, for that time, the only client, the amount of working capital was not as high as it might have been if the output were shipped to other clients. At that time, the working capital was mainly needed for the purchase of hides from China and the Lao People's Democratic Republic (12,000 hides from China and approximately 4,000 pieces from the Lao People's Democratic Republic), some stocks of chemicals and wages for labour and management staff for two months. It was also required for making payments to BCEL and to the Government (lease). With increased production, the amount of working capital should also increase.

2. Diversification and expansion of production

2.1 1994 and planned production capacity

The tannery was processing 105 hides per day on average in 1994. It could relatively quickly double and even triple this capacity if some planned additional investments were implemented. In the medium term, this capacity could be further increased in view of the availability of unused land on the tannery grounds, and the existence of an excellent market for the tannery output.

The tannery started production towards the end of October 1993. In 1994, it was producing exclusively dyed crust leather for use in the making of seat-covers for furniture and cars by Simon & Associates. It was estimated that, by the end of April 1994, approximately 15,000 hides were processed into dyed crust leather.

The output quality was of a high standard and compared favourably with the requirements of the international market. The leather still required some limited processing after shipment in view of the existence of small defects due to the quality of the hides used. This problem requires a long-term solution since it may not be resolved unless farmers are trained in better caring for the cattle.

For 1995, the business plan estimated a production of 130,000 processed hides (360 hides per day, approximately three times more than in 1994). However, the latter could not be achieved unless the hide supply problem had been satisfactory resolved.

Other splits were also produced, but were either wasted (first split which may be transformed into dog chews) or not processed further (one to more splits which could be transformed into suede leather and/or leather for industrial use). It was planned to further process the splits for the local and export markets within the next few months, once additional drums have been installed.

2.2 Current production costs

The unit production cost per hide processed, excluding overheads and interest payments on loans, varies according to the types of output produced (this affects the chemical and labour costs) and the price of raw hides (Lao hides are much cheaper than imported hides).

The unit production cost thus varies between US$32 and US$43 per processed hide. While the selling price of processed hides is determined by the market, the estimation of profits or losses should also take into consideration transport costs and overhead costs (administration and management costs) and interest payments on loans. Overhead costs include the salary and fringe benefits for the management and supervisory staff, office and other supplies, directors' fees, consulting fees, telecommunications costs, etc. While it was not possible to obtain overhead and other costs incurred in 1994, one can estimate the monthly cost at approximately US$25,000. In 1994 (100 hides processed per day), the unit overhead cost was approximately equal to US$8.5 per hide processed. If the capacity were to triple over the next two years (300 hides per day), the

unit overhead cost may be reduced to approximately US$4 per hide since overhead costs should increase at a lower rate than that of production. It was estimated that the total unit cost per hide processed should vary between:

- a maximum of US$51.5 per hide, assuming 100 hides per day of processed hides and use of imported hides; and
- a minimum of US$36 per hide, assuming 300 hides per day of processed hides and use of local hides.

3. Estimated revenues and profits

3.1 Revenues

In 1994, only revenues from sales indicated in the Joint Venture Agreement had been estimated. For 1994, revenues were estimated at US$1,722,000, assuming an average production of 120 hides per day. This was equivalent to an average selling price per processed hide of US$40.This average unit selling price compares favourably with that paid by Simon & Associates to other suppliers in Thailand.

3.2 Profits

Profits before taxes for the period ending April 1994 could not be estimated since it was not possible to obtain precise information on the revenues from sales and unit selling prices.

According to the business plan, there should be a loss of US$38,563 in 1994. Furthermore, after deduction of interest payments, this loss should increase to US$86,739 by the end of 1994. It is only in 1995 and thereafter that profits should be made, reaching US$3,700,000 in the fifth year (i.e. 1998).

4. Foreign exchange earnings

In 1994, the joint venture was already generating foreign exchange although production started only in October 1993. Foreign exchange originates from the following sources:

- payment of local production costs (local labour, supply of local hides, utilities, etc.);
- lease payment of US$50,000 per year to the MOV; and
- 25.1 per cent of net profits to be allocated to the MOV (during the first three years profits will be used for the repayment of the BCEL loan).

According to the 1994 projections indicated in the business plan attached to the Joint Venture Agreement, the sum of the above foreign exchange earnings should increase from approximately US$1,200,000 in the first year to between US$4 and $5 million in the fifth year in relation to the tannery operations only.

5. Payment of the lease to the Government

The lease amounts to US$50,000 per year, to be paid at the end of each quarter (US$ 12,500). In June 1994, Simon Lao had already made the first quarterly payment.

6. Repayment of the BCEL loan (US$306,000 plus interest accrued)

At the time of the signing of the Joint Venture Agreement, the total BCEL loan amounted to US$306,000, plus accumulated interest.

While the Joint Venture Agreement describes a number of options for paying back the BCEL loan, the following solution was adopted:

- Simon Lao borrowed money from BCEL in order to repay the Municipality of Vientiane loan, providing the tannery assets as a guarantee. The Municipality of Vientiane is now relieved from paying the loan back to BCEL;
- Simon Lao agreed to repay the loan within three years. Initial payments in 1994 will have to be made from the working capital put at the disposal of Simon Lao by Simon & Associates; and
- BCEL will charge an 8 per cent interest on the Simon Lao loan.

7. Adherence to financial requirements as per the terms of the Joint Venture Agreement

In 1994, it could be stated that Simon & Associates and IBC had adhered strictly to the financial requirements spelled out in the Joint Venture Agreement. Indeed, they had exceeded them through the provision of the additional funds mentioned earlier, although Simon Lao would have to pay back the US$800,000 loaned by Simon & Associates for the acquisition of new equipment and working capital.

8. Other socio-economic benefits generated by the Joint Venture Agreement

The Joint Venture Agreement would, in addition, have a number of positive multiplier effects on the economy which were difficult to estimate at the time the agreement was signed. The generated foreign exchange would be partly used for new investments by local entrepreneurs. These would generate further employment. The Joint Venture Agreement should also have positive backward effects on the cattle population if the planned meat-processing plant (considered in the Joint Venture Agreement along with a modernization of the abattoir) were to be implemented. Leather may also become available for local entrepreneurs wishing to produce leather goods for the local market. This would also reduce the import of some of the leather goods and generate new employment opportunities.

New jobs created
The tannery created 32 direct additional jobs in 1994 (from 12 at the start of the joint venture to 44). It was estimated that this number would increase quickly as production expands and that an additional 60 to 70 jobs could be created by the end of 1994. By the fifth year, close to 150 direct jobs should be generated once the tannery reaches its full capacity. Additional investments (e.g. processing leather into seat covers, leather goods production, processing of splits into dog chews, etc.) should generate hundreds of new jobs within a few years if the above investments were to be realized according to the business plan attached to the Joint Venture Agreement. The estimated large number of new jobs will result from the use of fairly labour-intensive processes associated with the above additional investments.

Staff salaries, fringe benefits and working conditions

Simon Lao has recruited all the technical staff required for its current operations. It has also recruited a foreign general manager. It did not need, in 1994, a marketing specialist since the output was directly bought by Simon & Associates (Bangkok). A part-time accounting consultant has been hired for the handling of local accounts (one week per month). Simon & Associates was handling the full accounting system with monthly accounts of production costs and expenditures provided by Simon Lao.

Simon Lao has retained all the staff in place prior to the Joint venture Agreement. Subsequently, two staff members decided to leave. In June 1994, the total staff at the tannery was equal to 43: 14 administrative and management positions, and 29 daily workers.

Thus, Simon Lao has strictly adhered to the terms of the agreement and has even exceeded them, since the business plan attached to the agreement specifies that the total staff in the first year should equal 25.

Salaries and wages

The Lao management staff and daily workers seemed happy with the wages received. The basic salary was three times that which was offered by the Government prior to the joint venture, and compared favourably with that offered by the Lao private sector. The staff received, in addition to the basic salary, bonuses and overtime pay (e.g. 150 per cent of basic salary for work on Saturdays or Sundays).

The average basic salary was approximately 65,000 kips per month, and varied between 35,000 kips for unskilled labour to over 200,000 kips for Lao supervisory and administrative staff (i.e. between US$50 and US$300 per month).

Lao labour laws

While it was not possible to fully verify whether Lao labour laws were strictly applied, information obtained from the Lao and foreign staff seemed to indicate that Simon Lao was strictly adhering to these laws.

Insurance against accidents

There was, at the time of the post-evaluation mission, no insurance against accidents for the Lao staff. The reason seems to be the difficulty of finding a local insurance company interested in providing coverage against sickness and/or accidents resulting from work at the tannery. The tannery management has put aside a fund (corresponding approximately to 5 per cent of the wage bill) in order to be able to pay for medical expenses whenever necessary. This was considered as a stop-gap solution while looking for a more permanent solution. The government representatives helped establish contacts in order to negotiate an appropriate insurance coverage.

Fringe benefits

Transport was provided for the workers between their home and the tannery free of charge. Showers were available for the workers, and it was intended to set up an appropriately equipped locale for eating and resting during the daily breaks.

Training

The Lao management staff was offered regular on-the-job training provided by the general manager. In the long term, the trained staff should constitute an important asset for the Lao economy as a whole.

Contractual arrangements

There were, in 1994, no formal work contracts between Simon Lao and the Lao supervisory staff and daily workers. The reason given for this lack of contracts was that the latter would require cumbersome administrative procedures, and that there was little time available for this task at that time. This was a very unsatisfactory situation which had to be corrected as soon as possible. It was estimated that a Lao clerk could be hired for this purpose, in order to relieve the management staff from the administrative duties required for the above contracts. The duration of contracts could be established on the basis of the planned production plan, and need not exceed a few months for daily workers. On the other hand, the Lao supervisory and administrative staff should receive one-year contracts. In addition, a pension plan should be considered for this staff.

Working conditions and safety measures

The tannery management has made commendable efforts in order to improve the working conditions of the staff and to apply some safety measures. However, in view of the very difficult environment of a tannery, more efforts should be made for further improvements:

— First, the protective gear (booths, gloves, plastic covers) should be completed by more appropriate work uniforms. The workers should also be induced to wear constantly the protective gear and clothing provided.
— Second, some parts of the equipment should be protected to avoid serious accidents.
— Third, the tannery should consider installing an exhaust system in order to reduce air pollution inside the tannery.
— Finally, the staff should be trained in appropriate safety precautions.

The tannery should also allocate a properly equipped place for the workers to allow them to rest or take their lunch during break-time. More showers should also be made available for use by the workers.

The following recommendations concerning the improvement of working conditions were made at the end of the post-evaluation mission to both the Government and the foreign partners:

"The government representatives on the Board of Directors should verify that the Lao labour laws are fully adhered to by Simon Lao, through an assessment of the conditions offered to the local staff.

They should also raise the following matters at the next board meeting and agree on acceptable solutions to the various problems described in the evaluation report:

— providing better protective clothing for the production workers;
— insuring workers against accidents and sickness resulting from their work at the tannery. Negotiations with a local insurance company should be initiated as soon as possible;
— protecting the moving parts of equipment in order to avoid accidents;
— installing an exhaust system to reduce air pollution;
— establishing work contracts for the Lao daily workers and supervisory staff; and
— considering the establishment of a pension plan for the long-term staff."

9. Upstream linkages with the agricultural sector

Expansion of the tannery and the establishment of a meat-processing plant considered by the foreign partner should have very important effects on the cattle population. Increased demand for buffalo or cows should also increase the farmers' income.

Furthermore, requirements for good quality hides which would be offered at higher prices would induce farmers to take better care of their cattle, and improve the overall health of the cattle population.

10. Effects of additional investments

Should the tannery expand as planned, and should current problems be resolved satisfactorily, the foreign partners would be induced to implement a number of additional investments considered in the Joint Venture Agreement. These include:

— modernization of the Vientiane abattoir;
— the production of leather seat covers for furniture and cars (sewn and cut operation);
— the production of dog chews for the export market; and
— the production of leather goods. The latter may also be produced by other local or foreign partners.

While it was difficult, at the time of the post-evaluation, to estimate the full effects of the above investments, it is probable that they would generate hundreds, if not more, new job opportunities, since many of the above investments would make use of much more labour-

intensive processes than in the case of the tannery. Furthermore, foreign exchange earnings could triple or more, reaching millions of dollars.

11. Protection of the environment

The Government, UNDP and ILO decided, well before the establishment of the tannery, to ensure that it will not create any harmful pollution, especially of the Mekong River water. Thus, a modern effluent treatment plant, probably one of the most modern in the Asian region, was built with funding from UNDP and ILO technical assistance. While everybody agreed, including the foreign partners, that this was a fairly efficient effluent treatment plant, there were still a few technical problems which could, in the long term, result in some limited pollution of the Mekong, although it was not known at this stage how serious it would be. The main problem concerned the drying beds which received the sludge produced by the treatment of the effluent. Some of the chemicals in the sludge could filter to the Mekong water. Furthermore, the drying process of the sludge created bad smells which had led to complaints from the inhabitants in the vicinity of the tannery.

It was recommended that the government representatives on the Board of Directors insist on a quick solution, especially since such a solution would require limited additional investments. A filter press or the improvement of the drying beds (this latter solution seems to be the cheapest one) seemed to constitute an appropriate solution at a total cost ranging between US$20,000 to US$40,000.

Alternatively, the Government could approach a donor (e.g. the Australian Government) for the funding of the required improvements of the effluent treatment plant. In principle, the Government was supposed to bring into the Joint venture a well functioning plant, and should therefore seriously consider this alternative.

It was then recommended that, in the future, the Government continues to monitor closely the quality of the effluent pumped into the Mekong in order to ensure that it is harmless. A government chemist should analyse the effluent and make a report to the Government and the tannery management staff on a regular basis (e.g. every three months).

Recommendations concerning the protection of the environment
The government representatives should discuss at the next Board meeting the matter regarding the improvement of the effluent treatment plant. An urgent decision on this matter was required. Financial assistance from a donor could also be considered at the above meeting for the improvement of the effluent treatment plant. The Government should also regularly verify the quality of the effluent flowing into the Mekong, and designate a government chemist for this purpose. During the first year of operation, the effluent should be checked on a monthly basis.

B. The Lao women textile centre

Remarks:

While the Joint Venture Agreement was signed in October 1993, it has not, in 1994, resulted in any increase or diversification of production specified in the agreement. Indeed, the formal application of the agreement, from a financial point of view, was still pending. Thus, the centre was still operated under the management in place prior to the privatization of the LWTC, and continued to be financially under the control of the Lao Women Union (i.e. any generated profits were not shared with the foreign partners).

All profits generated by the centre up to 30 June 1994 were allocated exclusively to the Lao Women Union. Expenditures made from such profits for improvement and expansion

of the current facilities were to be reimbursed by the new company to the Lao Women Union, or added to the capital brought in by the Government with an equivalent increase of the capital brought in by the foreign partners so as to maintain the agreed 49 per cent/51 per cent distribution of shares between the Government and the foreign partners.

1. Contributions of the Lao and foreign partners to the joint venture

The foreign partners had already brought into the new company ten mechanical looms with a value estimated at US$1,200,000. Invoices still had to be supplied by the foreign partners in order to verify whether this value is correct and to use it for calculating the share of the foreign partners in the joint venture. The foreign partners needed to provide, by October/November 1994 at the latest, the following additional equipment:

— one sizing machine (US$100,000);
— one warping machine (US$100,000); and
— sewing machines and small equipment (US$100,000).

The foreign partners were also supposed to provide cash and/or raw materials, including new vehicles, for a total value of US$208,500 as and when this was needed in the following months. Their total contribution should have reached US$1,708,500 (equivalent to 51 per cent of the shares) by the end of 1994. The mechanical looms already brought in by the foreign partners should have allowed production to start in early June 1994, once minor adjustments to the equipment had been made.

The Lao partner had brought in the joint venture equipment, buildings and stocks of materials valued at US$1,641,500, after deducting depreciation costs for some of the equipment. This included:

— an operating spinning unit;
— an operating dyeing unit;
— an operating pre-weaving unit;
— 225 looms;
— a garment-making unit;
— a leather-goods making unit;
— three retail shops;
— an administrative building and office supplies;
— a number of vehicles; and
— stocks of cotton and finished goods.

It may be noted that financial resources from the LWTC had been made available for the expansion of the buildings and other expenditures. These additional funds had to be reimbursed to the LWU or added to the assets brought in by the Government when estimating the total assets brought in by each partner.

2. 1994 production, revenues and profits

As stated earlier, in June 1994 no new production had taken place since the signing of the Joint Venture Agreement in October 1993. The current facilities continued to produce and sell at the same low capacity level. For example, information provided by the current director of the centre indicated that the total value of finished goods in 1993 was estimated at approximately US$258,000, although it was not known how much of the output was actually sold. Production and sales in 1994 seemed to indicate a lower monthly volume of output and sales than in 1993. For example, only 65 home-based weavers were working for the centre, compared to over 250 weavers a few years earlier when the centre was being operated as an ILO/UNDP project.

Nevertheless, the centre was able to cover its operating costs (excluding depreciation costs) and to generate some surplus for minor improvements of the current facilities required for business expansion.

3. Use of local raw materials

It was expected that, in 1994 or early 1995, all the cotton required for the production of yarn in the centre's spinning unit would be produced locally. Already, a large fraction of the cotton used by the centre in 1994 was produced in the Lao People's Democratic Republic. In June 1994, pilot production of cotton, using improved seeds, was to be initiated. In the following two to three years, over 1,000 ha of land were supposed to be used for cotton plantations that would supply the centre exclusively.

In addition to ensuring a steady supply of quality cotton to the centre which would substantially reduce the production costs of yarn, the growing of cotton would generate additional employment. While precise estimates were not available at the time of the evaluation mission, 100 or more jobs could be created during the planting and harvesting seasons, in addition to new jobs for processing the raw cotton into fibre.

4. Employment

4.1 Staffing situation of Lao Cotton

In view of the fact that the joint venture had not yet effectively started, no new staff members had been recruited at the time of the post evaluation mission. The foreign partners had made available the services of an accountant from Thailand for short periods of time, in order to improve the accounting system.

The foreign partners agreed during a 7 May 1994 meeting to review the whole staffing situation through a thorough interview of the staff. Following these interviews, each staff member would be offered a three-month contract as a probationary period. At the end of the latter, their performance would be reviewed and it would then be decided which staff members should be retained, those who should be replaced, and those who would be offered a second and final probationary period before their case would be settled.

The decision on whether to recruit local and/or foreign specialists for an effective and sustainable management and operation of Lao Cotton had to be taken at the end of the first three-month period. It was clear, however, that new Lao and/or foreign staff needed to be recruited in view of the planned expansion of activities.

At the end of the same period, there would be a need to decide on steps to be taken for ensuring a permanent and effective management of Lao Cotton. Management of the latter required highly skilled management and technical staff, the presence of which was a prerequisite for any future profitable operation of Lao Cotton. The arrangement of Lao Cotton, whereby technical and management skills had to be provided on a part-time basis by some of the foreign members of the Board of Directors, was not desirable nor feasible in the short or medium term. Therefore, urgent action was needed to correct the situation, including the hiring of foreign specialists if necessary. In any event, it was recommended that permanent and qualified technical and management staff be recruited by July or August 1994 at the latest. Without such staff, the *raison d'etre* of the Joint Venture Agreement would be lost.

4.2 Estimated employment generation

At this stage of the implementation of the Joint Venture Agreement, one could only estimate future socio-economic benefits which may be derived from the privatization of the LWTC. These benefits have been estimated on the basis of the business plan attached to the Joint Venture Agreement and discussions held with the Lao and foreign partners during the evaluation mission. The business plan, covering a three-phase expansion of the joint venture over a three-year period

(this period effectively started on 1 July 1994 and should end on 30 June 1998), indicates an increase in job creation from approximately 150 jobs prior to the joint venture, to approximately 1,380 jobs by the end of the third phase. If the business plan was to be fully implemented, the following jobs should have been created by the end of June 1998:

— 176 permanent jobs at Lao Cotton for the operation of the various facilities;
— 300 jobs for home-based women weavers; and
— 800 to 900 jobs for home-based women embroiderers.

The above employment levels were conservative, and could reach higher levels if efforts were made to ensure that the business plan is implemented according to schedule. Cotton plantations should also generate additional employment (see below).

4.3 Application of international labour standards

When drafting the Joint Venture Agreement, specific terms were included in relation to the application of Lao labour laws and the retaining of staff members present before the establishment of the joint venture. Thus, these terms should contribute to the adoption of fair labour practices, including improved working conditions. This matter had been discussed with the Lao and foreign partners, and it was anticipated that attractive contracts would be offered to the future and current staff of the centre. The latter was eagerly waiting for the effective implementation of the joint venture since they expected a significant increase of their current salary. Furthermore, working conditions at the centre were also attractive from the point of view of safety and various amenities for the staff. It was proposed that the government representatives on the Board of Directors of Lao Cotton pay special attention to this matter in order to ensure fair labour practices and working conditions in the future.

5. Foreign exchange earnings

Most of the future production would be either exported or sold to tourists, while the rest would be sold in the local market. However, even local sales would indirectly generate foreign exchange earnings, since local customers would otherwise import the textile products they need. Therefore, it could be safely assumed that the totality of sales would generate foreign exchange earnings.

Gross foreign exchange should have amounted to approximately US$3,610,000 by early 1998 from the sale of the following products:

— US$1,920,000 from the sale of 240,000 kg of terry cloth per year;
— US$190,000 from the sale of 96,000 metres of cotton cloth per year;
— US$660,000 from the sale of 10,200 table sets and/or bed sets per year; and
— US$840,000 from the sale of 240,000 metres of hand-woven cloth transformed into garments and home-furnishing goods.

Net foreign exchange would be lower since, unless linen fibre is produced in the Lao People's Democratic Republic, linen yarn would have to be imported for approximately US$200,000 per year. Thus, net foreign exchange for 1998 was estimated at approximately US$3,400,000. These earnings could have been higher with further expansion and diversification of Lao Cotton in 1997 when additional processing equipment should have been installed.

6. Multiplier effects on the economy

It was difficult to estimate the multiplier effects resulting from the production and marketing activities of Lao Cotton. If we estimate that altogether 1,500 jobs should have been created, this would mean that close to US$1,000,000 in salary and wages per year should be ploughed back into the Lao economy. This should create additional jobs since the above amounts should be, to a large extent, used for consumption of locally produced goods. In addition, some of the foreign

exchange generated would be available for the import of capital goods by local investors. The additional investments should also have positive effects on the economy.

C. Problems encountered in the process of implementing the Joint Venture Agreements

In 1994, the post-evaluation mission identified a number of problems and formulated some recommendations in order to resolve them.

1. Common problems encountered in both agreements

1.1 Weaknesses in the processing and monitoring of foreign investments and privatization agreements

First, it is not clear how the FIMC is structured. It would seem that the FIMC does not have a potentially important section, namely a monitoring section which will ensure that privatization agreements are implemented effectively and fairly by all the parties concerned, and that the latter adhere strictly to the terms of such agreements. The lack of clarity would not facilitate the negotiation and application of foreign investments and privatization agreements. Under these circumstances, the following recommendation was made to the Government at the end of the post-evaluation mission:

— ***The Government should urgently initiate a review and assessment of the current role, structure, functions and staff and other resources of the FIMC, with a view to identifying eventual weaknesses and to initiating remedial measures, and to establishing within the FIMC the following sections: an administrative section, a research or evaluation section, a legal section and a monitoring section.***

Second, it would seem that FMIC staff and the government representatives on the Board of Directors of privatized enterprises do not have the required qualifications and/or training for negotiating and processing complex privatization agreements and for monitoring the latter. This lack of qualifications and training could have very negative effects on future privatization agreements, and could deprive the Government from securing the full benefits from such privatizations. It was, therefore, recommended that:

— ***Both the government representatives on the Board of Simon Lao and the Lao women textile centre, as well as FIMC staff should be trained in the monitoring of the joint venture. In the short term, the services of specialists (e.g accountant, marketing specialist) should be used for assisting and advising the above staff.***

Third, neither the FIMC staff members, nor the government representatives on the Board of Directors of privatized enterprises have at their disposal clear guidelines for assessing, negotiating and monitoring foreign investments and privatization agreements. Without such guidelines, it would be difficult for the above staff to use systematic procedures for this purpose and to ensure an effective monitoring of such agreements. It was, therefore, recommended that:

— ***Clear guidelines on privatization policies and procedures, and on the monitoring of privatization agreements should be prepared for the benefit of the FIMC staff, the government representatives on the Board of Directors of privatized enterprises, and for representatives of other government agencies concerned. The content of the guidelines should ensure that the above individuals will systematically apply all the steps required for the assessment, negotiation and monitoring of foreign investment and privatization agreements. They should also ensure a transparent privatization process and full adherence to the Lao Foreign Investment Law.***

2. Problems encountered specifically by the tannery Joint Venture Agreement

All the above benefits may not be fully realized unless some current problems encountered by Simon Lao are quickly and satisfactorily resolved. These are briefly discussed below.

The first and most important problem concerns the supply of local hides. The tannery has not yet been able to secure sufficient hides from the Vientiane abattoir and other regions of the country for the full capacity utilization of the tannery. The latter has only been able to buy half of the hides presently produced by the abattoir, the remaining hides being exported to Thailand through local Lao dealers trading with Thai merchants. Currently, the tannery can only obtain approximately 45 hides per day from the abattoir, while 70 to 100 hides are actually available. The tannery is now forced to import more expensive hides from China (at almost double the Lao hides price) in order to be able to produce the required volume of leather. This has a number of negative effects on revenues, and on the economy as a whole:

— first, higher hide costs means lower profits, and therefore lower revenues for the Government from the sharing of profits (25.1 per cent) and from the corporate taxation of profits after the third or fourth year; and

— second, less foreign exchange will be channelled through the national bank, on the assumption that abattoir hides which are not used by the tannery are mostly exported illegally to Thailand. The amount of foreign exchange may not be lower, but illegal exports mean less control of foreign exchange earnings and less revenues from exports of hides. This also applies to hides produced in other parts of the country.

Under these circumstances, a solution to the hide supply problem should ensure a profitable operation of the tannery while increasing substantially government revenues and improving control of foreign exchange earnings. Suggestions for solving this problem are provided later.

A second problem concerns the marketing of processed hides. Currently, these hides are sold directly to one of the foreign partners, Simon & Associates. It would seem that the selling prices cover, at most, production costs, or could be even 40 to 50 per cent lower than the latter. Under these circumstances, it would be difficult to expect a profitable operation of the tannery in the future. Once production is diversified (e.g production of dog chews and splits), some profit could be generated. Nevertheless, the main tannery output, namely the processed hides exported to Simon & Associates, should under normal circumstances generate some profits. It is, therefore, very important for the government representatives on the Board Directors of Simon Lao to discuss this matter with the Board members, with a view to adopting a marketing strategy based on obtaining the highest export prices from Simon & Associates and other potential clients. Market diversification should also be the main objective of Simon Lao.

A third problem concerns the active and effective involvement of the government representatives on the Board of Directors of Simon Lao, with a view to ensuring strict adherence to the terms of the Joint Venture Agreement by all parties concerned, and an accurate and fair calculation and distribution of profits among the Lao and foreign partners. Currently, government involvement is minimal. This has two important negative effects. First, government officials may not benefit from training in business management practices and in a better understanding of international trade and financing. In other words, the tannery will be fully managed by foreigners without any impact on local capacity to understand and apply sound business practices. Second, the Government will have little control on the operations of the tannery, and could be deprived of substantial revenues and profits (see section on the monitoring of the Joint Venture Agreements).

A final problem concerns the local financing of Simon Lao operations. A credit line from local banks (e.g BCEL) in the form of "packing credit" should be made available to Simon Lao, since such credit is vital to any enterprise, and should facilitate the availability of working capital. At present, Simon Lao must depend on loans from one of the foreign partners, Simon & Associates. The interest of these loans is high (10 per cent) compared to that which usually

applies to packing credit guaranteed by letters of credit (2 or 3 per cent). Loans from the foreign partners are not desirable either in the short and medium term in view of possible conflicts of interests. Therefore, the authorities concerned should help Simon Lao to negotiate a "packing credit" with one of the Lao banks. Furthermore, it is recommended that all future financial transactions, including letters of credit, be negotiated through these banks instead of a Bangkok bank as has been the case in the past.

3. Specific problems encountered by the Lao women textile centre Joint Venture Agreement

3.1. Delays in the effective implementation of the Joint Venture Agreement

There are three main reasons for the above delays. First, the Joint Venture Agreement had to be revised in February 1994, in order to include additional foreign shareholders. Second, the equipment to be brought in by the foreign partners arrived later than expected, and new buildings had to be added for housing such equipment. Import of the above-mentioned equipment was a prerequisite for officially starting the joint venture. Third, there were some delays in officially registering the new company.

These delays were discussed during the 7 May 1994 meeting of the Board of Directors, and decisions have been taken during this meeting in order to officially start the joint venture — from a financial point of view — by 1 July 1994 at the latest. This starting date is subject to the following conditions which must be met prior to 1 July, 1994:

- starting up of production of machine-made cloth with the imported equipment;
- official registration of the new company;
- signing of the lease agreement to be attached to the Joint Venture Agreement;
- lease of 300 ha of land by November 1994 at the latest to the new company, with at least 15 ha to be made available by June 1994; and
- bill of lading for additional equipment to be provided by the foreign partners, to be submitted by June 1994 at the latest.

3.2. Monitoring of the Joint Venture Agreement by the Lao Women Union and the FIMC

The importance of effective monitoring of privatization agreements and the need to establish an effective mechanism within the FIMC for this purpose applies equally to this Joint Venture Agreement.

The Lao Women Union Vice-President is the Chairman of the Board of Directors of Lao Cotton. However, in view of her many other duties, it is doubtful that she can devote sufficient time for the effective monitoring of the Joint Venture Agreement. Therefore, it is strongly recommended that the Lao Women Union assigns a qualified half-time staff member, with a good knowledge of English, for the continuous monitoring of the Joint Venture Agreement, especially during the first two years. This staff member should be part of the FIMC monitoring section which will monitor this joint venture within the FIMC. A periodic evaluation schedule should be established by this section for the next two to three years, and systematically applied by the staff of the section. Training of the latter will probably be required and could be provided through UNDP/ILO assistance.

The Lao Women Union representatives on the Board of Directors of Lao Cotton should also prepare themselves regularly for the Board meetings and take an active part in the latter. They should be assisted for this purpose by the FIMC monitoring section assigned to this project.

Part VI. Situation of the two Joint Venture Agreements by June 1997

A. The tannery

By late 1994, the main shareholder of the tannery sold its shares to another foreign investor. This decision was linked to the discontinuation of this shareholder's activities in Thailand. The new foreign partner, in consultation with the Board of Directors of Simon Lao, redefined the production plan of the tannery. While production of processed hides will continue as in the past, the output will be sold to various clients rather than exclusively to the foreign partner who left the Joint venture. Thus, actual market prices will be applied in the future for the processed hides. The production of dog chews will also be further developed since this line of production is, by far, much more profitable than that of processed hides. A special plan for promoting the collection of raw hides all over the country will be put in place and should, if successful, solve the earlier problems of local hides supply. Finally, the new foreign partner will transfer to the Lao People's Democratic Republic some of his production of leather garments currently produced in other Asian countries. Another important new development is the decision of this new partner to establish himself permanently in Laos. This should ensure an efficient operation of the joint venture. Altogether, these new developments should establish the tannery on a firm basis and ensure its profitable operation over the long-term.

1. New repartition of shares

It should be recalled that the earlier shares of the company were distributed as follows:

Government of the Lao People's Democratic Republic (GOL)	25.1 per cent
Simon & Associates Ltd. (Simon)	67.4 per cent
International Business Centre (IBC)	7.5 per cent

The distribution of shares remains the same, the only difference being the replacement of Simon & Associates Ltd. by the new foreign partner, Mr. C. Schad.

2. Activities of the tannery

2.1 First phase: Redefining the production plan

In view of market demand for the various outputs of the tannery and the problems encountered, a new production plan was adopted.

Currently, the tannery produces processed hides for export to clients who will process them further according to their needs, as well as dog chews (a pet product made up of the inner lining of the hides). A strong demand for these products justifies such specialization. The latter was based on a marketing study of dog chews undertaken with ILO assistance in 1994. This study clearly indicated that the production of dog chews will be extremely profitable and will be necessary for ensuring a sufficient profit margin for the factory. The potential market for dog chews in the United States and Europe is huge. Prices have increased lately, and should continue to do so in the near future, especially in the United States. Tanners in this latter country may start producing dog chews locally at a higher cost and at, therefore, high retail prices in view of the high labour costs in the United States. Exports to the United States may therefore become more competitive and generate more profits. In Europe dog chews are mostly imported from Asia, including Thailand. Exports to the European market should continue to be fairly attractive.

The new production mix adopted by the tannery is very promising. The current production of dog chews, particularly in Europe, has grown quickly. It has now exceeded 50 tons/month, generating over US$200,000/month. The production of processed hides will, on the other hand, generate approximately US$114,000 in revenues with a much lower profit margin.

2.2 *Second phase: Implementation of the new production plan*

Organization of the local collection of hides

The tannery profitability is very much dependent on the availability of local hides which are cheaper than imported hides. The new management has now decided to resolve this issue in a systematic manner through the establishment of hides collection centres all over the country. A first centre has already been established, and it is expected that more centres will be established in the future. Thus, the tannery should be able to gradually increase the use of local hides from approximately one-third of all processed hides in 1997 to close to 100 per cent of local hides within two to three years.

Estimated production and revenues for 1998-99

16,000 hides will be processed per month and will generate the following revenues:

— US$1,000,000 from dog chews production; and

— US$500,000 from the production of partly processed hides.

In addition, improvements have been introduced in the production processes through new investments in equipment. The effluent treatment has also been improved, further lowering the danger of any pollution of the Mekong water. Such investments will also allow the production of new goods. Thus, the foreign partners intend to start production in 1998 of leather garments and fine leather which will generate over US$400,000 per month; 67 new jobs will be created for this purpose, and the workers will be trained by Thai experts.

2.3 *Employment generation*

The tannery employed 100 workers in 1997. It is estimated that by the end of 1998, 350 to 400 workers should be employed. It is also probable that 150 new workers will be recruited for the production of leather garments and fine leather for furniture.

Salaries and working conditions

The average salary is US$600 to US$700, approximately double the average per capita income. The tannery is offering very good working conditions, and has initiated a number of measures in order to protect the staff against occupational hazards.

Furthermore, economic benefits will accrue to the rural population which will be able to take better care of the cattle and therefore receive higher prices for good quality hides.

2.4 *Overall situation of the tannery to date*

The tannery has now reached a stage whereby one could expect that it will continue to grow and substantially benefit the Lao economy. This achievement is partly the result of the very good relations established between the foreign partners and the Municipality of Vientiane. It will probably face in the future the usual problems faced by enterprises, but should be able to overcome them. For example, the tannery's shipments to Europe were stopped at the customs as a result of new sanitary regulations adopted by the EU. The Lao People's Democratic Republic had to register again with the EU authorities in order to lift the embargo on its export of food products to the EU countries. It has now succeeded in doing so, partly through some assistance from the ILO. This also shows that a positive relationship has been established between the ILO and a company partly owned by the private sector and partly by the Government. The tannery will probably face other problems in the future. However, it is hoped that, by then, it would have reached full maturity and will not need any more ILO assistance.

B. The Lao women textile centre

The current situation of the centre is very much different from that of the tannery. Soon after privatization, prospects were very good for a rapid expansion of the textile centre: the

foreign partners brought into the joint venture a great deal of expertise at all levels; additional funding was available for new investments; attractive plans were adopted for increasing local cotton production and diversifying and expanding production, etc. However, mistrust between the foreign partners and the Lao Women Union on the one hand as well as mistrust between the foreign partners themselves prevented the achievement of the above plans. It is difficult to assign the full blame on one or another of the joint venture partners — all contributed to the failure of the joint venture. At this date, the Lao Women Union has unilaterally put an end to the joint venture and has taken over the management of the textile centre. In other words, the situation is similar to that before the establishment of the Joint Venture Agreement. The current Lao Women Union management will not be able to overcome the problems faced before the start of the joint venture. It is expected that the textile centre will, at best, continue to operate at a low capacity level and barely cover its operating costs. In the medium term, the centre will probably be forced to close down and sell its assets to another party since it is doubtful that the Government will continue to subsidize it. However, there is also the possibility that the foreign partners in the joint venture will decide to take this case to court and succeed in re-establishing the joint venture. Prospects for this outcome are now, however, very good. At best, the foreign partners would be able to get part of their initial investment in the joint venture. More details on the situation of the textile centre prior to and after the termination of the joint venture are provided below.

1. Situation of the textile centre prior to the termination of the joint venture

Soon after the signing of the Joint Venture Agreement, the foreign partners initiated a number of measures in order to implement the terms of the agreement and to ensure a profitable operation of the centre.

1.1 Increase of productivity and quality

The new foreign/Lao management team initiated immediately a number of measures to improve productivity and quality. The main ones include the following:

— *Review and improvement of the staffing structure.* The qualifications, skills and behaviour of each staff member were reviewed in line with the requirements of the centre. Subsequently, a large number of staff members were retained while a few members had to leave because they either did not have sufficient qualifications or because their behaviour was incompatible with the required work ethics. In a very few cases staff members were retained for a three month probationary period. Most of them were finally retained after this period.

— *Streamlining production with a view to improving productivity.* Important productivity increases were achieved in two main departments — the yarn production unit (it was possible to work on a three shifts basis seven days a week) and the garment production unit. This was accomplished without any further investments.

— *Improving quality and designs.* An effective quality control system was introduced and training was provided for producing designs in line with market demand.

These measurers helped increase production, an important factor in the face of increased demand.

1.2 Development of new market opportunities and increasing sales

In addition to improving productivity and quality, the new management of the textile centre, particularly one of the foreign members of the Board of Directors, initiated an effective campaign for promoting local sales and exports. This campaign succeeded in increasing sales to the point where the centre started to generate sufficient revenues to cover production costs and to make profits. This was a dramatic improvement from the period before the establishment of the joint

venture when the centre could not even cover its production costs. The number of foreign clients also increased to the point where foreign sales were becoming as important as local sales. It may be noted that the range of textiles products marketed by the centre was basically the same as that marketed before the joint venture since the new production lines indicated in the Joint Venture Agreement did not still materialize (see below).

1.3 Local cotton production

The foreign partners also started a new programme for increasing the production of good quality cotton in line with the centre's requirements. Land for cotton production was made available by the Government (this was one of the terms of the Joint Venture Agreement), and contracts were established with cotton farmers to whom advance payments were made before the start of the planting season. Better variety of seeds were also introduced. These efforts succeeded in making sufficient local cotton available for the needs of the centre. It was therefore not necessary to import part of the cotton required by the centre. In addition, a large number of farmers benefited from the assistance and were able to increase substantially their revenues.

1.4 Starting production of new products

The business plan attached to the Joint Venture Agreement specifies that new production lines would be developed. These included, in particular, machine-woven cloth for the production of table sets and bed linen to be locally embroidered by home-based women. One of the joint venture partners did get the weaving equipment to Laos and installed it in one of the centre's workshops. However, the full capacity use of this weaving equipment required an additional machine which was not yet imported from abroad although it was supposed to be available. In any case, problems between the foreign partners and the Lao Women Union started at that time (see below) and production of these additional goods never began.

To summarize: By the time the Joint Venture Agreement was terminated, the centre was using at full capacity the facilities available before the joint venture and was generating good profits. Production was streamlined, productivity increased and new markets were tapped. However, new production lines envisaged in the Agreement were not initiated.

2. Termination of the Joint Venture Agreement

The Joint Venture Agreement in the case of the tannery was fairly successful partly because relations between the foreign partners and the Municipality of Vientiane were altogether fairly good. This was not unfortunately the case of the relationship between the foreign partners and the Lao Women Union. Many reasons could explain this unfortunate situation.

First, contrary to the Municipality of Vientiane, the Lao Women Union has never been fully supportive of the joint venture. It agree with the joint venture because it could not do otherwise: the Government was pushing for the privatization of state enterprises and the textile centre was depending on some state subsidies which would have been discontinued in the future. Furthermore, the textile centre was the only enterprise operated by the Lao Women Union. The centre was a source of funds for the Union and also allowed it to place some Union members in the centre staff. Privatization put an end to these benefits although the Joint Venture Agreement included terms for yearly financial contributions to the Union. Under these circumstances, the Lao Women Union was often looking for reasons to terminate the joint venture. On the other hand, the tannery was one of many state enterprises operated by the Municipality of Vientiane. The latter was not adverse to its privatization.

Second, relationships between the foreign partners were often difficult. The main reasons were the lack of trust between the foreign partners and diverging views on business development strategies. The Lao Women Union took advantage of these conflicts by playing one foreign partner against another.

Third, delays in the implementation of some of the terms of the Joint Venture Agreement by the foreign partners and the Lao Women Union further aggravated the above conflicts.

In early 1997, the Lao Women Union unilaterally put an end to the Joint Venture Agreement although this should have required a specific procedure involving all the partners in the Agreement and clearly spelled out in the Joint Venture Agreement. The management of the centre is now under the responsibility of a Lao Women Union representative who has no experience in running such a centre. It is also probable that the earlier misuse of the centre by the Union will resume under the new management. In other words, the inherent weaknesses present prior to the Joint Venture Agreement will again apply. It is not clear whether the foreign partners will go to court in order to be compensated for their losses.

3. Concluding remarks on the textile centre

The Joint Venture Agreement did achieve important results although the business plan spelled out in the Agreement was not fully implemented. In addition to covering production costs, the centre started to generate profits. Cotton growing also helped generate rural employment and reduce cotton imports. Prospects were altogether promising although conflicts between the foreign partners slowed down progress. It is the opinion of the author of this report that, if the Joint Venture Agreement were not prematurely terminated, its full potential would have been achieved. The business plan was sound. The failure is due mostly to conflicts between the foreign partners (these were being gradually resolved) and between the latter and the Lao Women Union. It is also due to the weakness of the legal system in the sense that the Lao Women Union felt that it could illegally terminate the Joint Venture Agreement without having to worry about the legal consequences. This is a general problem which could affect all foreign investors. However, the potential for profits is sufficiently high in the Lao People's Democratic Republic for making the foreign investors accept the legal risks. It may also be noted that, when selecting the foreign partners along with the Government, the ILO was not in a position to estimate the risk of conflicts between the foreign partners.

Part VII. Joint venture agreements in the Lao People's Democratic Republic: Lessons learnt

It is clear that privatization was the only option for overcoming the problems and constraints faced by the two Lao state enterprises, including management, marketing and financial problems. In the absence of privatization, there was a real danger for a rapid deterioration of the situation which would have made a later privatization of the LWTC and LIT less attractive and profitable for the Government of the Lao People's Democratic Republic. Another real danger was the actual closing down of the two state enterprises if no foreign investors could be found.

However, it is also clear that the success of a privatization depends to a large extent on a strict adherence to the terms of the joint venture agreement by all the parties concerned: the foreign investors and the local government agencies responsible for the state enterprises. Apparently, it does not seem that it was the case of the Women Textile centre, even if we do not have at this time precise information on the actual reasons leading to the termination of the Joint Venture Agreement. In any case, it is extremely doubtful that this matter will go to the court and that the joint venture will be re-established. Should this unfortunately be the case, it is also clear that the textile centre will be facing an extremely difficult situation in the future: it may barely survive for one or two more years and will probably be forced to close down since the Lao Women Union will not be able to continuously cover the losses. The closing down of the centre would probably happen once expensive equipment will need to be repaired or replaced since the Lao Women Union would not be able to cover the cost. Then, it will probably be forced to find another foreign partner and to accept much less favourable terms than under the previous Agreement.

On the other hand, the future of the tannery Joint Venture Agreement seems very promising. The absence of conflicts between the foreign partners and the Municipality of Vientiane was an important factor in the success of this joint venture. In particular, the foreign partners felt confident about the future and took the risk to invest heavily in new equipment and facilities. These new investments have been instrumental to the rapid growth of production and exports and to making the tannery a very profitable enterprise. It may also be noted that the local capacity for operating a fairly complex plant has also been strengthened: there is now a single foreign staff member working with the Lao staff. Future prospects are very promising and should lead to a further expansion and diversification of production. Furthermore, the foreign partners made special efforts to promote basic labour standards: attractive salaries for the staff, good working conditions, insurance coverage, application of safety and health measures, etc. In addition, the foreign partners made special efforts to protect the environment by making further investments in the effluent treatment plant. It may be noted that the above considerations regarding the staff of the tannery and the environment were specified in the Joint Venture Agreement. It is interesting to note that the foreign partners honoured their commitments in these areas although they were probably not under pressure from the Municipality of Vientiane to do so.

Lessons derived from this privatization experience

The author believes that this is the only case of ILO involvement in the privatization of state enterprises, long before the start of the Action Programme on Privatization. Prior to this involvement, the ILO did not have any experience in providing concrete assistance to governments wishing to privatize state enterprises. It was therefore a learning experience for the ILO, requiring a preliminary study of a number of World Bank and other reports on this issue. While the ILO is now in a position to replicate this experience in other countries, it will be necessary to market this ILO product before further requests for assistance in this area can be generated.

The author feels that, although this was a novel technical cooperation area for the ILO, the latter succeeded in offering quality and effective services in view of the achieved results. The

retained privatization option was based on an extensive analysis of all the available options. The positive and negative effects of each option were systematically and thoroughly analysed. Subsequently, the ILO was able to contact a very large number of potential foreign partners and provided the latter with an attractively designed brochure on the two state enterprises to be privatized. In this case, the ILO needed to collect a large number of catalogues in order to identify companies which could be interested in establishing a joint venture with the Lao Government. The approach used was in line with the normal procedures required for transparent international bidding, with fixed dates for submitting the bids and the needs for the bidding documents to remain closed up to the time where they were to be reviewed.

The ILO, the UNDP office in Vientiane and the Government were directly involved in studying the bids. The latter were assessed fairly and a pre-selection of bidders was made. Subsequently, various rounds of negotiations were held with the selected bidders with the full and active participation of the ILO and the UNDP.

Once a final decision was made on the successful bidder for each state enterprise, the ILO was also directly involved in negotiating the terms of the Joint Venture Agreements. This also required the acquisition of expertise in the legal area in order to ensure an effective and fair application of the Agreements. The services of a lawyer were used for this purpose.

Altogether, it may be stated that the full privatization process was one of the most transparent processes ever implemented in the Lao People's Democratic Republic.

In addition, the ILO assisted the Government in improving the effectiveness of the government agency involved in the management of privatization projects.

ILO involvement in the privatization process did not stop after the signature of the Joint Venture Agreements. As a neutral partner in these agreements, the ILO was often called by the Government and the foreign partners to intervene whenever a problem arose. Such ILO interventions have certainly helped overcome, at least in the case of the tannery, potential problems which would have negatively affected the Joint Venture Agreement.

One of the lessons learnt from this privatization exercise is the importance attached by governments to the application of the rule of law to agreements with foreign investors. In this privatization exercise, it was taken for granted that full consideration of all legal aspects in the Joint Venture Agreement will help protect the joint venture partners against actions which are not in conformity with the terms of the agreement. In reality, some of the terms were often broken by the joint venture partners, either willingly or unwillingly. Differences were usually settled during board meetings without necessarily referring to the terms of the Agreement. Although extensive negotiations were required in elaborating the legal terms of the Agreements, little attention was paid to these after the Agreements were signed. This disregard for the legal aspects of the Agreements did not affect negatively the implementation of the tannery joint venture. On the other hand, it probably explains the Lao Women Union's unilateral decision to terminate the Joint Venture Agreement without following the agreed-upon legal procedures.

The question as to whether the ILO should have been involved in this privatization exercise is an important one. The author believes that, in this particular case, the ILO could not avoid such involvement. Years of efforts to establish potentially profitable enterprises would have been wasted without ILO further assistance in privatizing these enterprises. On the other hand, it is not clear whether the ILO should use this newly acquired expertise in future technical assistance projects.

Should the ILO only transfer this expertise to agencies responsible for privatizing state enterprises without getting involved in the privatization process? Would ILO involvement be necessary as part of on-the-job training of the staff members of these agencies? Should the ILO produce a manual on privatizing state enterprises based on material elaborated in relation to the Lao People's Democratic Republic case? Should the ILO further develop some expertise in relation to the policies and practical aspects related to the privatization of state enterprises?

A clear answer to all these questions would require a major policy decision from ILO management in view of the potential legal and ethical consequences of such a decision. This would constitute an area for further investigation as a follow-up of the Action Programme on Privatization.

Annex I. Assessment of privatization options

Privatization option	Guiding principles (Ranking: 1 to 3)						Search for a privatization partner	Conditions for a successful privatization
	Development of LAO leather sector	Foreign exchange revenues	BCEL loan	Development of local technical and managerial capacity	Generation of government revenues	Environment and working conditions		
Full divestiture option	1 or 2	1 or 2	1	2	2	2	Very difficult	— Government adopts policies and measures to secure supply of hides — Non-prohibitive sale price — Goods prospects for Lao economy — Privatization partner with the right credentials (know-how and financial resources)
Joint venture	1	1	2	1	1	1	Average difficulty	— Government adopts policies and measures to secure supply of hides — Privatization partner with the right credentials (know-how and financial resources) — Majority share for Government but guarantees for the partner — Qualified representatives of the Government in the management staff of the tannery — Tannery enjoys full managerial and financial autonomy
Management contract	3	2	3	3	3	1	Least difficult	— Government adopts policies and measures to secure supply of hides — Contract partner must have the required technical and managerial capacity — The Municipality of Vientiane must secure the require financial resources — Good supervision of management contract by the Municipality of Vientiane — Tannery enjoys full managerial and financial autonomy

Privatization option	Guiding principles (Ranking: 1 to 3)						Search for a privatization partner	Conditions for a successful privatization
	Development of LAO leather sector	Foreign exchange revenues	BCEL loan	Development of local technical and managerial capacity	Generation of government revenues	Environment and working conditions		
Lease agreement	3	3	2	1	3	3	Average difficulty	— Government adopts policies and measures to secure supply of hides — Partner must have the required technical and managerial capacity — Municipality of Vientiane must secure the require financial resources — Attractive lease fee — Good supervision of lease agreement by the Municipality of Vientiane
Marketing contract	—	—	—	—	—	—	—	Not feasible at this stage.