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Privatization in Theory and Practice

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INTRODUCTION

During the past couple of years government officials have become very interested in the transfer of government service delivery to the private sector. This privatization phenomenon has spawned a concomitant growth in academic attention given to this subject. Privatization in its broadest sense implies making the economy more private and giving the private sector a larger role in deciding how production is to be organized.

A distinction between privatization of ownership and forms of privatization that change the public-private mix without changing ownership is useful. Ownership privatization refers to the sale of state assets, whether whole corporations or partially, by sale of some of the stock. Nonownership privatization could refer to changes in finance, by transferring to the consumer or user of public services a larger share of their costs via higher user charges and reduction of subsidies; it could also imply changes in production or service delivery by voucher systems, deregulation, or contracting-out. Normally, privatization is associated with the first type of approach— the sale of state assets to private parties. But forms of privatization that do not involve ownership transfers have been more widespread, have had more profound effects, and have better prospects for the future. Privatization also denotes opportunity, in that it could expand access to economic opportunity among workers and citizens, creating new investors and entrepreneurs, strengthening competition, opening markets and helping set up an economic climate in which the private sector can flourish and take the lead in generating economic growth.

GENERAL EXPERIENCES

Countries of all political hues have been resorting to policies that favour a reduced role for the public sector and greater reliance on the private sector. This shift has been so strong that, at times, it has been able to overcome resistance from powerful political and economic interests. Many causes have been cited for this change in strategy: (a) the growing complexity and international integration of economies that made overly centralized decision-making practically impossible; (b) the proven inability of the public sector to make a satisfactory display; and (c) the excessive politicization and corruption created by over extended and overbearing public sector.

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Privatization, by forcing companies to face the discipline of competition in the marketplace, lowers efficiency. This reduction in inefficiency, while not necessarily immediate, comes from reducing the role of the state in the economy, both in the ownership and operation of individual firms and in control of the overall economy. Experiences have revealed that the pervasive control of the economy by the state generates inefficiency, often combine with corruption and other abuses.

The public often doubts the integrity of the financial institutions and officials who manage the privatization process. This is especially the case in societies where the public's confidence in the government is very low or where corruption is conceived to be a normal part of the political process.

Privatization and other structural reforms both reflect and enhance the movement toward political democracy. They instill the accountability among economic actors and public officials that is needed for business and political institutions to operate with integrity. Corruption is far harder to pull off in an open, transparent economy than in a behind closed door, state dominated one. Yet, the implementation of such reforms demands courage, for structural adjustment can have adverse consequences in the short-term.

PUBLIC VERSUS PRIVATE

Most studies have assessed public enterprises performance on the basis of financial rather than social profitability. Based on this criterion, many countries operate public enterprises (PEs) that show low profitability and mostly continuing financial losses. The losses are ascribed to the following factors: (1) inadequate and poor planning with respect to feasibility studies leading to ill- centralized decision making; (2) paucity of skill managers and administrators; (3) centralized decision making; (4) interference by the state in the day-to-day operations of the firm; (5) vague multiple objectives; and (6) political patronage.

Many governments recognized that the model of development that put state- owned business at the center of planning efforts and economic growth did not produce the desired results. Instead of sustained economic growth, increasing living standards and rising employment, many economies were suffering from the exact opposite. And with these, stagnating economies came with increasing corruption.

Government enterprises are managed to achieve a variety of objectives that relate to the complexities of politics, while private enterprises are largely managed to earn profits, and cost efficiency and market responsiveness are crucial to that pursuit. The more competitive the markets in which the private enterprise operates, the more it is compelled by its objectives of profits and survival to operate efficiently.

It was not only the increased awareness of public sector limitations that stimulated the governments toward privatization and private-

sector-oriented policies in the 1980s. It was also the growing recognition that private money, skills, an energies denoted a potentially powerful source of new economic growth and new dynamism. There was also the recognition that in an environment of extremely rapid technological change and intense international competition, survival and growth demanded highly competent, flexible, innovative industrial and service enterprises, qualities often absent in PEs.

There were also other reasons for governments to resort to privatization. These included shifting development theory and ideologies in the context of huge PE losses, the collapse of communism in Eastern Europe and the Soviet Union, and some success stories of early privatizers. Fiscal crisis also made some governments to privatize as a technique to collect revenues and stem losses, particularly in the context of soaring public debt . Some governments chose to privatize due to their inability to finance needed investment in their PEs than to their expectations of efficiency gains.

LIMITATIONS

Nonetheless, privatization is still opposed in some countries. Many officials are against it because it reduces their area of authority and hence their status. The beneficiaries of privatization are perceived to be the rich and privileged. In much of the third world the divestiture transaction is thus viewed by the intellectual community as the transfer of national assets, and hence additional wealth and power, to socially disreputable groups.

There are two negative factors often in the privatization process which also cast doubts about the efficiency-raising effects of sales of PEs to private owners. First, many of the PEs, that governments want to sell, are not economically viable, even with massive write-downs of book values. Many should never have been set up at all. Second, they are remnants of past investments mistakes and/or policy errors. Others are the victims of structural changes in the world economy or have been run down by poor management and/or inadequate resources.

In most instances these enterprises should be liquidate, not privatized. In fact they can only locate a private buyer-if rent-generating privileges are associate with them— a monopoly of imports of finished products of the kind being produced by the firm being sold— for example, monopoly contracts, or direct subsidies, or very high, long-term protection against external competition. To the degree that the privatization process leads to the awarding of such special privileges, the negative efficiency consequences counterbalance any efficiency gains emanating from more dynamic management and new investment.

Obstacles to privatization are numerous: (a) lack of a free market culture; (b) confusion over who owns the enterprises and how much they are worth; (c) poor physical infrastructures which discourage foreign

investment; (d) the absence of a legal framework governing the conduct of business; and (e) shortage of investment capital.

When privatization is actually implemented, the results can often lead to problems. For example, when a government sells a viable enterprise, the profits go to enrich investors, who tend to be wealthier than the average taxpayer. Thus income disparities are widened. Other consequences can include higher price for basic goods and services, large-scale lay-off, loss of national assets to foreign buyers and the possible closure of vital industries. These effects have led to social unrest in many countries.

For a country embarking on the promising but uncertain path of privatization, there are clearly many calculations to be made and choices to consider privatization which is not an end in itself, nor is divestiture the only option. There are many alternatives, ranging from full privatization to the restructuring of an enterprise under state ownership.

The privatization programme is more difficult to implement in least-developed countries. Nonetheless, there have been satisfactory results also. In Bangladesh, privatized textile companies were more profitable then state-run textile mills. This was partly ascribed to debt write- off, but more emphasis on cost containment and more aggressive marketing were also helpful. It was because of privatization that a near- dead textile company now functions profitably at close to full capacity with a greater work force. A development finance corporation, which had been shut down before sale, started to make profits in its second year of private ownership in Swaziland. Thus privatization can generate positive outcomes even in difficult environment.

There are two principal factors that determine the strategy and influence the outcome of privatization for economic productivity and consumer welfare. The first factor relates to country conditions, especially the degree to which free entry is permitted by the macroeconomic and regulatory policy framework, markets are competitive, resources are allotted on the basis of marginal returns, and the regulatory and supervisory institutions are efficient. The other factor relates to the nature of the market into which the enterprise is divested, that is, whether the market is competitive or potentially competitive opposed to noncompetitive.

NEPAL'S EXPERIENCES

In Nepal, the core problems of PEs are their demonstrable inefficiency and their massive financial losses, which have drained the public treasury of funds that could have been better utilized elsewhere. Thus, public enterprises are being privatized because it is believed that, in manufacturing and other productive sectors, private enterprise can deliver better results.

The financial position of PEs had deteriorated especially in FY 1991, because of enormous losses incurred by the Nepal Electricity Authority (NEA), the Nepal Oil Corporation (NOC), the Agricultural Inputs Corporation (AIC) on fertilizer subsidies and the Nepal Food Corporation (NFC) on food operations. The PEs incurred a loss of about 1.9 billion Nepalese Rupees in 1991/92. The figure was less at about 1.1 billion Nepalese Rupees for 1992/93. Some price adjustment have helped the NEA and the NOC to cover their operating losses, while the fertilizer and food subsidies were also lowered. Yet, PEs hardly break even or still remain unprofitable. Many PEs still suffer from over-staffing, government supervision in operational and management decisions, and a management culture which depends on the government for guidance. A Privatization Bill was passed in 1993 and a Privatization Cell was established under a concerned committee with the Ministry of Finance as a focal point.

In Nepal, the first phase of privatization has ended and the second is on. Under the first phase, the ownership and the management of three Chinese-built industrial establishments — Harisiddhi Bricks Factory, Bhrikuti Paper Factory and the Bansbari Leather and Shoe Factory — were transferred to the private parties.

The second phase has set a target to privatize 14 PEs. Out of this, the privatization process of three undertakings — the Nepal Film Development Company, Balaju Textile Factory and Raw Skin Collection and Development Corporation — have already been completed. In aggregate, all of the 62 PEs except those covering utilities and social service agencies are to be privatized. A time-table for implementing reforms has been framed, and the government is taking a more open attitude towards the sensitive issue of foreign acquisition.

Drawing from the experience of the first, the government has made some changes in the process. Accordingly, the management shares of the three PEs have been sold to the private parties. Since the basis followed earlier — of selling assets and the business — generated problems in dissolving the old corporations and in setting their liabilities, priority was accorded to the sale of the management shares as far as possible. As regards other 11 PEs, one — Jute Development and Trading Corporation — has been dissolved while the privatization process of the two other — Nepal Bitumen and Barrel Company and Nepal Lube Oil Ltd.— is in the final stage. Evaluation of some of the remaining undertakings has been completed . However, the modalities have yet to be formulated.

With the selling off of the PEs running in a loss, the budgetary burden of the inefficient PEs on the government has decreased. According to the Finance Ministry figures the government has collected, as of 1994, 370 million Nepalese Rupees from the sale of the PEs to the private sector . The money is expected to be utilized on clearing the liability and on priority sectors.

A number of measures have been announced by the government to stimulate private investment in sectors which have public monopolies until recently. These include air transport, electricity generation and distribution, and fertilizer import and distribution.

CONCLUSION

Experience and analysis have taught key lessons about the relationship between the structure of an economy and the ability of privatization to satisfy its goals and expectations. The first lesson is that, in order to be effective, the divestiture state- owned enterprises demands an appropriate set of institutions, a suitable legal system, and a strategy that is tailored to the country's circumstances. The second lesson is that achieving desirable performance requires a market-friendly institutional framework. The third lesson is the importance of a micro economic structure that is open to competition. And the fourth lesson is that in cases where the privatized enterprise gives infrastructure services that are natural monopolies, there must be an effective system of regulation to check the potential abuse of monopolies

On top of these four institutional categories, there is another that is essential to the success of privatization and that drives the difference between public and regulated private enterprises — the governments ability to confine its influence over the privatized firm. That is, the government must commit itself to *laissez-faire* or to a limited and predefined regulatory mechanism. Even where the other four categories of institutional prerequisites prevail, if the government does not have the capacity to tie its own hands and insulate the firm from arbitrary intervention, the expected benefits of privatization are unlikely to be realized.

Fundamental changes in the pricing regime, such as introducing an independent pricing commission for monopoly goods and abolishing existing price control statues need to be implemented. Predictable pricing policy is critical for promoting private sector investments.

The effects of privatization in any particular context will, therefore, be highly dependent upon the wider market, regulatory and institutional environments in which it is implemented. The challenge to economic analysis of privatization is to develop a more complete understanding of the implications for business conduct and performance of these complex interactions among ownership, market structure, and regulatory and political variables. Effective regulatory institutions must be established to ensure fairness and competitiveness after privatization are carried out. Without adequate regulatory safeguards, newly privatized firms may engage in predatory practices, particularly in sectors where there is hardly any effective competition.

The speed of privatization is also important. Establishing an appropriate framework of institutions and regulations takes time, so privatizations should not be undertaken hurriedly even when pressure is given by the financial institutions during structural adjustment programmes.

With a better sequence of policy measures, much unemployment could be avoided. Restructuring many of the enterprises before they are privatized and making advance efforts to build up alternative employment in the private sector would be much more rational. If layoffs seem plausible, governments should carry them out before the privatization programme. This could assist in ensuring that workers receive suitable compensation, with possible retraining or access to credit if they want to start their own enterprises. Finally, promoting private sector development and fostering commercialization require greater commitment to implementing existing policies rather than formulating new ones.

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