The Promises and Challenges of Privatization in Least Developed Countries (LDCs)

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Abstract- One major manifestation of New Public Management type of public sector reform has been privalization. Donor and aid agencies continue to pressurize countries – developed and developing alike – to privatize their public enterprises based on the rationale that privalization will reduce budget deficit, will make the enterprises profitable, will lower prices for customers and improve quality of service. This paper argues that although theoretically possible, the potential benefits may not be realised in LDCs where converting a public monopoly into a private monopoly may be counterproductive. The answer lies in either public enterprise reform to achieve both efficiency and social objectives or in accompanying privatization with liberalization and competition.

Keywords - Public Enterprise, Privatization, Liberalization, competition

I. INTRODUCTION

The 1960’s and 1970’s witnessed an enormous expansion of government intervention in developing countries when the public sector was seen as a major contributor for economic growth and socio-political stability. Public enterprises were set up to serve a variety of economic, social and political objectives (see Wortzel L.H & Wortzel H.V; 1989, Cook P & Kirkpatrick C; 1988, and Bienen H & Waterbury J; 1989). Bienen and Waterbury identified the rationale and goals for setting public sector enterprises in LDCs as for: serving social-equity objectives for distribution of income; job creation and rural development; infrastructure development and other ‘lumpy’ investments like steel and petrochemicals; collection of monopoly rents, especially on minerals; filling in for a deficient private sector; taking-over failed private enterprises; countering capitalist monopolies; nationalising foreign or indigenous private enterprises; strengthening economic sovereignty, especially vis-à-vis multinational corporations; and building national strength through defense sector. The span of public sector in certain LDCs like Algeria, Egypt and Zambia has spread so much that at various moments in the 1980’s, public enterprises were accounting for between 40% and 60% of GDP (Nellis J & Kikeri S; 1989).

However, the weaknesses of public sector institutions and operations subsequently began to show, especially after the world economic crisis of the 1970’s compounded by the two oil shocks of the decade. Although one must be cautious in making generalisations, public sector enterprises have increasingly failed in meeting their objectives. Even those that were considered as successes, observed by Mary Shirley’s research and highlighted in the 1983 World Development report, ‘have since then gone wrong and are no longer thought as successes (Summers L. in Galal A. et al; 1994:13). In fact, the public enterprise sector in LDCs has frequently failed to generate an investible surplus and instead has created a budget burden for the public sector. The overall budget deficits of public sector enterprises in LDCs averaged 4% of GDP in the mid 1970’s as compared to an average of 1.7% in the industrial countries (Short R.; 1984 & Floyd R. et al; 1984 in Bienen H & Waterbury J; 1989). Following Nellis J & Kikeri S (1989), a 1985 study of public enterprises in 12 West African Countries revealed at the end of the 1970’s that 62% had net losses and 36% had negative net deficits varied between 66% and 76% (Bienen H & Waterbury J; 1989). The results in whether the benefits of public ownership are worth the cost.

Public sector, as has been used in this paper refers to all institutions and operations in which the government has a majority of stakes. One of the major strategy that has been proposed for the reform of the public sector in LDCs is ‘privalization’. Although, the term has been used to mean different things to different people (Adam C et al; 1992), for the purpose of this essay ‘privalization’ will be taken as ‘the transfer of public sector activities to the private sector’ (Hemming R & Mansoor A; 1988, Ellis – Christensen, T.:2008). Privalization is a strategy which has become popular both because it is a felt need for developing countries and because it comes as part of structural adjustment policy package imposed on them by the International Monetary Fund (IMF) and the World Bank. The aim of this paper being to evaluate ‘privalization’ as a strategy for public sector reform in LDCs, this will be done by reviewing the arguments for and against privatisation and outline some of the problems involved in implementing a privatisation programme in the context of LDCs before reaching any realistic conclusion.

Professor Heald D (1990), however, succinctly notes that, ‘policy analysis should be built on a proper analysis of the weaknesses of the public enterprise sector.’ Indeed, if privatisation is to be an appropriate cure, it must cure the weaknesses in public sector institutions and operations rather than poor performances which are merely the symptoms arising from weaknesses in the latter. The case for privatisation will therefore be made, initially, by looking at the weaknesses in the public enterprise sector of LDCs followed by an investigation into whether or not private ownership is the panacea to the problems.
II. THE CASE FOR PRIVATISATION

A. Causes of Public Enterprise Sector Failure in LDCs

Although Millward’s R. detailed examination of studies undertaken on public sector productivity performance in Ides in Cook P & Kirkpatrick C (1988: 143-161) does not reveal that public enterprises are always outperformed by private enterprises, poor performance does occur in the form of productive and allocative inefficiencies. Productive inefficiency results due to a combination of factors. The most common cause of inefficiency in the public enterprise sector is political interference. In many LDCs the public enterprise sector is an important instrument for political patronage. ‘Senior staff’ are often political appointments with little industrial management experience; employment, purchasing and pricing decisions are subject to political intervention; the boundaries of government and enterprise control are ill-defined and continually shifting. The absence of clearly defined objectives and the limited operational autonomy given to public enterprises inevitably have an adverse impact on the efficient internal operations of the public enterprise sector’ (Cook P & Kirkpatrick C; 1988: 12-13). Other causes of productive inefficiency pertain to poorly motivated, badly paid and inadequately monitored managers who may be less interested. Also, because of the nature and importance of public sector activities, labour unions tend to be unusually powerful leading to relatively higher paid employees adding to the cost of production. These factors have combined to reduce the cost efficiency of public production, ‘often leading to heavy dependence on budgetary support’ (Hemming R & Mansoor A;1988).

Allocative efficiency is usually defined as a situation in which consumers’ needs are met at prices that reflect the cost of provision (Cook P & Kirkpatrick C; 1988:13). Public sector enterprises usually fail to achieve allocative efficiency because, more often than not, they operate in monopoly environments. Would Things be Different Under Private Ownership?

Public sector enterprises are characterised by productive and allocative inefficiencies which to a large extent explain their poor performance. If privatisation is to be a valid strategy for public sector reform in Ides, it must make possible the improvement of economic performance by eliminating the sources of inefficiency. Following Hemming R & Mansoor A (1988), a private firm can be characterised as one for which the product market guides prices and output while the capital market (including market for corporate control) controls costs. A firm that cannot sell its products will not make profits; unprofitable firms will go bankrupt or taken over by other firms or management changed. The market, therefore, regulates firms by providing the incentive for them to become efficient. This theoretical rationale for privatisation, although conveying a message of superiority of private ownership, seems exaggerated especially in the case of LDCs.

Certainly, a change to partial or complete private ownership can be expected to lessen the scope for political interference in the enterprise. The enterprise’s objectives will be simplified, overly complex networks of dysfunctional controls will be reduced and the likelihood of arbitrary interference in operating decisions will be lessened (Cook P & Kirkpatrick C; 1988:19). Also, the labour unions influence will be weakened; managers may be better paid, motivated and monitored; the threat of take-over may threaten management to aim at profitability and so on. Each of these changes can be expected to contribute to an improvement in productive efficiency. Some would argue that the above changes are not conditional on privatisation. Internal reform of the public enterprise is an alternative option for realising the same gains. ‘In theory, it is possible to create the kinds of incentives that will maximise efficiency under any type of ownership’ (Shirley M; 1983:50). Others like Summers L. in ‘A Changing Course Towards Privatisation’ (Galal A. et al; 1994: 11-17) would argue that most of the firms studied by Mary Shirley which were successes under reform have since then failed. He would conclude that ‘ownership matters’. Mary Shirley herself, in ‘The Experience With Privatisation’ (1988) was very much in favour of privatisation as opposed to her 1983 views. To the extent that ownership is concerned, therefore, it seems that the balance nowadays in is favour of private ownership, although it must be admitted that this is not always true as in the case of Mexico where change in ownership did not bring much change in the performance of PEs (Weiss J, in Cook P & Kirkpatrick C; 1995:p213-224).

The argument in favour of privatisation is based on the assumption that a change in ownership will impose the discipline of private capital markets on the enterprise thereby forcing it to improve efficiency. ‘While this argument may be important in industrial countries, it has limited relevance to Ides where the capital market is typically underdeveloped and denationalisation will normally involve the sale of enterprises to individual purchases; or the introduction of private capital with joint ventures’ (Peacock A; 1984 as cited in Cook P & Kirkpatrick C; 1988:19-20).

Private ownership is also based on the assumption that there is a private sector which is willing to invest. This argument seems to overlook the fact that in LDCs resources are often not available to finance privatisation, or interested buyers may be unacceptable, for example, because they belong to particular ethnic or religious groups, or are foreigners. In South-East Asia, for instance, private interests that might be able to purchase public assets are drawn from the Chinese minority. Same is the case in Africa where those with the purchasing power are minority Indians and Syro-Lebanese and in Kenya they are from the ‘wrong’ indigenous Kikuyu group (Bienen H & Waterbury J; 1989). The risks of selling the ‘store’ to minorities or unwanted buyers are too high if one is not cautious enough.

Although it may be admitted that private ownership will in general be more commendable than public ownership in LDCs, there is a problem of practical feasibility which may decrease its attractiveness as a strategy for the reform of the public sector. For the sake of argument, let us assume that the problem of capital market can be solved. In that case if
the privatised firm is a monopoly as it was under public ownership, the latter may only impose an incentive to lower costs solely to improve profits rather than benefit consumers through lower prices which, in fact, should be one of the objectives for privatisation in LDCs.

Indeed, converting a public monopoly into a private one without any change in regulatory regime will only provide the privatised enterprise the incentive to improve productive efficiency but no reason whatsoever to make prices reflect costs. Newberry D in ‘Comments on the Jigsaw Puzzle’ (Galal A. et al; 1994:115) beautifully puts it as ‘...the private sector is better at restructuring the public sector. I would argue that when it comes to breaking up monopolies, that is, patently untrue. The private sector has a very strong vested interest in preserving, creating and generally trying to reassemble monopolies, and handing one over to the private sector is putting the fox in charge of the henhouse.’ So, breaking up monopoly enterprises before privatisation is absolutely central to trying to improve the competitive environment, especially in LDCs where the interest of the vast majority of the poor has to be protected. Such findings are also confirmed by recent studies (Li, Wi and Xu 2004; Ros A.J, 2004)

The case for privatisation as a strategy for the reform of the public sector in LDCs is, therefore, a controversial one. Following the above discussions, it seems that many if not the major problem/s associated with public enterprises arise not from the fact that the argument in favour of private ownership is not to be totally ruled out. However given the thinness of the capital market in LDCs and other constraints which we will see alternative to privatisation, although such an environment should be central to privatisation also. Privatisation with competition, however is not a simple issue and is likely to face major complications.

III. PRIVATISATION AND COMPETITION

Most public enterprises are not subject to national or international competition. Many benefit from the statutory protection of the monopoly status or some other artificial barrier to entry by competitors. As we have already argued, privatisation in the form of divestiture will not succeed in making public enterprises efficient unless the process is accompanied by deregulation so that market forces are allowed to influence market behaviour. In this context, it can be argued that deregulation on its own is inappropriate. ‘Indeed, market concentration may increase if deregulation permits the monopoly firm to engage in anti-competition, predatory activities designed to eliminate competing firms by, for example, reducing prices below cost in markets which rivals are attempting to enter’ (Vickers J; 1984 as cited in Cook P & Kirkpatrick C; 1988:p22-23).

Deregulation, therefore, be it in the private or public sector must be accompanied by appropriate regulation to limit predatory or anti-competitive behaviour. In fact, at times the government must even use selective protection and provide government support to infant industries to allow firms to become established and through time competitive before complete deregulation and liberalisation is undertaken (Cook P & Kirkpatrick C; 1988:24). The issue of privatisation is, therefore, not only one of divestiture or divestiture with deregulation but also one of timing and sequencing for the process, and paradoxically, accompanied by some other forms of regulation to ensure that set objectives are met.

Following Hemming R & Mansoor A (1988), for a variety of reasons such as the need to generate maximum revenue or to secure compliance of management and workers, it may be thought appropriate to restrict competition at the time of privatisation, a protected monopoly being more attractive for sales. Still following Hemming R & Mansoor A, not only does this call into question the motives of a privatisation programme, it also makes it more difficult to believe that liberalisation will ever take place. The maximum efficiency gain will result from privatisation with deregulation. Governments of LDCs are likely to face a policy trade-off between economic and financial objectives when their immediate priority is the need for money. Given the poor performances of public sector organisations in LDCs governments may be just too tempted to provide monopoly status to firms to be privatised thus putting the fox in charge of the henhouse as we have already argued.

To the extent that public ownership reflects circumstances in which markets do not work well or produce outcomes that are considered socially or politically undesirable, removing barriers to competition would be insufficient or inappropriate. Following Hemming R & Mansoor A (1988), natural monopoly, for example, is a market outcome; to introduce competition in a monopoly setting, the market has to be redefined. One solution is to make the right to run a natural monopoly the object of competition by auctioning franchises to the private sector. Also, some activities associated with a natural monopoly such as maintenance can be contracted out has been successfully employed in a wide range of public services, such as street cleaning and garbage collection. To the extent that core activities of natural monopolies are inherently non-contestable, because they involve large national networks, public ownership is likely to remain the most efficient way of regulating such activities in LDCs where the social objectives of distribution to the large number of poor people need to be given some priority. Privatisation even with competition, therefore, is not likely to always be the best possible strategy for LDCs, especially when it comes to natural monopolies.

Social objectives would also be subjugated in a private market where there is a case for it. The public sector can support loss-making activities of social value through cross-subsidisation by profit-making concerns. In a liberalised market, the private sector will undertake only profitable activities and leave social needs to be met by other means. In such cases, the public sector may still have to intervene by payment of subsidies or the like to provide essential services say to sparsely populated areas where it is unprofitable for the private sector to operate. The issue in such a case should be one of cost-effectiveness of different types of interventions (Hemming R & Mansoor A; 1988). Having said that, it can be deduced that privatisation alone will not eliminate or considerably reduce the need for government interventions in LDCs.
Privatisation, therefore, even in its best possible form, privatisation with competition, does not really solve the problems of public sector in LDCs. Putting it into practice is not only complicated but the incentives of doing it wrongly are also quite high in LDCs. Setting the right regulations, contemplating more effective alternatives to privatisation, deciding about the minimum level of government intervention given widespread poverty and market failures, among others, are some of the important considerations that make privatisation a risky strategy if wrongly handled. Following the above discussions it seems that privatisation is not very much in the interest of LDCs at least in the short run. Privatisation, however, has other objectives in LDCs that does not totally eliminate it as a strategy for public sector reform in the latter countries.

IV. OTHER OBJECTIVES OF PRIVATISATION

While the prime objective of privatization is to improve the performance of the public enterprise sector in LDCs, it has got other important objectives. The most important of these objectives is that privatization, in most developing countries is, in part, a response to the need for fiscal austerity and is designed to reduce deficits generated by state enterprise(Bienen H & Waterbury J; 1989). Still following Bienen H & Waterbury J, given that LDCs usually have large external debts relative to GDP, it is crucial that they maintain their credit worthiness and access to external capital. Budget deficit reduction may be the quickest and most direct route to improving public finances and reducing inflation. Inflation reduction will protect efforts to expand exports through currency devaluation, and export expansion may be a measure of international competitiveness. Some may argue that deficit reduction through asset sales is only temporary. Following Hemming R & Mansoor A (1998), rather than being a structural measure akin to a tax increase or an expenditure cut, an asset sale is more closely related to bond financing in its impact. In both cases, there is an implicit commitment to raise additional revenue in the future---in the case of an asset sale to replace forgone income, and in the case of bond issue to service debt. Only if an enterprise is run more efficiently and profitably in the private sector, will the budget benefit from privatization on a permanent basis.

Governments can try to attain other socio-economic objectives by privatization viz.: relieve administrative and financial burden; balancing national budgets by eliminating/reducing subsidies to public sector; encourage popular capitalism by wide-shareholding - ‘a nation of shareholders’; reduce taxes and thereby stimulate the economy; stimulate economic growth by encouraging entrepreneurship; development of capital markets; improvement of managerial performance and business efficiency; eliminating bureaucratic and monopolistic tendencies of public enterprises; encourage foreign direct investments by liberalizing the economy, among others. These objectives are not to be considered as ends in themselves. They are only means to ends---the real end being surplus cash generation for further growth of the enterprises and the economy and consequently to improve the quality of life of the population at large (Adam C. et al; 1992:8).

Mauritius is one country which has successfully adopted such a strategy and taken the opportunity to attain the above objectives, but the extent to which Mauritius is an ldc is debatable. Attaining the above objectives in a ldc will depend on the realities of the country depending on the availability of private capital, the extent of market failures, the ability of ldc technocrats and institutions to handle a privatization strategy and so on. In fact a recent survey covering the post – 1980 period found that partial or total sale of public enterprises had occurred in only 15 developing countries (excluding Chile and Bangladesh) and involved fewer than hundred enterprises. ‘In most cases the privatized firms were small in terms of asset value and employment, and had previously been in private ownership’ (Berg E; 1995 as quoted in Cook P & Kirkpatrick C; 1988: 28). Because of obstacles, the pace of privatisation is projected to be slow in LDCs however much strong a case for it.

V. OBSTACLES TO PRIVATISATION IN LDCS

Part of the explanation for this slow progress is the few enterprises that are actually suitable for privatization, the practical difficulties in effecting privatization, and the socio-political obstacles to carrying through this type of programme, especially in LDCs. Indeed, many of the financial-lossmakers may not be attractive to the private sector and we have already argued resources are often not available to finance privatization, or interested buyers may not be acceptable because they come from unacceptable groups. Birdsall N. in ‘The Jigsaw Puzzle’ (Galal A. et al; 1994: 101-110) notes that there are two ways to characterize these difficulties.

First, there is a political problem because the gains are diffused. No interest group can know in advance that it will be certain to benefit from privatization, but the losers-to-be know who they are---the workers, the bureaucrats, the managers and all other interest groups involved with the public enterprises. Privatisation is likely to lead to resistance from interest groups who will be negatively affected even if the latter may be in the interest of the country. Given that such unpopular measures may be equivalent to political suicide, governments may be very much unwilling to go for it just to maintain power and ensure political continuity. Rajiv Gandhi’s attempts to liberalise and deregulate the economy, for instance, saw ‘India’s democratic system producing paralysis’. Same is the case in Egypt, Turkey, Tanzania and Algeria where the coalitions between interest groups and the respective governments have been remarkably stable.

The second difficulty is that in many LDCs there may be no competitive private sector or an underdeveloped one into which to privatise enterprises, and getting one established requires all kinds of institutional development first---contract enforcement, legal framework, a reasonable capital
market, among others. In Nigeria, for instance, where 92 companies, valued between $2 and $3 billion was being considered, it was virtually out of question that the local stock exchange could handle the share issues (Lewis; 1998 in Bienen H & Waterbury J; 1998). Let alone setting the appropriate institutions, most LDCs face a shortage of technocrats capable of managing a reform process and setting the regulatory framework. And, the situation is worse if the process is carried out in an atmosphere of crisis (Bienen H & Waterbury J; 1998). In Turkey, for instance, it took three months to find a general manager for Sumerbank, a large public enterprise for privatization, and to begin what is envisaged as a two year process of corporate restructuring before privatization.

So, the bias is not only political, it is also institutional in settings where there is a tremendous scarcity of people with the necessary know-how. So, even where the benefits may be potentially enormous, so are the difficulties in reaping them in LDCs. ‘Just doing the privatization at all is likely to be a daunting task, let alone doing it right’ (Birdsall N; ibid).

VI. CONCLUSION

What is the conclusion therefore following the above discussions? It may be true that public sector organizations have greatly failed in meeting their objectives. The case for privatization, at least on economic grounds, is, however, not as clear as it is often made out and the instances where it is appropriate are frequently limited in LDCs. Its justification rests heavily on grounds of efficiency and its success on accompanying measures to promote a competitive environment as evidenced even by recent research in Telecommunications Sector around the world (Li, W and Xu, 2004) ‘While the creation of competition with or without privatization is central to improving efficiency of an industry and the economy, it is probable that the public sector will remain large throughout the world’ (Hemming R & Mansoor A; 1998). This will be especially the case in LDCs where market failures are more widespread and the non-economic benefits of public ownership tend to take greater significance. Even where there may be a strong case for private ownership, economic, socio-political and institutional obstacles in LDCs are likely to slow down the pace of privatization, let alone the incentives of doing it wrongly. As Handoussa H in Galal A. et al. (1994: 115-117) notes, ‘for the least developed countries, privatizing on a large scale is a luxury because of the scarcity of entrepreneurial skills and private savings and the greater number of people living in poverty.’

Privatisation, nevertheless, does have some benefits that are likely to come with it if properly handled, and done at a time when LDCs will be ready for it. There are other alternatives, like contracting out and franchising, to radical change of ownership for which LDCs do not seem to be prepared. All these lead me to conclude that the arguments for divestiture of public enterprises in LDCs should be carefully examined on a country basis and appropriate alternatives considered.

VII. LIST OF REFERENCES


