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# Emerging Issues of Privatization and the Public Sector

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Privatization in developing countries has been modest, with little contracting out of services and a wide gap between plans and achievements — but the push for privatization has limited expansion of public enterprises.

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Pressure to move toward privatization has mounted in the face of severe economic crises. Privatization in developing countries has focused almost exclusively on the divestiture of industrial and commercial enterprises, not public utilities or sectors characterized by monopoly. The pace of privatization has been slow and its impact modest. The reasons include the limited resources in the private sector (and popular re-orientation of foreign investors), the resistance of such important interest groups as labor unions, and the inability of many governments to prepare adequately for the complex tasks of privatization. But as a result of the push for privatization, or reprivatization (the divestiture of nationalized enterprises that were once private), some countries have resisted starting new public enterprises or expanding old ones. And some governments have encouraged joint ventures (with private partners, shareholders, or employees) to limit the flow of government funds and to make public enterprises more responsive to market pressures.

Among developing countries, divestiture has been most effective in Chile and Bangladesh. Africa has moved slower than Latin America. Many developing countries have preferred more informal liquidation of public enterprises — through “mothballing” and slow death (by denial of funds) — because it attracts less adverse publicity than outright divestiture.

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Privatization tends to increase efficiency, but only if managers face a competitive rather than a monopolistic environment — which may require not only the sale of public enterprises but bidding for franchises, breaking up monopolies, and removing entry barriers.

Certain issues recur with privatization and the contracting out of services, particularly in the developing countries: the ways competition and ownership affect performance, the tension between multiple objectives (such as generating more cash yet lowering the price of shares to widen ownership), and the proper balance between the enterprise's autonomy and the government's role in regulating market power. The long-term benefits of privatization will not materialize if these issues aren't thought through.

Contracting out of services, an important feature of privatization in Britain and the United States, is rare in the developing world, with such exceptions as Argentina and the Ivory Coast. Contracting out, which is generally assumed to be simpler than privatization, is most effective when competition exists among suppliers, and when government is inexperienced at delivery of the services being contracted out but has incentives to pursue efficiency and is committed to overseeing the contractors.

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## PRIVATIZATION AND THE PUBLIC SECTOR: EMERGING ISSUES<sup>1</sup>

Privatization has emerged as a major public policy issue in the eighties in many parts of the world. Britain, France and the United States are among the more developed countries which have made considerable progress in the field of privatization. In the developing world, some countries like Chile, Brazil, South Korea and Bangladesh have resorted to privatization in a significant way whereas many others are at varying stages of planning and implementation in their privatization programs. The policy dialogue of the World Bank, IMF and other donors with LDC governments has in recent years focussed on the issue of privatization, among others, as a response to the poor performance of their public enterprises and mounting public deficits.

The recent literature on privatization can be classified into two categories. One set of writings focuses exclusively on the divestiture of stated-owned commercial and industrial enterprises. Within this group, some are concerned with privatization in the developed countries while others examine privatization issues and experiences in the developed and

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1/ The author is grateful to Myrna Alexander, Bela Balassa, Arturo Israel, Lloyd McKay and Mary Shirley for useful comments on an earlier draft of this paper. He alone is responsible for any errors that remain.

developing countries (LDCs).<sup>2</sup> The second set of writings deals with the privatization of public services which have traditionally been delivered by government departments/agencies.<sup>3</sup> The literature on this subject is confined largely to developed country experiences. An important difference between the two groups is that in the latter case, government agencies are expected to continue to play an active role vis-a-vis the privatized services through the processes of periodic contracting out, monitoring and supervision. This is not perceived to be a major issue in the privatization of state-owned enterprises where market competition is assumed to take care of the private enterprise behavior and performance.<sup>4</sup> In both cases, most authors are concerned primarily with implementation of privatization decisions, the approaches, techniques and procedures used, and proposals for better planning of privatization.<sup>5</sup> There are, of

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2/ See for example, Vickers, J. S. & Yarrow, G. K. Privatization and Natural Monopolies, London, 1985; Yarrow, G. K., Privatization, Economic Policy, April 1986; Berg, E., and Shirley, M., Divestiture in Developing Countries, World Bank Discussion Paper No. 11, Washington, D. C., 1985, Asian Development Bank, Privatization: Policies, Methods and Procedures, Manila, 1985.

3/ See for example, Savas, E. S., Privatization: The Key to Better Government, Chatham House, N. J., 1987; Roth, G., Private Provision of Public Services in Developing Countries, Oxford University Press, 1987; Young, P., Privatization Around the Globe, Dallas, 1986.

4/ This is not to ignore the fact that in the case of public utilities that do not face competition, government has to interfere in pricing decisions.

5/ See Vuylesteke, C., Techniques of Privatization of State-Owned Enterprises, Vol. I, Mimeo, World Bank, Washington, D. C., 1988; Herley, M. L. and White, T. H., Privatization for Development, International Law Institute, Washington, D. C., 1987; Marlin, J. T., Contracting Municipal Services, Wiley, New York, 1984.

course, important policy issues which emerge from the experiences of both developed and developing countries with reference to the divestiture of state-owned enterprises and the contracting out of public services. The literature, however, does not provide a distillation of such strategic issues and their implications for privatization decisions from the perspective of LDCs.

Based on a survey of the literature, this paper reviews the privatization experience of both developed and developing countries with a view to highlighting the major strategic issues which seem to emerge from this wide range of experience. The primary objective here is to compare experiences and pull together the key policy issues in a summary fashion. These are issues which LDC governments embarking on privatization and donors who advise them may wish to consider carefully even if all of them are not equally relevant to all countries. The paper, however, does not evaluate privatization techniques nor does it assess the Bank projects which have divestiture components as they have been examined by others.<sup>6</sup>

We first examine the privatization experience of the U.K. and U.S.A. as a backdrop against which to assess the experience of LDCs. The reasons for the differential performance of the two groups of countries and some of the lessons and emerging issues associated with privatization are then discussed. Privatization here refers to the (1) sale of all or some of the assets of public enterprises or other public entities; (2) the

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6/ Shirley, M., Guidelines for Bank Lending for State-Owned Enterprise Sector Reform, World Bank, 1988; Vuylesteke, op.cit; Savas, op.cit.

leasing of such assets; and (3) the transfer of the management of public entities (without transfer of ownership) and contracting out of public services to the private sector. Thus, the scope of privatization is not confined to the enterprise sector or ownership transfer alone. Rather, all actions leading to a substitution of private for public provision of goods and services fall within the purview of privatization.

### I. Privatization in the Developed Countries

Programs of privatization are under way in several western countries such as the U.K., U.S.A., Canada, France, Spain and Italy. In view of data limitations, however, discussion here will not cover all the relevant country experiences. The French privatization program, for example, is just getting under way. A total of \$10 billion was expected to be raised by the French government through divestiture in 1987. The French privatization plan covers 42 banks, 2 financial holding companies, 9 industrial enterprises and 3 insurance companies. The French Government accelerated the privatization program in 1987 in response to the successful sale of the first two enterprises.<sup>7</sup>

It was the return of a conservative government in 1979 that led to the emergence of a significant privatization program in the U.K. By 1987, the U.K. had raised nearly \$21 billion through the privatization of public

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7/ The program, however, came to an end with the re-election of President Mitterand and the constitution of a socialist government in 1988.

enterprises.<sup>8</sup> Of this amount, 80 percent was due to the sale of eight enterprises. The most visible elements of the program have been the complete or partial sales of selected public enterprises, the sale of public sector housing and the contracting out of some public services to the private sector. Between 1979 and 1983, nearly 600,000 public housing units were sold.<sup>9</sup> Until 1984, the sale of public enterprises was regarded as the least important component of the privatization program. During this period, ownership transfer was limited to enterprises operating in a competitive market. The sale of British Telecom and British Gas was a major departure from this pattern as both were dominant firms and the question of how to regulate and monitor private firms with substantial market power had to be faced for the first time. The creation of a new regulatory agency for the telecommunication industry (OFTEL) was the British government's response to this challenge.

Privatization or denationalization in Spain was initiated by the first fully socialist government the country has ever had. The Rumasa holdings which the Spanish government sold, for example, consisted of 20

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8/ Including the proceeds from the sale of British Telecom and British Gas of which \$2.6 billion will be realized only in April 1988.

9/ G. Yarrow, "Privatization in Theory and Practice," Economic Policy, April 1986, p. 326.



banks and some 60 companies.<sup>10</sup> In Italy, IRI, one of the main state-owned holding companies, has sold 15 companies and 4 banks since 1980. Several Italian public enterprises have sold their stock to private investors on a minority basis.

In the U.S.A., the growth of privatization has been predominantly in the area of "contracting out" of public services. Urban services such as garbage collection, wastewater/sewage treatment, solid waste disposal, electricity, public transportation and fire protection have been contracted out by many state and local governments. About 35 percent of the cities in the United States used private contract collection for residential refuse in 1982, compared to 21 percent in 1975. Contracting for this service has become popular also in the U.K., West Germany and Latin America.<sup>11</sup> More than 75 communities in the United States contract with private firms to operate and maintain their wastewater treatment plants. Similarly, 87 percent of the electricity users in the U.S.A. get their power from one of nearly 200 private companies.<sup>12</sup> The U.S. executive

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10/ See "Privatization," Financial Times (Section III), London, September 10, 1987, p.7.

11/ C. Valente and L. Manchester, Rethinking Local Services: Examining Alternative Approaches, International City Management Association, Washington, D.C., 1984, p.4.

12/ Savas, op.cit., p. 150. Also see G. Roth, Private Provision of Public Services in Developing Countries, Oxford University Press, New York, 1987; H. P. Hatry, A Review of Private Approaches for Delivery of Public Services, Urban Institute, Washington, D. C., 1983; B. Stevens, "Comparing Public and Private Sector Productive Efficiency: An Analysis of Eight Activities," National Productivity Review, Autumn 1984.

budget for 1987 proposed selling all power generation and transmission facilities at federal dams while retaining ownership and control over the dams themselves. A new public service that has emerged at the local level is resource recovery which employs an innovative disposal technology. Private firms in the U.S.A. are financing, building and managing these capital intensive plants under contract with local governments. A recent study has concluded that local governments in the U.S.A. are more likely to resort to privatization when budgetary constraints become severe, and have some prior experience with alternative service delivery methods.<sup>13</sup>

Privatization of industrial and commercial public enterprises has been insignificant in the U.S.A. The main reason is that public enterprises are a minor feature of the governmental scene in this country. The public enterprises that exist are for the most part in the infrastructure sectors and not in manufacturing. While most privatization activities in the U.S.A. have so far been concerned with routine housekeeping or infrastructure services, the latest trend is to privatize more sensitive areas such as health and human services and public safety. The contracting out of child welfare services through competitive bidding has become increasingly popular. A growing number of local governments are now contracting out the management and operation of public hospitals to commercial hospital chains. A 1982 survey showed that 47 percent of the cities and counties (responding to the survey) had sub-contracted emergency medical service to private operators. A sample survey showed that 44

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13/ R. W. Poole & P.E. Fixler, "The Privatization of Public Sector Services in Practice: Experience and Potential," unpublished mimeo., 1986, p.3.

percent of public law enforcement agencies had contracted out the protection of public property.<sup>14</sup> Turnkey prisons built and operated by private firms and water supply services, large solid waste disposal and gas recovery waste-to-energy plants are other examples of new privatization activity.<sup>15</sup> There is speculation that the technology of limited access highway networks with electronic road pricing systems (eliminating the need for toll booths) might offer scope for further privatization in the transportation sector. Experimental programs in Minnesota have been funded by the state for school districts (local) to contract out to groups of teachers the task of teaching non-core subjects such as art and music.

The privatization experiences of the U.K. and U.S.A. have several noteworthy features. First of all, in both countries a combination of severe budgetary constraints, increasing failure of the public delivery of some services, and a strong political commitment in favor of the private sector contributed significantly to the progress of privatization. The reduction in the federal support to state and local governments and the drying up of other sources of revenue were important factors in the U.S. The rising budget deficits of the government and the need to reduce public borrowing requirements weighed heavily in the U.K. context. Second, the relatively fast pace of privatization in the U.K. and U.S. seems to be

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14/ ICMA, The Municipal Yearbook, 1983 (Washington, D.C.), pp. 216-217.

15/ Sandra Bellush, "Private Choices," American City and Country, October, 1985, p.62.

associated with the existence in these countries of a strong private sector and well developed capital markets. For example, in both countries, there are numerous firms and contractors interested in and capable of taking over and managing public assets. There is a large middle class with resources to invest in the shares of the public enterprises being divested. The undervaluation of shares when selling public enterprises may also have contributed to the demand pull from the public. Nearly 20 percent of the adult population of the U.K. now own company shares. In the case of the British Telecom, 47.4 percent of the shares were bought by institutional investors, 34.3 percent by British nationals and 18.3 percent by overseas investors.

Third, the British experience shows that the profit performance of several of the divested enterprises improved significantly since privatization. Managerial autonomy made possible by the elimination of political control seems to have made a positive impact on performance. For example, the flexibility managers enjoy in pricing and investment decisions, personnel matters and performance evaluation and incentive setting are deemed to have played an important role in this context. It is possible that to some extent the partial economic recovery in the U.K. since 1981 also helped. After a careful review of the performance of the privatized enterprises, Yarrow's conclusion is that there is no hard evidence to support the claim that improved financial performance reflects efficiency gains in all cases.<sup>16</sup> The evidence from the U.S. on contracting out also claims that private provision of services are on the

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16/ Yarrow, op. cit., pp. 337-340.

whole more cost effective than their public counterparts. In solid waste collection, public provision of the service has been found to be 68 percent more costly than the private alternative.<sup>17</sup> Similarly, a comparative study of governmental and contractor provision of eight local public services in California found that contractor provision was significantly less expensive for seven of the eight services, the only exception being payroll servicing.<sup>18</sup>

Fourth, privatization of monopolistic enterprises has been followed by the creation of specialized industry specific institutions to regulate their operations. In the U.K., separate regulatory bodies have been established to monitor the newly privatized telecom and gas enterprises. These specialized institutions are required, in part, to help build up the highly specialized information and expertise necessary for effectively monitoring the behavior of dominant firms which are likely to resort to predatory pricing. The importance of this function and the institutional mechanisms involved were not fully anticipated by those who planned the U.K. privatization program. On the whole, U.K. policy did not fully take into account (at the planning stage) the problems likely to be faced by regulators in trying to prevent the abuse of monopoly power by dominant firms. The establishment of the regulatory agencies, however, is no guarantee that the function will be effectively performed. The capture of regulators by the regulated is not uncommon.

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17/ Quoted in Poole and Fislser, op.cit., p. 6.

18/ Ibid., p. 9.

## II. Privatization in LDCs

It is in the past six years that privatization has been widely debated and acted upon in the developing world. This is not to deny that in the 1970s, a few countries (Chile, Bangladesh and Pakistan, for example) had resorted to privatization or reprivatization because they were in effect returning nationalized enterprises back to the private sector. Their privatization programs have continued into the eighties too. The focus of this section, however, is on the post 1980 period when a much larger number of LDCs, facing severe economic crises, designed policies and programs for privatization. A recent survey of such programs in 28 LDCs shows that of their 3,975 public enterprises, 35 were liquidated, 102 were closed, 85 were sold (fully or partially) and 45 were leased or their management contracted out.<sup>19</sup> The value of assets of these enterprises is not known. It is therefore difficult to pass any judgment on the significance of the divestiture that has occurred. But as a percentage of the total number of public enterprises in these countries, the number of public enterprises sold is only two percent, the number leased or contracted out is about one percent and the number closed or liquidated is 3.4 percent. There is some evidence that the divested enterprises in many countries were relatively small enterprises. In Brazil, for example, of the 17 public enterprises sold, only one had employment exceeding 1,000 workers. On the other hand, even a small country such as Jamaica had sold a much larger number of public enterprises (33 jute mills and 26 cotton

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19/ Elliot Berg and Mary Shirley, Divestiture in Developing Countries, World Bank Discussion Paper No. 11, 1987, pp. 25-30.

textile mills by the end of 1983). Global generalizations tend to hide these variations.

Another study provides a breakdown of the public enterprises targeted for divestiture by country and region.<sup>20</sup> In Africa, nearly 35 percent of the public enterprises in 16 countries were targeted for privatization. In Latin America, 16 percent of the public enterprises in 12 countries, and in Asia, 3 percent in 9 countries were targeted for privatization. In Africa and Latin America, it would seem that rather ambitious programs of privatization were planned. Effective divestiture was the highest in Zaire, Bangladesh and Chile, in Africa, Asia and Latin America respectively.<sup>21</sup> (as a percentage of the total number of public enterprises).

Reviews of the progress of privatization in LDCs reveal several interesting features:

- (1) Compared to the privatization programs in the U.K., and the U.S., the LDC achievements in general, seem to have been quite modest in scale and their pace of progress has been on the whole much slower.<sup>22</sup> Among the regions, Africa seems to have moved more slowly than Latin America where countries like Chile and

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20/ R. Hemming and Ali Mansoor, Privatization and Public Enterprises, unpublished manuscript, IMF, 1987.

21/ Most of the divestiture in Chile and Bangladesh took place in the seventies.

22/ "Big Obstacles Bar Way", Financial Times, London, September 16, 1987.

Argentina have achieved greater progress. Liquidation and closure of firms rather than divestiture seem to be the preferred approach to privatization in a number of LDCs.<sup>23</sup> Here again, informal liquidations have been more frequent than formal liquidations. "Mothballing" and slow death of public enterprises (by denying additional funds, for example) tend to attract less public attention than outright divestiture and the adverse publicity and political hostility it generates. Furthermore, according to some observers, the degree of political commitment associated with the U.K. program, for example, is not evident in several of the LDC cases.<sup>24</sup>

- (2) Most of the privatized firms are in consumer or capital goods, and not in public utilities or sectors characterized by monopoly. This is not to say that targeted enterprises do not include dominant firms. Data on their market power are simply not available. It may be safe to conclude, however, that most of them are in potentially competitive industries and not natural monopolies which require regulation. There is general agreement in the literature on this point.

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23/ Berg and Shirley, op.cit.; Hemming and Mansoor, op.cit. It is, of course, true that liquidation and closure have been practiced before the 1980s too.

24/ S. Commander and T. Killick, "Privatization in Developing Countries," mimeo, 1987, p. 3.



- (3) Contracting out of public services which has been an important feature of the U.S. and U.K. privatization programs is conspicuous by its absence in the developing world. A few countries such as Argentina and Ivory Coast have contracted out enterprises or services. The focus of privatization in LDCs however, has been almost exclusively on the divestiture of industrial and commercial enterprises. A major reason for this is the overriding concern about budgetary deficits and the hope that the divestiture of public enterprises would bring in much needed revenues to minimize these deficits. Contracting out of public services may improve efficiency, but entails highly decentralized operations usually handled by provincial and local governments. Even if some assets are sold in the process, there is no guarantee that the proceeds will accrue to the central government.
- (4) The pressure to divest public enterprises has led some governments to offer concessions to potential buyers in terms of price and other conditions of sale.<sup>25</sup> Often LDC governments are not in a strong position to bargain with potential buyers. The latter have in general managed to extract special privileges (tax holidays, subsidies, protection against external competition) which minimize their risks. There are, of course, instances where new burdens were imposed on the private sector as a result of privatization. For example, the buyer may be forced to keep excess labor by a

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25/ Ibid., p. 29.

selling government which refuses to permit retrenchment. In general, however, while the divestiture of public enterprises has contributed to the revenues of the state at a time of severe financial stringency, it may have led to costly distortions in the economy and potential revenue losses in the future in some cases.

Why has the pace of privatization in LDCs been rather slow and its impact modest though many countries had proposed fairly ambitious divestiture programs? Some might argue that the process has just got started and that it is too early to pass a verdict. While granting that there is something to be said for this argument, the fact remains that for several reasons, there remains a wide gap between the plans for privatization in LDCs and the corresponding achievements.<sup>26</sup>

- (1) Among the factors responsible for this gap, one of the most widely reported in the literature is the limited capacity of the private sector in many LDCs. In countries which have a limited or relatively undeveloped private sector, there is bound to be a narrow range of buyers. If public enterprises are rationalized or toned up before sale, a larger number of potential buyers might emerge. Breaking up large enterprises into parts of interest to smaller buyers may also help. For example, a state farm could be subdivided and sold to several private farmers. In general, however, the sophistication, resources, and institutional capacity

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26/ Based on the review papers cited earlier.

of the capital market, the legal framework, and the infrastructure required for consultancy, underwriting, speedy communication, etc., tend to be modest or poorly developed in such countries. A large scale program of privatization does not make much sense under these conditions. If the local buyers and their resources and infrastructure are limited, the only alternative is to depend on foreign buyers. However, in LDCs which are politically hostile to the sale of enterprises to foreigners, it is unlikely that this option will be used except marginally. A major wave of privatization will not occur under these conditions. The question whether anti-foreign attitudes are rational or not is beside the point.

- (2) Resistance to privatization from important interest groups is a fact to be reckoned with in the LDC context.<sup>27</sup> Trade unions in the public sector are often strong in their opposition to privatization. Many public enterprises are overmanned and unions therefore feel threatened by the spectre of retrenchment. In countries controlled by strong political regimes, (e.g., military dictatorships), this problem may not be serious for obvious reasons. Similarly, political and bureaucratic interests are often averse to what they perceive to be a threat to their power and patronage. Intellectuals in some LDCs oppose privatization on distributional grounds. There could thus emerge a powerful

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27/ Commander and Killick, op.cit.

combination of interests against privatization in a number of LDCs, whereas in the more developed countries, opposition is generally much less pronounced as is clear from the U.K. and U.S. experiences. The issue here is not whether such opposition is rational, but that its existence slows the pace of privatization and limits its scope even if there is a political commitment to get on with it.

- (3) The problem is exacerbated by the inability of many LDC governments to prepare adequately to implement privatization. In part, this inability could be attributed to a lack of knowledge or limited capacity to foresee the complexities involved in privatization. But it may, in some cases, be due to the government's reluctance to move forward which in turn reflects its lack of will or political commitment to divest.<sup>28</sup> At least, some governments seem to have underestimated the management problems of divestiture.<sup>29</sup> A privatization program is a complex and huge operation which requires careful preparatory work and good management on the part of the government. A detailed analysis and classification of public enterprises to determine which need to be divested, settlement of labor-related matters and of legal and financial liabilities which buyers are usually unwilling to take

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28/ Commander and Killick, op.cit.

29/ Berg and Shirley, op.cit., p. 11.

over, proper valuation of these enterprises, assignment of clear administrative responsibility for implementing the program, resolution of policy and administrative conflicts, and assembly of the specialized technical expertise necessary to prepare for and negotiate the divestiture case by case are key components of such preparatory work. Lack of systematic attention to them and the consequent underestimation of the efforts required have caused avoidable delays and errors to the detriment of the privatization programs of some LDC governments.

### III. Emerging Issues

An important conclusion of this review is that the extent of privatization that has occurred in many LDCs, for which data are available is modest in relation to their planned programs of divestiture.<sup>30</sup> The scale and pace of privatization in the more developed countries, in relative terms, has been more impressive. In part, this reflects the ideological shift that has occurred in the governments and the society at large in several of the western countries.<sup>31</sup> Thus in the U.K. and the U.S., strong political leaders with a commitment to the private sector have

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30/ The basic sources of data used are the papers by Hemming & Mansoor and Berg and Shirley (cited above).

31/ Commander and Killick, op.cit.

been responsible for the wave of privatization that has taken place.<sup>32</sup> They came to power without any ideological attachment to the previous regimes which had set up most of their public enterprises. Similar ideological and political shifts have not yet taken place in most LDCs. Chile in Latin America and Guinea in Africa are notable exceptions. In many other LDCs, political leaders who set up the public enterprises are still in power. In cases where changes have occurred, leaders may still be committed to the same ideology or political parties. Even where there is little evidence of an ideological shift, the push for privatization has caused several LDC governments not to further expand public enterprises or start new ones. In some cases, governments have begun to encourage private sector joint ventures with existing public enterprises, thus limiting the flow of government resources into the public sector for expansion. A comparative analysis of the privatization experiences in the developed countries and LDCs highlights several important issues and lessons.

1. Privatization and Efficiency Gains

The transfer of productive activities to the private sector is generally believed to improve economic efficiency. Reduction in political interference, the exercise of greater autonomy by managers, and the flexibility to adjust prices as demand and supply as conditions change are

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32/ The importance of political leadership and ideology should not be exaggerated. Privatization has occurred also in countries with socialist governments such as Austria, Finland and Spain.

features of privatized operations which are expected to contribute to greater efficiency. Though privatization is likely to lead to a greater emphasis on profit goals, the transfer of ownership by itself need not necessarily augment productive and allocative efficiency significantly.<sup>33</sup> The existence of competition and effective regulation where market failure exists and competition is limited are more important determinants of economic performance and efficiency than privatization per se.<sup>34</sup> If there are deficiencies in these areas, the approach under normal conditions should be to increase competition and strengthen the regulatory function and not merely to transfer productive activities to the private sector. It is through behavioral changes in managers and owners induced by shifts in incentives that privatization tends to influence performance. Thus privatization generally induces managers to pursue profit goals. But whether this will lead to an increase in efficiency would depend on whether they face a competitive rather than a monopolistic environment. The sale

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33/ Yarrow, op.cit., p. 363. There is some empirical evidence, however, that private enterprises are more efficient than public enterprises in developing countries. The two need not, of course, be operating under comparable conditions even in the same country. See, for example, B. Balassa, Public Enterprises in Developing Countries: Issues of Privatization, DRD Discussion Paper No. 292, World Bank, Washington, D.C., 1987.

34/ Samuel Paul, "Privatization and the Public Sector," Finance and Development, December, 1985.

of a public enterprise by itself will not cause any change in the market structure. Other actions such as breaking up of monopolies, removal of entry barriers and franchise bidding where natural monopolies cannot be eliminated are necessary to induce greater competition.<sup>35</sup>

## 2. Privatization and Regulation

The privatization of British Telecom and British Gas, both giant monopolies, has brought into focus the new regulatory role that governments should play when a competitive market structure does not prevail. The potential inefficiencies associated with market power are serious enough to warrant special attention in the context of privatization. The theory of contestable markets which is invoked to deny the need for regulation applies only to conditions where sunk costs are absent.<sup>36</sup> Similarly, franchise bidding (letting entrepreneurs compete at the stages of entry and contract renewal) can be shown to improve efficiency in monopoly settings where problems of contract specification, monitoring and contract renewal are relatively simple. These conditions, however, do not apply to dominant public enterprises. Where significant investments in durable specific

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35/ Yarrow, op.cit.

36/ Contestable markets are those where the threat of entry by rivals exists because exit is easy. Even if the number of firms is limited, the threat of entry by potential rivals is seen as an adequate safeguard to limit incumbent firms' anti-competitive behavior.



assets are required and contracts operate under technological and market uncertainties, franchise bidding will require a complex administrative apparatus not very different from a regulatory system. Simple deregulation or franchising will not therefore be enough to prevent the abuse of market power. More vigorous regulation of anti-competitive practices may be required to cope with the problem as incumbent firms could counter the removal of statutory entry barriers with strategic entry barriers or predatory practices.<sup>37</sup>

The creation of specialized regulatory bodies to monitor the privatized British Telecom and British Gas was a step in the right direction. Though the risk of interest groups capturing the regulators is real, the design of regulatory policy and institutions should be a matter of priority for governments which face anti-competitive practices in their industries. This argument applies equally well to public sector monopolies. Most LDCs and international donor agencies are yet to pay adequate attention to this issue. This question will assume special significance as and where LDCs begin to privatize public utilities, for example.

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37/ Yarrow, op.cit. The verdict on franchise bidding is mixed. Franchise bidding may work in the case of local service airlines, postal delivery, trucking, etc., where the winning bidder can be easily displaced without serious asset valuation problems and such assets have an active secondhand market. See Williamson, The Economic Institutions of Capitalism, the Free Press, New York, 1985.

3. Conflicting Objectives

Privatization is often resorted to by governments with multiple objectives. Thus, improving efficiency and competition, reduction of public deficits, cash generation, elimination of political interference in enterprise management, and widening of the ownership of economic assets are among the objectives of privatization adopted by governments.

The simultaneous pursuit of these objectives, however, is not easy. The goal of widening share ownership in the U.K. has led the government to consistently underprice the shares of public enterprises on the stock market, thereby hurting its cash generation objective.<sup>38</sup> The recent decision to sell 25 percent of the British Airports Authority by tender is an improvement on this situation. More importantly, the need to generate revenues through the sale of public enterprises has led some governments to pay less attention to the goal of increasing efficiency and competition. To generate cash, the British government had turned to the sale of its large monopolistic public enterprises. Some public enterprises which are in the more competitive industries are yet to be privatized. Yet the latter could have made a greater contribution to the goal of efficiency improvement through privatization. A monopolistic firm will have to be regulated in addition to privatization in order to yield efficiency gains. LDC governments, faced with rising public deficits, are also under pressure to sell their dominant public enterprises, but with scant attention paid to

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38/ "Privatization Revisited," The Economist, July 18, 1987, p.17.

its impact on efficiency and competition. Protection from imports, offer of subsidies and other concessions which potential buyers are able to extract generally lead to inefficient outcomes even if the cash generation objective is achieved in the short run. Similarly, for natural monopolies, sole reliance on the disciplines of market competition and capital market monitoring will not be adequate to produce efficient outcomes when firms are privately owned.

4. Efficiency and Accountability in Contracting Out

The major argument for contracting out public services is that it is a more efficient alternative compared to the bureaucratic delivery of services. Experience in the United States and other countries, however, shows that efficient contracting out is contingent on the presence of factors such as competition in the supplier's market, and adequate information on the part of buyers and sellers.<sup>39</sup> In addition to these conditions, contracting out has been found to be effective when government does not have the requisite experience or expertise to supply a service; when government has to provide a service only occasionally or seasonally; where fair competitive procedures can be adopted and enforced; and where government has the commitment and resources to exercise effective oversight over delivery by contractors.

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39/ R.H. De Hoog, Contracting Out for Human Services, State University of New York Press, New York, 1984, p. 130-143.

But there are several reasons why these conditions may not always obtain, especially in LDCs. Some case studies of contracting out in the U.S. have shown that though efficiency was the objective, neither government officials nor contractors were primarily interested in cutting costs and improving service quality. Government agencies may contract out in response to organizational imperatives such as ceilings on agency personnel, hiring freeze, or the need to commit funds by fiscal year's end. Fiscal constraints may limit the resources to gather information, evaluate alternatives adequately and exercise effective oversight. Procedures for contracting may be designed to favor suitable suppliers and not to promote efficiency. Thus the personal goals of officials, organizational pressures and the lack of information and organization on the part of beneficiaries (clients) may conspire to defeat the objective of achieving efficiency through the contracting out of public services.<sup>40</sup> Contracting out, then, is not a costless alternative. It is important, therefore, to choose this alternative for service delivery only when competition is built into both the environment and procedures, incentives are provided for decision makers to pursue effectiveness and efficiency, a suitable process for the review of expenditures, performance and outcomes exist, and resources are available and are utilized to perform an effective oversight function. In brief, the benefits of contracting out should be weighed against the costs imposed by the organizational context in which contracting takes place.

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40/ Ibid.

5. Efficiency in the Public Sector

Those who have reviewed the LDC experience with privatization seem to be pessimistic about the potential of the divestiture of public enterprises as the primary vehicle to solve the problems of public sector inefficiency.<sup>41</sup> The exclusive focus on the sale of public enterprises with the deficit reduction objective in view has meant the neglect of other options which may well be more practicable in the LDC context. It is imperative, therefore, that intermediate solutions be explored that fit the circumstances of LDCs and help governments at the same time to take positive steps towards solving the problem of poor public sector performance. First of all, it is useful to explore the potential for contracting out parts of the production and distribution operations of public enterprises to the private sector. It will be easier to find subcontractors in LDCs to manufacture components and ancillary items or provide services needed by large enterprises than to find local entrepreneurs to buy them outright. The hiving off of ancillary activities will reduce the assets and management problems of large public enterprises. In the manufacturing sector, the contracting out of components and other technical services may have to be coupled with support programs for small or medium scale local entrepreneurs so as to enable them to maintain the required quality and standards. In several cases, there will be scope for hiving off goods and services unrelated to production operations that

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41/ Berg and Shirley, op. cit; Hemming and Mansoor, op. cit; S. Commander & T. Killick, op.cit.

state-owned enterprises now provide. Examples are catering services, health and educational services, transport, maintenance of premises, etc. It is also possible that facilities and equipment could be leased to private contractors who may then deliver the required goods and services to the state-owned enterprise or other clients. Public sector holding companies could sell off some of their units while retaining their primary activities. In some countries such as Britain and France, the less important subsidiaries of state-owned enterprises such as railways, ports and telecommunications, have been hived off, leaving the core activities only in the public sector. This approach is appropriate in cases where outright privatization seems politically unacceptable or not feasible for other reasons such as the concern about market power.

Second, much greater attention should be given to the ways and means to increase competition in the industries in which public enterprises operate. Deregulation that permits private entrepreneurs to compete with public enterprises is one option. This will call for a complete or partial removal of the barriers to entry by private entrepreneurs in sectors reserved for state-owned enterprises. Even without the entry of private firms, it is possible to generate competitive pressures within the public sector. Natural monopolies, for instance, may lend themselves to be broken up on a regional basis without much loss of scale economies. Individual power stations could be separately incorporated and permitted to sell electricity to the national grid. This is likely to increase competition at the generation stage. Public or private distribution companies (regional, if necessary) could buy from the grid and sell to the public.

The grid could be jointly owned by the distribution companies or remain as a public entity. A similar approach could be applied to service industries such as insurance and banking in which government may wish to play a dominant role. Instead of leaving such services to monolithic undertakings which face no competition, each enterprise could be split up and several entities created, consistent with the requirements of the economics of scale.

Third, public enterprises could be made more responsive to market pressures by turning them into joint ventures with private partners, shareholders or employees. Government may still have a decisive voice, but the greater autonomy and active role played by private partners could lead to improved performance. This could be accomplished through a capital increase of the state-owned enterprise and new public subscription or through a merger. This approach has also the merit of reducing the flow of government resources to support the operation of these enterprises. In Tunisia, the government's equity in a state-owned textile company was reduced from 88 to 49 percent through a capital increase.<sup>42</sup> Another promising approach is to promote employee stock ownership plans along the lines attempted in the United States. There is some evidence that productivity and enterprise performance have improved through partial employee ownership. There is an urgent need to invent imaginative ways of encouraging better performance and greater competition in the public sector. Even if the objective is to divest certain public enterprises eventually, the experience of a number of LDCs confirms that the steps taken to improve their operational management and performance have helped

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42/ See Vuylesteke, op.cit., p. 21.

to prepare the ground better for the process of divestiture.<sup>43</sup>

#### IV. Conclusion

Compared to the privatization programs in developed countries, the extent and the pace of privatization in developing countries has been quite modest. Contracting out of public services which has been a notable feature of privatization in the U.K. and the U.S.A. has been conspicuous by its absence in the developing world. The wide gap between the plans for privatization and the corresponding achievements in developing countries seems to be due to a combination of factors such as the limited capacity and resources of the private sector in these countries, the resistance to privatization from important interest groups such as trade unions, and the inability of many developing country governments to prepare adequately for privatization. It should be noted, however, that the push for privatization has caused governments in a number of countries not to further expand existing public enterprises or to start new ones.

The paper has highlighted several important issues which have emerged from the privatization experiences of both developed and developing countries. Their implications have become clearer as evidence from the field has accumulated. Of these issues, the tension between the multiple objectives of privatization, the balance between the autonomy of enterprises and the government's role in regulating market power, and the

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43/ USAID, Private Enterprise Development, Washington, D.C., 1985, p. 15.



role of competition and ownership in determining performance are particularly relevant to LDCs. It is interesting to note that these issues are germane also to the contracting out of public services though it is generally assumed that contracting out is a much simpler operation than the privatization of public enterprises.

Many LDCs are still in the early stages of their privatization programs. Some may have initiated privatization programs without necessarily thinking through the issues discussed above, in part, out of economic necessity when the pressures on them to act were strong. It is not surprising, therefore, that the side effects and the long-term implications of such actions are not always taken into account at the planning stage. It is clear, however, that the expected long term benefits of privatization will not materialize if these issues are neglected. The lessons of experience presented above will hopefully be of some assistance to governments in preparing better for privatization.

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