

OECD DEVELOPMENT CENTRE

POLICY BRIEF No. 3

**THE PRIVATISATION IN DEVELOPING COUNTRIES:
REFLECTIONS ON A PANACEA**

by

Olivier Bouin

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Introduction

Public enterprise privatisation policies have aroused enormous interest during the past decade. The majority of both developed and developing countries, and more recently the countries of Eastern and Central Europe, have launched ambitious programmes for transferring public sector property to the private sector. In the developing countries, these programmes have been actively promoted by international organisations, notably the United States Agency for International Development (USAID) and the World Bank, the latter making some of its structural adjustment loans conditional upon the implementation of privatisation operations. Privatisation therefore rapidly became a priority task for the governments of many developing countries.

This movement fits into the context of a broader process of rebalancing the public and private sectors and is an essential, though not the sole, component of policies aimed at reforming the functioning of the economic system with a view to transition towards a market economy. It thus represents a major turning point, since the disengagement of the state and the increased role of the private sector imply the complete recasting of development strategies and call very much into question the functioning of the different types of mixed economy, generally dominated or promoted by the state and marked, in many cases, by the circumstances under which the countries concerned achieved independence. While the privatisation of public enterprises appears in this context to be a way of “redimensioning” the public sector, it remains closely linked to the application of policies in conformity with the new objectives of development strategy, notably greater economic efficiency and integration in the world economy.

In practice, the movement has not always been based on a satisfactory definition of the problem of privatisation, as the theoretical controversy over the comparative efficiency of private and public ownership has dominated the debate, concealing the real issues. It is therefore appropriate to begin our analysis by recalling the origin of privatisation policies before attempting an initial evaluation of experience to date: examination of the main difficulties encountered and the reasons for the lack of success of many of these experiments paves the way for consideration of the conditions required for successful privatisation in the context of policies aimed at rebalancing the public and private sectors.

1. The origin of privatisation policies

The 1970s were characterised by the multiplication of the number of public enterprises in the majority of developing countries. By way of example, in Morocco the number of public enterprises quadrupled between 1969 and 1979, increasing from 160 to 617 units. Similarly, almost two-thirds of the public enterprises in Mexico were created between 1970 and 1982, whereas the first had been established as long ago as the 1930s. This expansion was accompanied by great diversification of a public sector increasingly far removed from the reasoning used as justification for the creation and the reinforcement of national public sectors in the 1960s, often as an extension of accession to independence. The dominant theories then advocated the achievement of economic independence, which implied “self-centred” development based on import substitution and accelerated industrialisation thanks to a strong public sector occupying the “strategic sectors” of the national economy.

During the 1970s, however, public enterprises proliferated in sectors that could scarcely be called strategic: service activities (marketing and exporting offices, tourism, hotels and catering, financial services, etc.) and to a lesser extent small and medium industrial enterprises. This expansion of the public sector in all directions is evidence of the growing role of the state within the different types of mixed economy in the developing countries and resulted in the most heterogeneous public appropriations in the late 1970s. It made a reaction in favour of the private sphere in the form of privatisation virtually inevitable.

1.1 Public sector sprawl

The very great expansion of national public sectors resulted from decisions taken, according to economic or political circumstances, by different authorities which did not necessarily co-ordinate their actions. This was made possible by the substantial external financial resources generally enjoyed by states during the 1970s (commodity export earnings, international loan facilities).

A prime factor explaining the growth of public sectors was the **multiplication of salvage operations** for private enterprises in difficulty.

In January 1983, when President de la Madrid began his term of office, there were 1 214 enterprises in Mexico’s public sector, almost half of which had formerly belonged to the private sector and had been salvaged in this way. Similarly, in Chile in 1982 the threat of a collapse of the entire banking and financial system imposed the nationalisation of virtually all banks and insurance companies on a liberal government which was in favour of privatisation. Thus, in the countries considered, it was often the lack of initiative and management skills in the private sector that led to the expansion of the public sector.

The rapidity with which the public sector absorbed private enterprises in difficulty reveals the state's refusal to accept the operating rules of the private component of the mixed economy, notably the liquidation of an enterprise as the ultimate sanction for its inefficiency. This highlights the asymmetry that was generally found in the sharing of responsibilities within the different types of mixed economy. The "privatisation of the private sector", a precondition for any policy aimed at rebalancing the public and private sectors and reviving the economies of developing countries, implies full acceptance by the authorities of the private sector mode of operation.

Public sector expansion was in many countries also the result of a strong tendency for existing public enterprises to create **subsidiaries**. By way of example, of the 245 public enterprises in the Philippines, 179 are subsidiaries created during the period of martial law because of the desire of certain senior civil servants to get round the rules of public management, which they considered too restrictive. Morocco, Tunisia and Malaysia experienced a similar phenomenon of subsidiary creation, a sign of a certain loss of control by the state over public sector growth.

In any event, the **consequences** of this public sector sprawl finally transformed the system so far as to make it unmanageable.

First, the extension of the public sector in all directions and the multiplication of regulations called into question **the very nature of mixed economies**. The self-perpetuating dynamic of reinforcing the public sphere led in fact to the relegation of the private sector, domestic and foreign, to the role of an increasingly marginalised partner.

Second, the lack of knowledge on the part of the state itself about the size and composition of the public sector **prevented any attempt to restructure public enterprises**. In the case of enterprises that had found refuge in the public sector in order to avoid bankruptcy, public appropriation was supposed to be only a transitory phase. The aim of the state as rescuer, at least in principle, was to rehabilitate and then reprivatise these enterprises, but the control exercised by the state over public enterprises turned out to be too limited to ensure effective restructuring and rehabilitation. State administration of these enterprises was characterised by *ad hoc* intervention in their management, generally to impose non-economic objectives. Public sector enterprises were therefore in the worst of situations: *ad hoc* political intervention, but a lack of regular and detailed monitoring of their performance. The advocates of restructuring and privatisation took advantage of this to denounce the laxity and negligence of public sector management. They imposed the launching of census and audit operations to remedy the lack of information concerning the number of public enterprises and their performance. These operations constituted the first stage in the public sector reform programmes.

Third, the incompatibility between the structural nature of public sector expansion, notably as regards investment and job creation programmes, and the instability of government financial resources made the system **increasingly fragile**. At the beginning of the 1980s, the drying up of external financing sources (deterioration of the terms of trade, debt

crisis), together with the reduced tax take caused by the recessions induced by these external shocks, suddenly triggered a public finance crisis in the majority of developing countries. The application of orthodox monetary policies in the context of economic stabilization plans further limited governments' room for manoeuvre and greatly accelerated the re-examination of the question of public enterprise deficits. Loss-making enterprises were accused of being an unbearable burden on the budget and of using the resources made available to them in an unproductive fashion. The increasing financial burden caused by the virtually systematic salvage of ailing private enterprises reinforced the criticisms concerning budget transfers to public enterprises. The impossibility of financing the haphazard expansion of the public sector led governments to consider reforms and to accept the prospect of privatisation as a miracle cure for their difficulties.

1.2 The problem of privatisation

The problem of privatisation, as defined at the beginning of the 1980s, revolved around two factors.

- (a) The acute public finance crisis experienced by the majority of developing countries revealed the fragility and instability of the different types of mixed economy. The relative failure of import substitution policies and the potential bankruptcy of the public sector reflected the increasingly unbalanced nature of economic growth. This situation imposed a redefinition of the role of the state and of public sector enterprises. The decision to privatise was thus to a large extent dictated by the limitation of states' financial resources. For this reason, one of the prime objectives set for privatisation was to help **reduce current budget deficits** through the revenue obtained from transfer operations.
- (b) The strong influence exercised by liberal thought led to the idea of the transfer of property rights over a public enterprise to the private sector as the be-all and end-all of privatisation. On the basis of the postulate according to which the economic efficiency of an enterprise depends mainly on the nature of the property rights, attention was mainly concentrated on the modalities for the transfer of public assets, the questions of market structures and the reinforcement of competition being considered as indirectly linked to the privatisation process.

It was in this spirit that the public enterprise privatisation programmes were launched in the developing countries. Privatisation was seen as a "panacea" making it possible in the short term to ease the public finance crisis while at the same time having positive impacts on the economic efficiency of the enterprises transferred to the private sector, the development of financial markets and income distribution.

In certain countries, such as Jamaica and Mexico, the new teams in power shared these views. Looking at experience to date, however, it is clear that the privatisation operations have for the most part neither had the desired results, nor satisfactorily achieved the objectives set, due to the lack of a sufficiently detailed definition of the problem. An initial evaluation will enable us to remedy this.

2. An evaluation of privatisation policies

Evaluating the privatisation policies implemented by developing countries is not easy for reasons mainly connected with the lack of information. These need to be recalled in order to situate the limits of our analysis. Subject to these reservations, the relative failure of privatisation policies can be measured in terms of the scale of the operations and the realisation of their objectives.

2.1 Scope and limits of the analysis

There are essentially three factors that tend to limit the precision of our evaluation.

First, the privatisation process often developed at a time when **the inventory of the public portfolio** was far from complete. For this reason it is sometimes difficult to identify the privatised enterprises precisely. This uncertainty as to the number of operations carried out is aggravated by the lack of transparency generally surrounding such transactions.

Second, evaluation of the results of privatisation implies limiting the study to **true privatisation operations**, but unfortunately the abundant literature on the subject is characterised by a certain lack of precision in the definition of the content of these operations. As a general rule, studies have attached only a formal importance to the problems of definition and have resolved them summarily using one of two complementary propositions. The more usual one is based on the criterion of ownership of the enterprise, which leads to a fairly restrictive definition that considers the transfer of ownership of part or all of the capital as the sole factor constituting privatisation. Taking a more general view, though still without providing a clear definition, the studies by the World Bank (1988) and the Reason Foundation (1987, 1989) list the many measures and operations that contribute to the reinforcement of the private sector. The result is that a transfer of 10 per cent of the capital of an enterprise, a management contract, the granting of a lease, and an increase in the capital subscribed by private investors are all indiscriminately counted as so many privatisation operations. The major disadvantage of such an approach is that it does not single out the cases of “effective privatisation”, a concept to which we shall return below.

Lastly, there are still but few studies dealing with privatised enterprises. In these circumstances, the **microeconomic impacts** of privatisation on factor productivities, financial results and employment are difficult to evaluate. In addition, any comparative evaluation of the situation before and after privatisation gives rise to serious methodological

problems. The only valid comparison would be to evaluate the performance of the privatised enterprise with what it would have been had the enterprise remained public, “all other things being equal”. But privatisation operations generally take place in a rapidly changing environment whose impact on the performance has to be assessed. In the developing countries, this assessment is all the more difficult because of the multiple impacts of the implementation of economic and financial liberalisation programmes.

2.2 The extent of privatisation

Taken as an indicator of the success or failure of a policy, the extent of privatisation has so far remained fairly limited both as compared with the number of public enterprises in existence and as a percentage of total public sector value-added.

The case of Malaysia is a good example: between 1983 and 1989, only 15 out of a total of 988 public enterprises were privatised. The detail of these operations gives an even better idea of the limited development of the process. The three biggest transfer operations, through public offer for sale, concerned the national airline, Malaysian Airline System (MAS); the biggest shipping company, Malaysian International Shipping Company (MISC); and the national lottery (Sport Toto). The first two operations involved only 30 and 17 per cent respectively of the capital of these enterprises, the state remaining the majority shareholder in the first case (with 62 per cent of the capital) and the biggest shareholder in the second (with 49 per cent of the capital). It is thus far from evident that these were effective privatisations. The field of activity of the third enterprise gives this privatisation operation a symbolic value only. For the rest, certain contracts were signed between the authorities and private investors in which the latter finance and supervise the development of infrastructures (notably the construction of the biggest motorway in the country) and the installation of new power stations. We would point out that these operations could not be considered privatisations if the definition centred on the transfer of ownership were used. Similarly, in Bolivia, Ghana, Morocco, Tunisia and the Philippines, privatisation operations do not yet seem to have developed significantly, even though they were launched several years ago.

Of the ten developing countries studied, only Chile (counting operations effected since 1985), Jamaica and Mexico have so far implemented major privatisation programmes. In Jamaica the revenues from transfers amounted to almost 7 per cent of GDP, i.e. more than ten times the level obtained in Malaysia (0.6 per cent of GDP). These figures taken from Adam and Cavendish (1991) tend to underestimate the extent of privatisation in Jamaica since they exclude revenues derived from the granting of leases, a method used in almost one-third of the some 40 operations effected in this country. In Chile and Mexico, several hundred enterprises have been transferred to the private sector, domestic or foreign. In the case of Mexico, the process of *desincorporacion*, in which privatisation played a prominent role alongside the liquidation and merging of public enterprises, was concentrated on small and medium enterprises between 1983 and 1988. This policy enabled the state to withdraw

entirely from 15 branches of industry out of the 25 in which it had been involved. Approximately one-third of public sector value-added was concerned by this first wave of *desincorporacion*.

Above and beyond this simple quantitative approach, the size of the enterprises involved and their sector of activity are significant factors in the evaluation. By way of example, Jamaica has privatised the country's biggest bank, the National Commercial Bank, one of the biggest industrial enterprises, Caribbean Cement, the telephone company and several hotel chains in the key sector of tourism. In Mexico the second wave of the privatisation process, starting in 1987, has affected large enterprises belonging to sectors of prime importance: mining (Mexicana de Cobre), air transport (Aeromexico), telecommunications (Telmex) and virtually the entire banking sector. In Chile, the majority of the big industrial enterprises, banks and financial institutions have been transferred to the private sector. Only the companies exploiting the rents derived from copper and oil are excluded from the privatisation process.

2.3 Realisation of the objectives

Among the many objectives assigned to privatisation, it is well known that reduction of the budget deficit and increased economic efficiency are those most frequently aimed at. These two objectives are of a macroeconomic order, whereas the direct impact of privatisation is microeconomic: it concerns the financial situation and competitive position of the individual enterprise transferred to the private sector. Insofar as privatisation in the majority of developing countries is still at the embryonic stage, the macroeconomic impact can obviously only be limited.

Privatisation operations were decided upon in a context of public finance crisis and governments generally expected them not only to provide additional revenue resulting from the transfer of public shares or assets, but also to help reduce budget transfers to the enterprises concerned. Closer study reveals that this optimism is misplaced, and it must be concluded that the **reduction in the central government budget deficit** can only be marginal. This conclusion is drawn from several observations:

- (a) In the simplest case, the transfer of a **profit-making** public enterprise amounts to the replacement of a physical asset by a liquid asset, in principle of the same value. The impact should therefore be evaluated over several years. While the revenues obtained from the transfer of public assets reduce the current budget deficit, the corollary is the cessation of financial transfers from the enterprise to the state in following periods. If the transfer price is calculated on the basis of expected future profits, the overall impact of privatisation on the public purse should be nil.
- (b) In fact, the impact depends essentially on the **utilisation of the transfer revenues** by the government. In order to produce a durable positive effect on the budget, these revenues should be used to reduce the public debt and bring savings on future

debt service greater than the anticipated return on the public asset. If, on the contrary, the state increases its current expenditure by the amount of the transfer revenue, the budget deficit for the year of transfer will remain unchanged, but there will be a deterioration in the public finance situation in following periods.

- (c) The problems are different in the case of **public enterprises making heavy losses**. Such enterprises are unattractive for private entrepreneurs and are thus only marginally involved in transfer operations, so that the savings on subsidies and capital injections are very limited. It is therefore necessary to consider either other methods of privatisation (leasing, management contracts) or the restructuring or actual liquidation of the enterprises concerned. It should be added that where the efforts made by the authorities to rehabilitate the enterprise financially lead to a privatisation operation, the state in fact bears a net financial cost for the transfer of ownership to the private sector.
- (d) Lastly, it should be pointed out that if there is an upward trend in the **financial results of the privatised enterprises**, a source of additional tax revenue, the final budgetary impact of each operation will generally be nil or negative for the reasons just mentioned. The improved financial performance of the privatised enterprise must not, however, be achieved through exploitation of a non-competitive situation. The existence of monopoly situations and rents is in fact traditionally considered to be in conflict with the achievement of an economic optimum and hence with the objective of efficiency.

This objective of efficiency is generally defined by means of the two concepts of allocative efficiency and productive efficiency. Briefly, **allocative efficiency** corresponds to the best allocation of productive resources among their different possible uses in the economy; this stems from the action of competition and the setting of prices at the level of marginal cost. As for **productive efficiency**, this means the best use by enterprises of the resources available to them, and hence minimisation of their costs; the increased productive efficiency of privatised enterprises is the necessary condition for a positive and durable impact of privatisation on the public purse. If competitive pressure remains low, however, there is no guarantee that a private enterprise rationale and the motive of profit maximisation will lead to cost minimisation or the setting of prices at marginal cost. As pointed out by Kay and Thompson (1986), only the interaction between private ownership and competition makes it possible to obtain efficiency gains in allocation and use of productive resources. In other words, the transfer of property rights must be accompanied by the strengthening of competitive practices on both factor and product markets.

On the basis of privatisation programmes that are very unequally developed depending on the country, it must be said that governments have not particularly encouraged the development of competitive market structures. The biggest privatisation operations have involved enterprises in a dominant or even monopoly position and have not promoted

competition. Governments seem in fact to have been mainly concerned with ensuring the effective realisation of the operation through privatising the most attractive enterprises in terms of market power and potential profitability.

In order to increase competition durably and create the conditions for increasing economic efficiency, it is necessary to adopt regulations adapted to the new situations of enterprises and to market economy behaviour.

3. Problems with privatisation policies

If, in the majority of developing countries, privatisation programmes have not so far really achieved their economic and financial objectives, this seems to be due to three factors: the existence of many constraints preventing the satisfactory development of these programmes; the ambiguous attitude of governments towards privatisation operations; and insufficient awareness of their close links with other structural reforms.

3.1 The burden of constraints

The relative failure of privatisation policies finds its origin to some extent in the numerous obstacles to the satisfactory development of the process.

First of all, the **start-up phase** of the privatisation process was prolonged because of the numerous preliminary steps such as the constitution of privatisation bodies, the preparation of a minimum legal framework and the detailed inventory and audit of public enterprises. These studies of the composition and performance of the public sector turned out to be all the more protracted and difficult the greater the relative loss of control by the administration over the public enterprises.

The Malaysian privatisation process is a perfect illustration of the length of the preparatory stages. Under study since the beginning of the 1980s, officially considered a priority task with the publication of the *Guidelines on Privatization* in 1985, reaffirmed as such in the privatisation plan of December 1989, the Malaysian programme did not really get under way until 1990. This slowness is explained by the amount of work involved in collecting economic and financial data on some thousand public enterprises and the detailed organisation of the privatisation process, tasks undertaken respectively by the Central Information Collection Unit and the Economic Planning Unit.

Various options were adopted as regards the constitution of the public bodies responsible for implementing the privatisation process. It is possible to identify two main approaches: the first is characterised by the formation of specific commissions, either “independent” (Bangladesh and the Philippines) or at ministerial level (Malaysia, Morocco and Tunisia), while the second attempts to minimise the bureaucratisation of the process by encouraging *ad hoc* or decentralised decisions (Chile, Jamaica and Mexico). These two

approaches are to be seen in connection with the choices adopted regarding the establishment of the legal and institutional framework: their respective advantages and disadvantages are discussed in the following section.

A second set of constraints not only slows the development of the privatisation programme but also limits its positive effects. Thus, the lack of local buyers with adequate financial resources, the large proportion of unattractive public enterprises, the low level of domestic competition, and the narrowness or even absence of financial markets constitute so many factors blocking the process. At different levels, these **objective constraints** reflect the state of development of the economy in which the privatisations are to take place. For example, the very many situations where there is no competition in the developing countries make the positive impact expected from privatisation on economic efficiency subject to the parallel implementation of measures aimed at stepping up competition. Similarly, the difficulties involved in evaluating and pricing public assets for transfer do not allow the state to obtain satisfactory transfer revenues. In view of these constraints and the limitations they impose on the impact of the privatisation process, a realistic reformulation of its methods and objectives appears more necessary than ever.

Uncertainty is a third major obstacle to the privatisation process. Potential candidates, domestic or foreign, for taking over public enterprises in fact adopt a cautious attitude because of two types of uncertainty. The first concerns the “privatisable” enterprise itself: the fragmentary nature of the financial information available makes it impossible to evaluate satisfactorily the net assets of public enterprises. This is a particularly serious problem in that many public enterprises in the developing countries have exceptionally high levels of indebtedness (investments are generally financed through bank loans rather than own funds). This pre-existing indebtedness is perceived by the private investor as a factor weakening the enterprise by making it highly sensitive to interest rate fluctuations — which determine the debt servicing burden — and a debt-equity ratio making it difficult to contract new loans to finance the development and modernisation of the enterprise. Potential private buyers are therefore inclined to be very cautious.

Improving the data on “privatisable” enterprises thus appears to be an essential precondition for the realisation of privatisation operations.

In addition, political and economic uncertainties accentuate the suspicion of private actors. Insufficient guarantees with respect to property rights, pessimistic expectations as to the continuation of stabilization and structural adjustment programmes, and above all unfavourable growth prospects are so many factors slowing the privatisation process.

3.2 The attitude of governments

With the exception of just a few countries such as Chile and Mexico, privatisation was imposed on developing country governments. Under these circumstances, the attitude of the authorities to the privatisation process is a crucial factor.

In the first place, governments find themselves in the paradoxical situation of having to reduce their own power of intervention in the economy by transferring public enterprises to the private sector. In view of their relative loss of control over a now heterogeneous public sector, however, it seems that the “redimensioning” of the public presence in the economy could lead to more limited but more effective intervention. With this in mind, many governments considered privatisation as making it possible simultaneously to resolve certain contradictions in the functioning of mixed economies and to satisfy World Bank requirements.

Reform of the method of functioning of mixed economies cannot be effected without causing substantial political and social tensions that governments have to try to control. The urban working classes are affected by the elimination of subsidies on consumer goods and by job losses in the administration and public enterprises. Senior civil servants see their power base demolished by the reduction of direct and indirect state intervention in the economy. Private rent-seekers fear the disappearance of the lucrative sphere of public contracts and artificial situations of non-competition. Threatened by the calling into question of the traditional populist orientation, these different social groups could form political alliances and paralyse the reform process in order to preserve their acquired advantages.

Governments have had to integrate this political dimension into the implementation of privatisation policies. They have favoured methods that make it possible to demonstrate that powerful financial groups, national or foreign, are not the sole beneficiaries of the process. Thus, the public offer for sale, although difficult to use because of the narrowness of securities markets in most of the countries considered, is often used in the case of politically sensitive transfers (those involving enterprises in monopoly situations, possessing national prestige or belonging to a sector of prime importance). The public offer is a means of “democratising” shareholding among the middle classes, the main buyers of the shares offered, and whose support is sought by reforming governments. This broadly based holding of the capital of big public enterprises is made attractive by the vision of substantial capital gains resulting from the big discounts applied to subscription prices. It also constitutes a safety net against possible renationalisation. Chile has given priority to this consideration since 1985, encouraging the multiplication of individual small shareholders. Mexico and Malaysia, but also Bangladesh and Jamaica, these last having embryonic securities markets, have also made considerable use of public offers for sale. But because of the limited absorption capacity of securities markets and the length of the preparatory stages, the use of this method is restricted to big enterprises only. In addition, the realisation of the political objective of broadly based participation in the privatisation process induces a financial cost measured by lower transfer revenue because of the size of the discount and the high transaction cost (underwriting, promotion).

At the same time, governments have paid a great deal of attention to the reactions of public enterprise personnel. For example, the Malaysian authorities have laid down very precise conditions regarding the situation of employees after the transfer of ownership.

Under the provisions adopted, private buyers undertake to keep any employee having chosen to remain in the enterprise after its privatisation and to maintain the acquired social advantages. Using a different approach, certain countries reserve part of the capital of the privatised enterprises for the employees. The employees' holding is defined either case by case, as in Chile, or by decree as in Bangladesh — the Denationalization Amendment Ordinance of June 1987 fixed the share of the capital of privatised enterprises reserved for the employees at 15 per cent.

The state's attitude toward the implementation of privatisation highlights the importance of socio-political considerations. The political feasibility of privatisation operations imposes constraints that may limit the positive impacts as regards financial and economic objectives. Thus the employment constraints imposed on the private buyer reduce not only the revenue obtained by the transfer, but also the margin for improving the financial results of the enterprise. As a result, the positive impact on the central government budget is reduced, and privatisation is not carried out in a political environment suited to the realisation of its initial objectives.

3.3. The interdependence of structural policies

The relative failure of privatisation operations is also explained by the inappropriate purposes assigned to them. As pointed out above, they have in fact often been perceived as a simple transfer of ownership and an expedient in response to an acute public finance crisis. Under these circumstances they can only have a limited impact. In order to determine the effective role that privatisation may have in developing countries it is necessary to consider it from the broader standpoint of the reform of mixed economies.

This reform is based on the reinforcement of market mechanisms and integration in the world economy. It requires more stringent budgetary constraints for public sector enterprises (tighter state control) and for those of the private sector (abandonment of systematic salvage operations by the authorities) and increased domestic and international competition. The requirements of efficiency and competitiveness call for the rebalancing between sectors, the "redimensioning" of the public sector, giving the private sector the role of locomotive for economic growth. From this standpoint, privatisation appears to be a policy that can contribute to the renovation of the mixed economy and seems particularly appropriate for cutting down the public presence in sectors of activity into which it had expanded, with no real justification, during the 1970s. This reversal of the public sector sprawl nevertheless appears indissociable from economic and financial liberalisation measures, all the more so where governments are envisaging the privatisation of public enterprises in sectors with far from perfect competition.

The fact is that a substantial proportion of public enterprises tend to be specialised in a single branch of production or distribution and enjoy protection from both internal and external competition. Governments therefore have to define the most appropriate method

for each privatised enterprise in order to achieve the effective and durable reinforcement of competition. In general terms, recognition of the close link between privatisation operations and measures aimed at exposing an increasing share of the economies of developing countries to the action of market forces should make it possible to improve the overall coherence of the reforms.

While the difficulties encountered by privatisation experiments partly result from the inadequate perception of the interdependence of structural policies, at least they pave the way for consideration of the conditions required for the success of the reforms now under way.

4. Conditions for the success of privatisation operations

The successes and failures of the privatisation operations in the ten countries considered in the study by Bouin and Michalet (1991) provide a number of lessons to bear in mind for a better formulation of privatisation programmes. Without claiming to be exhaustive, this reformulation concerns the definition of privatisation operations, the preparation of programmes, and their implementation.

4.1 Definition of effective privatisation

The inadequacy of the traditional definitions of the privatisation process makes it impossible to describe the different situations which can characterise a privatised enterprise satisfactorily. It is therefore essential to clarify and define what constitutes effective privatisation.

In the traditional view, the concept of privatisation is generally limited to the transfer of shares of public assets to private buyers or takers which tends to equate a change in the distribution of the enterprise's capital to a change in management. This leads to two major limitations:

- (a) It excludes cases in which **the transfer of ownership and the evolution of management are not linked**. A complete reform of management through the granting of leases or management contracts can be effected without modifying the distribution of capital, i.e. without affecting the state's ownership rights. These methods are applied where, in certain cases (politically difficult privatisations, sectors with weak competition), the state wants to take advantage of this separation between ownership and management. Conversely, partial or total transfer of the capital of an enterprise to the benefit of the private sector does not necessarily lead to any substantial change in the way the enterprise concerned is managed. This arises either because of the previous behaviour of the public enterprise (adoption in the context of restructuring of objectives and criteria in line with private management), or because of the nature of the regulatory environment

(certain employment, pricing or equipment constraints limiting the field of application open to private rationale), or, lastly, because despite the transfer of ownership, effective control of the enterprise is not transferred to the private investor.

- (b) It does not permit the **precise identification of where control over the privatised enterprise lies**. In principle, control goes to the shareholder who is able to impose a type of management in line with his objectives. It is nevertheless difficult to lay down a threshold percentage for the private holding against which to judge the reality of the transfer of control. After a transfer operation involving 51 per cent of the capital, the state frequently remains the biggest shareholder and in the final analysis retains effective control over the enterprise. This is notably the case when, after a public offer for sale, the private holding is in the hands of thousands of small shareholders. Conversely, the transfer of a minority holding in an enterprise to a private investor is likely to transfer effective control over the running of the enterprise if the sale is interpreted as the first stage in the total withdrawal of the state (the case of Chilean transfers) or where the state adopts a permissive attitude (by giving itself non-voting shares or creating golden shares).

On the basis of this attempt to clarify the relationship among ownership, control and management, we can now better identify **what makes a privatisation operation effective**.

- (a) A privatisation is “effective” if the private purchaser or contracting party performs all the functions and activities of the enterprise not explicitly defined by the state. The private agent’s ability to apply his rationale in the management of the enterprise depends on the degree of constraint exercised by the regulatory environment, notably regarding decisions on employment, pricing and equipment. With this in view, clear rules of the game need to be defined so that on one hand, the purchaser’s objective of maximising utility can be pursued through the activity of the privatised enterprise, and on the other, the enterprise is not operated to the detriment of the collectivity (competitors, employees, consumers). The adaptation of the regulatory framework, and hence the attitude of the state are decisive, as will be seen below.
- (b) “Effective” privatisation also implies that the private purchaser should bear the financial costs associated with the modernisation and development of the enterprise, but also, if they arise, the financial losses. The fundamental difference between effective privatisation and restructuring lies precisely in the financial commitment of the private shareholders. In the context of restructuring or privatisation through management contracts, the state remains the main backer of the public enterprise. As a result of a transfer operation or the granting of a lease, the private agents become financially responsible for the operating results. Those shareholders who have effective control of the enterprise exercise continuous pressure on the managers, using both the threat of removing them and a system of

incentives based on results. This reduction of the asymmetry of the relationship between the hard core of control and the managers has a great influence on the gains to be expected in the field of economic efficiency.

4.2 Preparation of privatisation programmes

The design of the privatisation programme is vital for two reasons: first, it partly determines the efficacy of implementation of privatisation operations, notably their duration, and second, it determines the procedures that are to ensure transparency and hence the irrefragable nature of such operations. It requires an appropriate institutional framework and the precise selection of the “target enterprises” to be privatised.

As far as the **institutional framework** is concerned, the results recorded by the countries in our sample are scarcely encouraging in either execution or transparency. The initial phases of the privatisation process in fact generally turned out to be considerably longer than planned. Apart from eminently political retarding manoeuvres, the organisation of the process came up against the technical problems of the administration’s lack of preparation and the inadequacy of the information available on public enterprises. Two approaches were developed to overcome these constraints, one based on the preparation of a detailed framework and substantial administrative intervention, the other based on minimal legal structures and simplified administrative procedures. Analysis of these two approaches makes it possible to draw certain lessons concerning the efficiency and transparency desiderata. It is partly based on the comparative study by Wilson (1991) on privatisation experience in Nigeria and Côte d’Ivoire.

- (a) Where a **detailed approach** is adopted (Ghana, Malaysia, Nigeria, Philippines), the privatisation process is not instituted until all the conditions considered necessary prerequisites are fulfilled in their entirety. As a rule these conditions are: i) creation of a privatisation body with independent legal status; ii) adoption of a law or decree specifying the modalities for the transfer of ownership to the private sector; iii) adoption of provisions concerning in particular any possible disputes resulting from privatisation operations and the situation of the employees of privatised enterprises; and iv) publication of a list identifying the different actions for each public enterprise (privatisation, restructuring, merger, liquidation, etc.).

Fulfilling all these requirements — and in particular the last, which implies completion of the work of collecting information on public enterprises — considerably delays the launching of the process. What is more, the execution of the programme is based on a cumbersome administrative apparatus and requires numerous interventions by foreign consultancy bodies. The advantage expected from this approach is the exercise of permanent control over the process (no “back door” privatisations, availability of information at each stage).

Even the most minutely detailed procedures, however, do not totally eliminate the lack of transparency where foreign or domestic investors benefit from debt conversion mechanisms to finance the purchase operations. It also seems difficult, by means of legal provisions, to prevent political pressure, clientelism and corruption in tendering procedures. Similarly, the problem of evaluating the assets of an enterprise to be privatised, which implicitly involves the — more political — issue of transferring public property to local or foreign private interests, cannot be dealt with satisfactorily in the course of a general audit of the public sector.

- (b) At the other extreme, the **minimalist approach** is expected to make it possible to privatise without the creation of independent administrative bodies, without an arsenal of legal instruments, without an exhaustive census of public enterprises. These operations are executed by means of *ad hoc* procedures. Some of these elements characterise, among others, the Chilean, Ivoirien, Jamaican and Tunisian programmes. Such a case-by-case approach is supposed to promote flexibility and rapidity, often to the detriment of perfect transparency. The discretionary nature of the procedure limits the availability of information. The list of enterprises privatised and the transaction conditions generally remain unofficial, fuelling rumours and giving ammunition to the opponents of privatisation. The effect on potential buyers is likely to be disastrous and the anticipated advantages of efficiency and flexibility are considerably reduced, especially if legal actions are instituted as a result of the initial privatisation operations.
- (c) Analysis of the facts thus tends to argue against the sharp opposition between the two methods and in favour of a **midway approach** more likely to promote the transparency of operations and the fairness of tender procedures while minimising the bureaucratisation of the process and the delays in implementation. For this it is necessary to encourage administrative decentralisation for the preparation of dossiers and the technical aspects of the operations. The example of Jamaica illustrates the advantages inherent in this approach. The majority of the 40 operations effected in this country were conducted directly by the body responsible for the enterprise to be privatised (ministry, holding company or parent public enterprise). Under these conditions it does not appear to be essential to have an exhaustive census and audit of the entire public sector. For certain individual operations, *ad hoc* procedures under the responsibility of the prime minister were set up. Thus the realisation of the public offer for sale of the National Commercial Bank of Jamaica took less than ten months from the political decision to the first quotation on the Kingston stock market. In any event, the adoption of clear legal provisions concerning property rights, the participation of foreign enterprises and the competences of the body responsible for executing the operation (notably in countries with a federal constitution) appears necessary in order to fix a normative framework.

As regards **the selection of “target enterprises”**, the privatisation process should normally be concentrated, at least initially, on enterprises that were created or entered the public sector during the 1970s. Such an approach has several advantages.

- (a) The enterprises that became public during this period generally did so with no real economic justification. There is likely to be little social or political resistance to their exit from the public sector, as they do not belong to sectors of activity considered by the state to be “strategic”. The pool of privatisable enterprises in these sectors for which state intervention is judged to be neither exclusive nor priority is potentially substantial. A rapid review of the sectoral distribution of the population of public enterprises shows the large number of enterprises in sectors of activity such as transport, tourism, services and sundry industrial activities. Several hundred enterprises would thus be concerned in the ten countries considered by Bouin and Michalet.
- (b) These public enterprises are generally of medium size and operate in fairly competitive sectors. They thus appear to correspond to the financial resources available to local buyers. In addition, the risks associated with the application of private rationale in market structures with a low level of competition are limited. The large-scale privatisation of these small and medium enterprises can easily fit into the context of a decentralised process. They are generally owned by industrial or financial public holding companies (CORFO in Chile, SOMEX and NAFINSA in Mexico, NDC in the Philippines, etc.) able to prepare and organise a transparent call for tender procedure.
- (c) The rapid reduction of the size of the public portfolio should permit more effective control over a reduced number of public enterprises, which will facilitate the restructuring actions undertaken by the state. In any event, the state has shown itself to be incapable of managing the consequences of the proliferation of public enterprises, keeping a substantial number of them in a situation of potential bankruptcy.
- (d) The transition to a second phase of privatisation programmes would be easier thanks to the experience acquired in the realisation of many operations involving small and medium enterprises. This second phase would involve big national companies, as was the case in the Mexican programme. The splitting of the privatisation programme into two phases does not mean, however, that a very big privatisation operation cannot be envisaged if the opportunity should arise; it reflects above all the impossibility of the wholesale rapid privatisation of big public enterprises because of the insufficient financial resources available to the local private sector and the caution of foreign investors. The second phase would also involve those enterprises for which a restructuring action had previously been launched.

It would thus appear preferable to envisage the wholesale privatisation of small and medium public enterprises rather than concentrating on a few large national companies. Moreover, it should not be forgotten that the privatisation of a large number of small and medium public enterprises may trigger a dynamic accelerating the entire process of transformation and renovation of the economic system in the countries considered.

4.3 Implementation of privatisation programmes

In the strict sense, the implementation of privatisation programmes implies a choice of technique. However, the interdependence and coherence of reforms aimed at modernising the economies of the developing world require the parallel adaptation of the regulatory framework, a basic precondition for the efficacy of these programmes.

The wide variety of privatisation techniques reflects the diversity of situations affecting both the privatisable enterprise and the context for the realisation of programmes (government objectives, financing constraints, etc.) (see Bouin and Michalet, 1991; Ramanadham, 1991). Indeed, the developing countries in the reference sample used transfer operations as the privatisation method far more than any other. In view of the major problems of the early 1980s, this is scarcely surprising, but it must be said that the majority of developing countries do not offer satisfactory conditions for the successful realisation of such operations.

- (a) **On the financial side**, transfer operations through private sale or public offer come up against two problems. First, the lack of local buyers with substantial financing capacity is obvious. A competitive call for tenders can thus be envisaged only for the sale of small and medium public enterprises. Second, the banking and stock market structures are frequently inadequate, limiting the possibilities for financing transfer operations. By way of example, the limited success of the public offer for sale of Caribbean Cement a few months after the successful sale of the National Commercial Bank of Jamaica illustrates the low absorption capacity of securities markets in certain developing countries.
- (b) In **estimating the value** of privatisable enterprises, the impossibility of assessing their future profitability — because of changes in the costs of production, selling prices and markets during and after the liberalisation phase — makes it difficult to determine a precise transfer price. This is a major problem, as uncertainty concerning the present and future value of the enterprise is a factor that naturally dissuades potential purchasers.
- (c) As regards the **control** of the privatised enterprises, the transfer operation does not in itself constitute a satisfactory option. In the developing countries, transfers generally involve only a fraction of the capital, the state remaining the biggest shareholder. This results in a duality in the objectives pursued by the enterprise (social and political for the state, financial for private investors) which tends to

complicate decision making and the running of the enterprise. In the particular case of public offers for sale, the dispersion of the capital limits the possibilities for controlling the managers of big privatised enterprises.

Transfer should therefore not be automatically preferred over other methods. The fact that there are several privatisation techniques argues in favour of selection on a case-by-case basis of the most appropriate method in view of the government's objectives. In this respect, the increased number of operations combining several methods shows the authorities' growing preference for mixed procedures for the transfer of management and ownership. This approach also reflects the specificity of the constraints imposed on each developing country.

Consideration should be given in particular to two methods hitherto relatively little used but which have undoubted advantages with respect to the factors discussed above.

The first is an **increase in capital** not subscribed by the public shareholder(s). This has two advantages. First, it mainly benefits the privatised enterprise. The injection of fresh money by private investors subscribing to the increase in capital helps to recapitalise the enterprise and finance the modernisation investment necessary for its development. The increase in capital does not generate revenue for the state, thus limiting the problems associated with the utilisation of the product of transfer, but it is not neutral with respect to public finances. The private sector, by replacing the authorities in the financing of the enterprise's activities, enables the state to reduce considerably its capital injections and subsidies aimed at financing investments. Second, financing the modernisation effort gives the private investor a decisive role in the orientation of productive investment and in the operation of the enterprise. This control by the private investor puts him in a position to estimate the value of the enterprise and, where appropriate, to formulate takeover proposals for an additional share of the capital. Private subscription to increase capital thus makes it possible progressively to dilute state intervention in the management and operation of the enterprise while favouring the emergence of internal private control.

The second method is the **staff buy-out**. This has rarely been used in the countries studied, the main reason being the inability of the banking institutions to lend the funds necessary for employees to take over their enterprise, even if they have an attractive plan to offer. The risks run by the banks are fairly limited, however, since the debt contracted by the employees is against the assets of their company. The advantage of such a procedure is that it transfers control of the enterprise to agents working on a private rationale basis at two levels: first, the banks select the takeover projects with the best potential risk-profitability ratio, and on the other, the employee-owners form the controlling nucleus of the enterprise.

Adaptation of the regulatory framework in parallel with privatisation operations is an essential aspect of the process of renovating and modernising mixed economies. In the system now being set up, the new paradigms are competition and private rationale. They impose new criteria for performance evaluation: competitiveness, economic efficiency and financial profitability.

Having recognised the primacy of market forces, the state should both encourage their emergence and mitigate their shortcomings. The reinforcement and protection of competitive practices are crucial for the success of privatisation programmes. Competition on product and factor markets is in fact at once the most powerful incentive for and the most efficient control over private rationale. What is more, privatisation makes existing regulations obsolete. A process of reregulation is therefore necessary to preserve the conditions for reaching an economic optimum. Governments that have introduced major privatisation programmes cannot ignore these two factors.

Three examples show the need to adapt the regulatory framework after privatisation. First, the transfer to the private sector of enterprises generating substantial negative external effects, such as environmental pollution, leads to the adoption of new protection standards. Second, the privatisation of transport and telecommunications enterprises gives rise to the problem of access to these services for disadvantaged social categories and of the territorial coverage of remote regions. Certain transport routes, certain telecommunications networks, certain water or electricity distribution networks could be abandoned because deemed unprofitable by the new private operators. When such public services are privatised, it appears essential to have clauses concerning public service obligations for the private purchaser or contractor. Lastly, in the case of the privatisation of enterprises possessing considerable market power, reregulation is intended to prevent the application of private rationale from being solely for the benefit of the purchaser and to the detriment of all other economic agents. The prolongation of certain pricing constraints may then be decided, effective privatisation without regulatory control being in this case sub-optimal in terms of collective welfare.

Insufficient attention has been paid to these problems so far. Privatisation in the telecommunications sector, often carried out because the state no longer has the financial resources necessary for the modernisation and development of the networks (Chile, Jamaica, Malaysia and Mexico), is a perfect illustration. The possibilities for controlling these natural monopolies (creation of a monitoring body, pricing constraints) have but rarely been studied in depth. In any event, the difficulty of controlling the behaviour of the private monopolist (problems of information, monitoring, etc., highlighted by United Kingdom experience in a context totally different from that of the developing countries) calls for consideration of the choice between modernisation of these networks and the transfer of a monopoly to the private sector. More generally, the state's decision as regards the privatisation of public enterprises depends on its financial capacities, the choice of "strategic" sectors and its development priorities.

Be this as it may, any national privatisation strategy has to be defined with respect to its coherence with the overall orientation of the economic reforms introduced to renovate mixed economies in the developing countries.

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The privatisation of public enterprises has become a daily preoccupation for the governments of developing countries, as it loses its heavily ideological connotations of the early 1980s. Persistent economic problems have led political leaders to a greater realism, and privatisation has come to be seen as an essential component of the rebalancing of developing economies in favour of the private sector. Now that the principle has been accepted, it is henceforth necessary to define privatisation policies adapted to the economic financial and social constraints of developing countries. This is the purpose of this Policy Brief which offers elements for a reformulation of the privatisation process.