Overseas Development Institute
Briefing Paper
September 1986

PRIVATISATION: THE DEVELOPING COUNTRY EXPERIENCE

Recently, under pressure from donor agencies and in the face of mounting budgetary deficits, developing countries (ldcs) have increasingly begun to implement economic reforms designed to change the balance between the public and private sectors in economic activity. The experience of privatisation in the developed economies has undoubtedly encouraged this process, and privatisation has been held up by most donor agencies as a policy of universal applicability. But developing countries face special difficulties in adopting such a strategy — difficulties that are not simply of a political nature. This Briefing Paper examines the experience of privatisation in some ldcs at a time when donors have been exercising increasing pressure on ldc governments.

Privatisation as a Policy Reform

Both bilateral and multilateral donor agencies have in recent years given growing prominence to the need for major reforms in government policy in ldcs. Greater emphasis has been placed on general 'programme' lending as opposed to specific 'project' lending, while, as a condition for continued funding, borrowing countries are increasingly being required to implement certain basic economic reforms. In particular, ldc governments have been urged to allow the private sector to enjoy a greater role in their economies. Such has been the importance attached to this question that in early 1986 the World Bank set up a section to deal explicitly with measures for improving the efficiency of public enterprises by restructuring and privatisation.

Since many bilateral donors now link their interventions to ldc acceptance of World Bank and IMF policies for substantive economic reforms, measures designed to rationalise public expenditure and increase the scope of the private sector have become almost standard features of the economic packages that ldc governments are under pressure to implement. The call to reduce the role of the State has been further fuelled by privatisation programmes introduced in several developed economies. An ideological preference for a greater private sector role, coupled with a belief that such a preference is valid across all types of economies has proved to be a crucial factor in determining the framework for policy reform in ldcs.

The current interest in privatisation stems in part from the belief that many ldcs have entered into 'overextended' public sector commitments, associated with profound macro-economic instability — large public sector deficits, high inflation rates and balance of payments deficits. In the past twenty years there has been a significant increase in state-promoted economic activity in many low and middle-income economies. Of particular importance has been a proliferation of state-owned or parastatal enterprises, many of them located in key sectors of the economy — power, transport and communications. At the outset, these parastatals were looked upon as instruments for modernisation. But as pressure on government revenues has increased, resources for financing existing state concerns or initiating new investment have become scarcer. Inefficient public enterprises — operating outside normal commercial constraints — have increasingly been regarded as a serious drain on limited public funds. A lack of clear managerial objectives, coupled with non-economic pricing policies and a high degree of political scrutiny have commonly added to their difficulties. Critics have also pointed to the inhibiting effects of public expenditure on the private sector. According to this view, it has 'crowded out' a more or less equivalent amount of interest-sensitive private capital, without providing any net increase in funding.

To tackle severe external and domestic economic imbalances, an increasing number of ldcs has had to adopt major adjustment programmes with elements of privatisation, aimed at reducing and restructuring public expenditure. A number of influential donor studies have argued strongly in favour of the intrinsic virtue of free market mechanisms, notably the Berg Report of 1981[1]. Some donors — such as USAID — have also pointed to increased opportunities for foreign investment, as well as likely gains from less regulated markets, as a benefit of privatisation. Such arguments have not met with universal agreement. Some question the direct or causal association of public ownership with poor economic performance and doubt the willingness of foreign capital to invest in many ldcs under any circumstances. Others have reaffirmed the value of infrastructural public investment as an effective method of mobilising domestic resources. To counter such objections, the advocates of privatisation have been careful not to base their case on the nature of ownership alone; it is rather seen simply as one element in a larger set of prescribed liberalising measures, upon which the success or failure of privatisation itself is ultimately dependent.

Modes of Privatisation

It is generally accepted that if full advantage is to be gained from it, economic reform must be accompanied by moves towards greater competition. Simply to convert a public monopoly into a private monopoly will not confer any benefits. Therefore privatisation strategies should be designed to achieve not only a transfer of ownership but also to change market structure. Debate has focussed on the effectiveness of different modes of privatisation in achieving this dual objective.

Denationalisation. The denationalisation (or divestiture) of state-run monopolies, by selling them back to their former owners, by initiating a new share flotation via the stock market, or even by closing operations altogether, has been the most common privatisation method. Typically it has been deployed in connection with manufacturing and processing enterprises. The pioneering example of South

1. World Bank, *Accelerated development in sub-Saharan Africa*, Washington DC, 1981.

Box 1

Clarifying the Public/Private Mix: The Case of the Philippines

The ambiguity of public and private sector operations is well illustrated by the agricultural sector of the Philippines economy. The key sugar and coconut industries, while ostensibly government-run through regulatory agencies, were in practice for many years subject to control by powerful monopolists closely allied to the former régime of President Marcos.

The IMF/World Bank 'relay' operation agreed upon with the government in late 1985, which released the third of seven tranches of the 615 million SDRs (approx $711m) standby credit first granted to Manila in November 1984, was designed to rectify this situation. Rationalising the public sector, alongside the implementation of privatising reforms, was seen as a way of bringing to an end long-standing financial mismanagement and curbing the use of public corporations as a source of corrupt incomes.

In the case of sugar, the government was to establish real authority over the affairs of the Philippine Sugar Commission (Philsucom), previously dominated by a handful of business figures, while the National Sugar Trading Corporation (Nasutra), which dealt with domestic purchasing and exports, was provided with a new marketing arm, to be run solely by private interests. Moreover, Philsucom would divest itself of its many subsidiaries — in transportation, refining and sugar milling — restricting itself to overseeing the industry and co-ordinating the diversification of Philippine agriculture away from the traditional staple crops, the export demand for which has been steadily declining. The World Bank's prescribed reforms therefore aimed at encouraging a clearer separation of public/private sector functions, while enforcing stricter accounting procedures. However, negotiations about the dismantling of the sugar monopoly in late 1985 only confirmed suspicions that these corporations would simply be restructured to retain their monopoly privileges.

This development followed a period when a great many state-owned enterprises and conglomerates, particularly those formerly in the hands of government banks, had been made ready for divestiture. Firms placed on the list for sale included the Delta Motor Corporation, the Restort Hotels Corporation and the Bataan Pulp and Paper Mills company. Government officials stressed as a reason for divestiture the combined deficit of some $542m which such enterprises had incurred in 1985.

After the election of the Aquino government in the spring of 1986, a pledge was made to carry through the implementation of IMF/World Bank proposals. A joint donor mission to Manila unblocked a $200m loan dependent on this sectoral adjustment. Additionally, many of the 300 remaining state owned enterprises set up over the last two decades are being considered as candidates for divestiture.

Korea, in which large industrial combines were established with state backing and then subsequently sold off to the private sector, has been much quoted. Such a strategy has also the possible advantage of providing the state with the opportunity to divest itself of the burden of unprofitable enterprises under public expenditure rationalisation. In developed economies an additional justification for such strategies has been to widen share ownership. But this is to presuppose the existence of a well-functioning capital market together with a substantial investing public — a rare occurrence in developing countries. In sub-Saharan Africa, for example, only the stock exchange in Abidjan and, to a lesser extent, those in Harare and Nairobi are of sufficient size. There is also the risk that enterprises will retain monopoly power. Governments, eager to present sell-offs as attractive propositions, may be tempted to preserve certain monopoly privileges for the denationalised enterprises such as protected markets or privileged access to inputs. In areas where entrepreneurial activity is scarce — as in many ldcs — newly-privatised but monopolistic concerns are likely to be effectively controlled by a business élite. The regulatory bodies set up to guard against monopolistic practices are vulnerable to influence by the industries they are intended to oversee. In these circumstances, with the reappearance of old market distortions, denationalisation may even worsen market structures.

Contracting-out. By contracting out, or leasing, the state can finance an enterprise while permitting a private firm to run it, or equally, private interests can finance an enterprise subject to state approval. Public works, urban development and water supply schemes are frequently cited as examples of this approach. A shift to smaller enterprise units able to bypass bureaucratic red tape and adjust rapidly to fluctuations in demand may achieve substantial cost savings. But it is not easy to define and quantify performance, and there is an ever present danger of corruption in the granting of contracts and licenses. Contracting-out does not involve the clean break with State control offered by total denationalisation. But on the other hand, joint government-private co-operation frequently represents a safer investing option for private entrepreneurs.

Self-Management/Cooperatives. Another option is to hive off state-run activity either into self-managing enterprises, owned and managed by their workforce, or into co-operatives. Direct responsibility — and increased independence — is then placed in the hands of employees working in a decentralised environment. Within the agricultural sector, a further possibility is presented by the formation of agricultural co-operatives or farmer associations to take over functions previously run by government corporations. But this presupposes an adequate level of technical and managerial expertise, and in many ldcs these abilities are lacking. Given inadequate working capital and an absence of satisfactory back-up services, co-operative ventures have had limited success.

Deregulation. Deregulation, the abolition of statutory barriers preventing private operators from competing with state enterprise, complements measures designed directly to transfer ownership. Such market 'loosening' is often associated with other measures of economic liberalisation. The reform of crop marketing boards and service agencies for the agricultural sector in ldcs is a case in point. Here it is argued that allowing greater competition tends to ensure an increased level of marketed output as well as to raise farmer incomes through higher product prices. This would tend to reverse the common ldc-government practice of subsidising urban consumers at the expense of farmers. However, it is assumed that the markets in question are large enough to support a multiplicity of private agents at sufficient levels of profitability.

It can be seen that the key issue is the degree to which each privatising option meets the test of transferring ownership and improving competition. Clearly a mere change of ownership is not sufficient. At the same time steps must be taken to strengthen the need to compete. In the absence of such measures, the increase in private market power and additional scope for speculation could result in the widening of existing wealth differentials, a serious problem for governments committed to greater equity. Ultimately, the degree to which ldc governments are prepared to redefine the public-private boundary remains as much dependent on their wider social and economic priorities as on the exertion of donor pressure. However, with many ldc economies facing an increasingly hostile trading and financing environment there is less room for manoeuvre, and therefore greater scope for donor pressure.

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Privatisation in Practice

Until now many ldc governments have opposed privatisation or at least had deep reservations about its merits. Firstly, after independence, in many ldcs the state came to assume a vital nation-building role, binding together diverse ethnic or social groups, as well as becoming an important source of power and patronage. The nationalisation of foreign-owned concerns was an assertion of independence and, particularly during the 1960s, was associated with a preference for economic planning and State control of the 'commanding heights of the economy'. In some cases — as in West Africa — state control over exports and marketing pre-dated independence. Secondly, aid recipients have been reluctant to be seen to be acting under outside duress, and are sensitive to any attempts at 'imposing' free market solutions upon them. Thirdly, state intervention may have been prompted originally by market failure, the effective absence of a willing and compatible private agent. Thus a wide range of reasons, political and traditional as much as economic, have been given to justify high levels of state intervention. But despite these objections, the combination of budgetary constraints, unease with State sector inefficiences and donor conditionality has prompted ldc governments to give more encouragement to private sector initiatives, and a growing number of ldc governments have now actively begun to pursue a policy of privatisation.

In **Turkey**, it has become a key plank in government policy, and a detailed privatisation strategy is now being prepared. Extensive restructuring of cement, textiles, fertilizer, pulp and paper enterprises, amongst others, is proposed, involving selective denationalisation. Additionally, the largest state bank, Ziraat Bankasi, plans to sell shares in the 19 enterprises it owns. A partial flotation of the national airline is also planned.

In Latin America, the major debtor nations, **Argentina**, **Brazil** and **Mexico**, have sought to reduce their public sector deficits through privatisation. The Argentine government's proposals, put forward early in 1986, were explicitly linked to the association between additional lending and policy reform stressed by the American Treasury Secretary, James Baker. But planned divestiture of the large steel company Somisa, as well as a number of petrochemical and chemical enterprises, has run into trouble on political and economic grounds. Private investors have been deterred by unfavourable market conditions and there has been strong opposition from the trade union movement, which views privatisation as leading inevitably to mass redundancies. In **Brazil**, non-voting shares in the highly profitable state oil company — Petrobras — have been sold and ownership of a number of manufacturing concerns transferred to the private sector. In **Mexico**, the government announced at the end of 1985 that 15 parastatals — mostly involved in tourism or food processing — would be sold to private interests.

In **Bangladesh** the direct influence of donor pressure for policy reform can be discerned in the measures taken under a new industrial strategy that has evolved since 1982. As part of a package of reforms, almost 100 publicly-owned enterprises — including the loss-making steel and engineering corporation — have been sold. Large parts of the jute and textile industry have also been transferred into private ownership. Many of them were simply sold to the highest bidder. The latest proposal envisages the denationalisation of a number of state-owned banks. But such measures have, as yet, not been satisfactorily linked to complementary reforms of the public finance system, let alone of remaining public enterprises.

Box 2
Privatisation and Agriculture

The difficulties in pursuing a successful privatisation programme in ldcs are most obvious in the agricultural sector. State intervention in agriculture is often associated with price regulation and the taxation of rural producers, primarily through marketing boards. Yet other publicly-provided functions have come about as a result of market failure. Both agricultural research and extension services, for example, very rarely provide sufficient returns to private capital. Even the provision of basic inputs, such as seed and fertiliser, is an activity that the private sector has largely avoided, particularly in Africa, except in the case of a narrow range of high value crops.

The case of *Senegal* provides an interesting example. Since 1980 the Government has pursued a major institutional and policy reform programme aimed at rationalising the market system for groundnuts — the key crop — as well as decentralising the distribution of seeds and fertilisers and transferring more responsibility and authority to rural communities, co-operatives and the private sector. At the same time, greater incentives have been given to farmers by raising producer prices.

The area of highest State intervention has traditionally been in groundnut marketing. In 1980 the Government abolished the groundnut Marketing Board, ONCAD. Consequently, co-operatives have been able to market groundnuts directly to the mills without dealing with a State intermediary. But less progress has been achieved in reducing the State's role in the critical area of inputs supply. Here, the main problem has remained the ability and willingness of private entrepreneurs to take over the state's role. For instance, the collapse of the state-sponsored rural credit programme in 1980 depressed demand for fertiliser and agricultural tools.

With demand for inputs remaining low and variable as a result of the weak purchasing power of farmers, the private sector has been very reluctant to stray from the more remunerative trade and transportation and urban investment activities that have historically been its preserve. While raising input prices could in theory make the supply of inputs more attractive to private entrepreneurs, such price rises would tend to reduce demand from farmers. Weak demand, coupled to the absence of infrastructure and the lack of economic diversification in rural areas has thus limited the move towards private sector involvement. At the same time, decades of high state intervention have resulted in a private sector heavily dependent on state contracts and subsidiaries. For the rural sector in particular, it appears that the Senegalese private sector will only play a greater role if significant incentives and credit are made available.

This example illustrates, firstly, the problems involved in privatising services to agriculturalists, particularly where agriculture is backward and, secondly, that successful privatisation requires, at least initially, continued support as well as, in the longer term, a move to greater competitiveness in the private sector itself.

However, despite such examples of its active espousal, the general progress of privatisation in ldcs has been more halting. A recent World Bank report[2] estimates that for low-income African economies, around 5% of public enterprises have been either closed down or denationalised in the 1980s. This slower progress can be attributed to a range of factors, not simply to political hostility.

From the Frying Pan into the Fire: some ldc anxieties about privatisation

Many ldc governments have been reluctant to risk being accused of disposing of national assets at undervalued prices, the more so where 'foreign' interests could gain

2. World Bank, *Financing Adjustment with Growth in Sub-Saharan Africa, 1986-1990.* Washington DC, 1986, p2

control. In Indonesia, where a substantial part of trading and merchant operations are controlled by the local Chinese community, any privatisation proposal that might result in their further domination of any sector usually fails to gain official approval. Twenty of twenty-six recent palm oil projects, for example, were bought by Chinese entrepreneurs, causing much consternation; and as a result, some areas are now specifically closed to Chinese investors. The continuation of state control over important public utilities has been defended on political and ethnic grounds.

Monopolisation is a real danger, given the immature state of the majority of ldc capital markets. In Sierra Leone, following a recent State denationalisation, a single businessman was able to acquire extensive trading concessions, even including a temporary hold over most foreign exchange dealings. The present Pakistan government, one of the few actively to pursue privatisation, faces a similar difficulty. Over the past year, the domestic and export trade in cotton has been opened to new entrants, electricity distribution has been privatised, and the government's telephone and telegraph department forced to compete with private companies. A 'public profitability' indicator has been developed for state enterprises, with the intention — as more become viable — of putting them onto the market; and a national deregulation commission is to oversee a series of ambitious forthcoming privatisations, the total share value of which is expected to reach $125 million (Rs.2 billion). But this is tempered by the already concentrated pattern of shareholding. The Finance Minister, discussing the sale of State banks with the hope of making their ownership more broadly based, has confessed to anxiety about the fact that 80% of all existing stocks belong to only '200 families'. Measures to exempt dividend income from tax, and so to stimulate smaller investors to come forward, will — initially at least — tend to exacerbate inequalities rather than correct them.

Resistance from vested interests which stand to lose by privatisation has also acted as a powerful constraint (see Box 1). Unionised public sector employees, not only those in state owned enterprises but also working in the health, housing or educational services, are liable to resist the regressive income implications of privatisation and measures of economic liberalisation, especially where this affects staffing and salary levels. The experience of **Chile** following the military coup of 1973, which resulted in an abrupt challenge to a long-standing tradition of state involvement, lends some support to their arguments. In 1981 a private pension fund system was inaugurated to provide old age and sickness benefits, health insurance and unemployment benefit. This currently serves over one million subscribers, about 70% of the total formerly affiliated to the State scheme. Whether cost savings have accrued from the changeover has still to be established, since although contributions are lower in the private scheme, marketing costs at its launching have been far higher. There has also been a radical reappraisal of the provision of other public services. For example, educational coupons have replaced state-sponsored education. But at a time of recession and economic hardship, poorer households have cashed-in their coupons rather than maintain their children's schooling. The result has been a fall in literacy levels. Most available evidence suggests that Chile's privatisation programme, involving both productive enterprises and services, has restored earlier problems of ownership concentration and economic power. The decline in public services has hit the poorest groups hardest. This has promoted labour unrest which in turn has called forth a further curtailment of civil liberties. Divestiture of state companies has been done without any regard to changing the competitive environment.

Finally, a combination of a continuing faith in state control over the economy and, particularly in agriculture (see Box 2), an absence of private entrepreneurs willing or able to take over the role of state concerns has limited the spread of privatisation. Even where governments have been receptive to the idea, and such constraints are not binding, definite limits have been enforced. Thus, in **Thailand** — partly at the urging of the World Bank — the government has developed a policy of denationalisation that has cut the number of state corporations from a peak of 109 in the late 1960s to a present level of 70. By 1985, sections of the profitable electricity authority and the national airline had been earmarked as candidates for share flotation. Loss-makers like the Bangkok bus company are also being considered. The government, even so, still believes in retaining control over public utilities that are in their view of national and strategic importance. This criterion tends to be broadly interpreted. Consequently, it appears that greater private investment in some new form of 'national company' — basically public-private joint ventures, as with some petrochemical enterprises — will be a more likely model of advance.

Conclusion

Privatisation has achieved relatively limited progress in most ldcs. The central issue is not so much the desirability of privatisation as its feasibility. Fears of outside dominance, undeveloped capital markets, inflexibility in public finances, workforce opposition and a private sector highly dependent on the State for subsidies and contracts are common constraints. In addition, many public enterprises have little asset value but high liabilities. For these reasons, both donors and recipient governments now tend to see privatisation as a later stage where public sector restructuring is the first priority.

But the halting progress of privatisation does not indicate that it will cease to be an effective policy option for ldc governments. Indeed, it seems clear that donors will continue to press for further privatisation, and that budgetary constraints, amongst other factors, will make ownership transfer and higher levels of private sector participation a necessary feature of the reform packages being implemented by ldc governments. But it is also probable that privatisation will only be a part — and not necessarily a dominant part — of public sector reform . It is clear that in most instances considerable prior restructuring of the enterprises whose ownership is to be transferred will be required. Though less newsworthy, such restructuring, rather than rapid denationalisation, is likely to be a major feature of economic policy in ldcs in the coming period.

ISSN 0140-8682