

Is privatisation a public good?

A review of recent literature

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Foreword

The purpose of FMF *Monographs* is to use the analytic method of political economy to shed light on how best the promotion of free markets will improve the workings of the South African economy. In particular, authors are urged to apply the microeconomic approach of studying how individuals, firms and households behave in response to either naturally occurring or regulatory induced incentives. This requires that they display a sound, institutional knowledge and understanding of their theme. Where macroeconomic aggregates are introduced into the discussion, FMF authors analyse them from the market perspective, namely from the foundation stones of economics itself, supply and demand, the interactions of countless individuals with differing preferences and intentions. This approach also requires that authors pursue their analysis in a logical fashion to policy proposals unencumbered by preoccupations as to what is or is not politically practicable at any given time. They should not be tailored simply to gain the approval of pre-existing (but from a historical perspective transient and ephemeral) vested interests or political groupings.

The authors of this *Monograph* write explicitly within this framework. Perlmann and Zarenda repeatedly emphasise that privatisation is a microeconomic not a macroeconomic phenomenon. They repeatedly stress that the claims and counter-claims made for privatisation should not be regarded as an easily-adapted surrogate for overall monetary and fiscal rectitude.

What then is privatisation and how should it be promoted, monitored and evaluated?

Government does have a policy of privatisation although even now, in early-1997, little has been achieved. There are two main reasons – other than raising revenues for government – for privatisation. These are improving microeconomic performance and promoting wider share ownership. How will privatisation improve industry's performance? The men, machines and management remain the same before and after. Any difference in performance must come from changes in the constraints and opportunities newly privatised firms face. The autonomy of management is increased when statutory controls are removed. They are better able to follow their own commercial judgements in investment and planning decisions when politicians are distanced.

But what leads us to expect that this increased level of discretion will be used for the benefit of society rather than the managers themselves? The answer lies – as Perlmann and Zarenda make clear – in the competitive spur to efficiency which will now exist in the product market they operate in, or the capital market, or both. Firms will be disciplined to meet consumers' wishes by the threat of transfer of custom to other firms or alternative products, while the capital market imposes the threat of bankruptcy or takeover if resources are applied to relatively less valued uses. What if newly privatised firms tend still to be dominant, or near dominant, sellers?

A monopoly in the product market is not cause for concern provided entry is easy. Furthermore, if private firms – monopolists or not – fail to operate efficiently, that is reflected in their share price. This in turn makes transfer of controlling interests in the firm likely (or existing shareholders become discontented). A less quiescent group of shareholders will affect managerial tenure and performance. Privatisation thus provides incentives to achieve productive efficiency (the achievement of profits) and allocative efficiency (the keeping of prices close to consumer product valuations).

There are, however, reasons why privatisation (British fashion) could fail to achieve both the productivity goals and the objective of promoting wider share ownership and redistributing wealth. If wider share ownership is the objective of privatisation, selling off state assets to the insurers, banks and mining houses with their complex cross-linkages would be self-defeating. Sales on the stock market would result in increased concentration and not wider share ownership. The wealth base of individuals in South Africa is narrow, unlike the UK, where privatisation issues have raised the number of shareholders from three million to nine million in about a decade.

However, much has been learned about privatisation processes from the British examples of the 1980s. The authors examine international experiences and show that there is an enormous range

of choices available to governments wishing to change the ownership of state assets. Which of these routes is more appropriate in local circumstances, or whether some hitherto unthought of privatisation mode should be sought, is an issue which recurs throughout the following pages.

There are different routes to privatisation. One way to go is to convert public monopolies into private monopolies, which will maximise state revenues from the sale of public assets and will ensure monopoly rents for the new owners. But on equity and efficiency grounds it leaves a lot to be desired. As Perlmann and Zarenda emphasise, it should be a prerequisite for privatisation that former state firms operate in a competitive world.

And it is desirable that this world should be competitive not only in the markets for goods and capital. It should also be competitive in the market place for policies and ideas.

What is unfortunate about so much current discussion is that it totally ignores the findings of the theory of public choice, or the economic theory of politics. The central conclusion of public choice analysis is that the state sector does not consist of well-informed and altruistic individuals who impersonally pursue the public interest. Like businessmen, politicians and bureaucrats do the best they can for themselves. Unlike businessmen, they are not subject to the discipline of the market and find it easier to promote their own interests at the expense of the public. What we see around us in South Africa today does little to refute the economic theory of politics, and Perlmann and Zarenda in their discussion ensure that this lack of refutation is not overlooked.

Perlmann and Zarenda write in their own capacity as academic observers. Their views are not those of the FMF (which has no corporate view), nor of its Council Members or Directors. But their understanding of the international experiences of privatisation over nearly two decades and in several continents is deep. As such, the FMF believes this *Monograph* is an important contribution to the current debate.

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1

Introduction

The general attitude towards privatisation has shifted dramatically since the latter half of the 1990s. This has been noticeable even in South Africa and many parts of the subcontinent. The announcement of a privatisation initiative in South Africa by both the Deputy-President as well as the President, more recently, coupled with the explicit commitment to such a policy in the Macroeconomic Strategy document in June 1996 bear testimony to this. The appointment of Hong Kong and Shanghai Banking Corporation (HSBC) and Swiss Bank Corporation (SBC) Warburg as advisers to Government on privatisation, mark the serious manner in which the South African Government is approaching the issue. The Post and Telecommunications as well as the Transport Ministries are currently actively engaged in the search for strategic equity partners as well as large foreign and domestic investors for their respective privatisation initiatives. The acceptance by Congress of South African Trade Unions (Cosatu) central executive of a “partial privatisation” process also marks an important development.

Buoyed by trends towards substantial privatisation in the former Communist/Eastern Bloc countries as well as several Latin American and East Asian countries, one can regard the movement towards increased divestiture of formerly state-owned assets as a truly global phenomenon – in contrast to the hostility towards the policy of a decade ago, when only selected European and North American countries were seemingly indulging in the process, much to the chagrin of the rest of the world. Analysis of the underlying reasons frequently mooted for the widespread acceptance of such a policy reversal reveals several multifaceted sets of explanations. Indeed, taken to their extreme, some would regard the success of the marketing of privatisation as a catch-all reform initiative capable of solving almost every structural problem of developing and transforming economies. Whether these problems relate to the supposed increased efficiency in the private provision of “public” goods, to the substantial reductions in state budget deficits, to the possible injection of massive amounts of foreign investment, to empowerment and the development of an incipient entrepreneurial class, the so-called benefits of privatisation can be rationalised as an all-embracing solution to several of the above problems. The policy reform that can purportedly overcome as many of the above problems as possible – preferably in one fell swoop – becomes all the more persuasive in its acceptance. The central theme in the accompanying review is that such claims regarding the widespread benefits of privatisation may be exaggerated and that a more mooted approach to what privatisation can achieve, particularly in a South African context, is necessary. If the review succeeds in encouraging debate and introducing a more circumspect approach to the issue – it could help boost the attraction of the concept. The authors feel that if the many exaggerated claims regarding what privatisation can achieve, do not come to fruition, the policy itself may be sacrificed and even reversed. In short, the central theme emerging from this critical review is that in economies subject to transformation (such as Southern Africa and Eastern Europe) in particular, although definitionally privatisation implies a reduction in State ownership in selected enterprises and industries, it does not necessarily mean a reduction in the important role of the state in overall economic activity.

Indeed, a lack of State authority, accountability and transparency in policy initiatives could well jeopardise economic growth and stability substantially. Privatisation does not absolve Government from its basic responsibilities. In fact such responsibilities shift and if the State does not incorporate this shift, the entire policy objective could be threatened.

2

The theoretical underpinnings to the privatisation debate

Traditionally and historically, neo-classical economic theory has tended to focus on “market failure” as the only reason legitimising a role of state intervention. Such failures are considered as possibly occurring at three levels:

- a) demand-type failures, when individuals are considered to have insufficient information to rank in a rational fashion various alternative choices in order of importance.
- b) supply-type failures, which are associated with the familiar example of public goods and externalities, whereby firms will tend to underprovide in the case of a positive externality and overprovide in the event of a negative externality, implying subsidies or taxes to ensure optimisation in such provision and,
- c) market-structure failures which occur mainly in the presence of natural monopolies enjoying economies of scale. Other monopoly distortions, where the marginal revenue/marginal cost equality is disturbed, leading to allocative inefficiency, are also regarded as providing some justification for intervention, through regulation and anti-trust legislation.

An interesting aside to the regulation issue is the possibility of what Stigler considers as “regulatory capture” (Stigler, 1971). Dodgson, commenting on such capture, explains it as “the possibility that, in preference to continually battling with each other, the regulated industry and the regulatory agency may prefer to enjoy a cosy relationship in which regulation acts to protect the regulated industry from new competition” (Dodgson, 1987, p.222).

Lawson (1994) contends that the decision whether to create a State-Owned-Enterprise (SOE) or merely to regulate a private firm is dependent on the cost of monitoring such enterprises. In the event of high monitoring costs for private enterprises, even though they may be productively efficient, SOE’s may be preferred. Williamson interprets the Lawson argument to imply that the creation of an SOE is tantamount to a decision to vertically integrate the enterprise (Williamson, 1975).

As can be seen from the above, the case for state intervention has tended to focus mainly on two of the three commonly-listed failures, namely, the supply and monopoly situations. In some cases the supply factor is enhanced to incorporate the case of developing countries. Apart from the historically important “infant industries” argument, the latter set of arguments have attempted to take into account situations where, for example, capital markets are rudimentary, the ability of private firms to bear risks is lacking and markets do not successfully disseminate information. The rationale for such intervention is, in some instances, further extended to a more dynamic framework in the context of such countries to incorporate aspects such as the need to industrialise, particularly in sectors identified as having significant linkages with the rest of the economy – as well as helping achieve a variety of socio-economic goals such as employment creation, reduction of income and asset inequality and as a means of providing low cost services to poor communities.

Historically, an interesting aspect in the debate regarding the attraction of state intervention was that it, in turn, was used as an all-embracing, catch-all phrase to solve virtually any problem that markets failed to address. As has been pointed out, the marketing of privatisation is possibly following a similar development pattern. The failure of the state to deliver on a sustainable basis, (and to resolve some of the problems that were used as a basis of rationalising such intervention) has been analysed by various theoretical schools ranging from the public choice to property rights to transaction costs approaches, not to mention neo-classical theory itself.

Public choice theorists (e.g. Buchanan, 1978) contend that government officials are just as likely as private managers to maximise their utility. Although it is the role of politicians to monitor

the government officials, they in turn are self-interested and are motivated by maximising their chances of re-election (p.151). Consequently, pressure groups lobby politicians who subsequently run the public sector in the interest of these pressure groups.

According to the property rights literature, the owner-manager has an incentive to run the firm efficiently as he has claim to the residual. In public companies, there is a divorce of ownership from control. Supposedly the firm is owned by the shareholders but resources are controlled by the managers. However, if managers do not maintain profits, share prices will fall due to shareholders selling their shares and the firm will be vulnerable to a takeover. Hence, although both state-owned and private monopolies may be X-inefficient, one might conjecture that private monopolies are likely to be more efficient as private managers are constrained by the risk of takeovers if share prices fall below the potential value of its assets.

However, transaction costs may be significant and information asymmetries (between incumbent managers and shareholders and potential purchasers) may impede the market for corporate control. Further, the diffuse ownership of shares, as well as the fact that each shareholder may hold a diverse portfolio in order to reduce risk, combine to reduce the effectiveness of the market for corporate control – as each shareholder has less incentive to monitor every firm in

his/her portfolio.¹ Some agency models propose that shareholders should have greater involvement in decision-making and be provided with fuller information, in order to improve monitoring. However, Kay and Silberston (1995) point out that this is reminiscent of the role of the state in nationalised industries.

Both property rights and public choice theories conclude that public enterprises will not achieve technical efficiency. Further, if SOEs are subject to controlled prices or are monopolies then neither will they achieve allocative efficiency.

Consequently, efficiency gains resulting from privatisation are two-fold – due to ownership and competition. The threat of possible competition is an issue that Baumol addresses in his famous article dealing with contestable markets. Baumol (1982) submitted that what is important is not the number of firms in the industry but contestability – the threat of entry will constrain firms to produce at the allocative-efficient (price = marginal cost) and technical-efficient (i.e. minimal average cost) levels of output. But “for the threat to be effective there must be no natural or artificial barriers either to entry to the industry or to exit; such as the existence of sunk costs, (which) is important because firms will be reluctant to enter an industry if they know that if they prove unsuccessful they will be unable to avoid the losses implied by remaining in the industry.” (Dodgson, 1987, p.225.) Indeed, contestability may be more important than ownership.

¹ For a more specifically South African discussion of this issue see Brian Kantor, FMF Briefing Paper No. 16, *Corporate Restructuring and Competition Policy*. Kantor suggests this problem is less acute when stock markets (such as the JSE) are characterised by pyramid companies with strong owners.

3

The alternative forms of and rationale for privatisation

At first impression there appears little ambiguity regarding the meaning of privatisation. In its narrowest form, the concept refers to the sale of public sector assets. Several excellent review articles of trends in privatisation reveal a wider meaning when associated policies are incorporated (Bishop and Kay, 1989; Vickers and Yarrow, 1988). Additional to the direct sale of public assets, Jackson and Price (1994) include:

- deregulation,
- the opening up of state monopolies to increased competition,
- contracting out of public services,
- the private provision of public services in competition with the public provision,
- joint capital projects using public and private finance, and
- reducing subsidies and increasing or reducing user charges.

The above range of options serves to reinforce how, conceptually, “privatisation” can be expanded to beyond the narrow confines of the interpretation. The more obvious and pervasive theme common to all the above variations is the reliance on the market mechanism – rather than the administrative fiat of the bureaucracy – in the quest to establish superior allocation of resources (Jackson and Price, 1994). This element is central for advocates of the policy, in that the reliance on markets would ensure enhanced resource allocation through the greater incentives for cost minimisation, more effective managerial supervision and greater employee effort. In addition, when the performance of privatised corporations is judged by criteria such as financial profits and returns on capital rather than what some privatisation advocates would regard as vague, ephemeral and subjective socio-economic criteria such as employment generation, poverty alleviation etc. – it is not only the structure of incentives that are altered but more relevantly the criteria for judging success (Jackson and Price, p.7).

A careful reading of the World Bank and other pro-privatisation literature reveals that it is essentially the reliance on the “efficiency” criterion that has dominated much of the rhetoric on the nature and form of privatisation (being associated with asset transfer to the private sector).

The central argument is that private sector ownership is preferable to state ownership as a means of achieving such a goal.

As Holden and Rajapatirana (1995) explicitly state, “The goal of privatisation, stated simply is to increase the role of the private sector in the economy, thereby promoting the more efficient use of resources.... Alternatively, privatisation can be viewed as putting more resources at the disposal of the private sector, thereby promoting efficiency and growth” (p.75).

While Kikeri, Nellis and Shirley (1992) are less explicit regarding the superiority of private enterprise over state ownership in achieving this goal, their emphasis on improved efficiency maximising the benefits of privatisation involve a reliance on competition in attaining the objective (p.6).

The most recent World Bank *World Development Report* (1996) confronts the issue regarding ownership quite directly in its survey of the reconstruction of Central and Eastern European Economies. Posing a question as to whether it matters whether property is privately or publicly owned, the *Report* cites “extensive empirical literature concluding generally, (but not uniformly), that private firms exhibit higher productivity and better performance than public enterprises” (p.49). Citing additional evidence of performance before and after privatisation for sixty-one companies in a variety of developing as well as industrialised countries, at least two-thirds of the divestitures showed post-privatisation increases in profitability, sales and capital investment (*op. cit.*).

Given that the concept of efficiency is so crucial to the above debate, there appear several contradictions worth mentioning. Apart from the frequently-cited externality and imperfect competition arguments being frequently overlooked, the above position fails to distinguish between allocative and technical/productive efficiency. Much of the popular literature on privatisation has tended to focus on technical efficiency and ignore allocative efficiency. As Jackson and Price conclude, this frequently results in policies of cost-cutting – while policies that might result in prices reflecting costs more closely are frequently ignored (1994,p.8). Moreover the preoccupation with efficiency on such a static and short-term basis has frequently resulted in other issues such as distribution and longer term economic stability being overlooked. For longer-run dynamic efficiency, one has to consider questions regarding the effectiveness of investment in future productive capacity, as well as decisions being made based on correct and undistorted long-term prices. Comparisons of the type alluded to above in the *1996 World Development Report* are still too premature to answer these issues. The emphasis on short-term efficiency criteria also avoids analysing the behaviour of certain macroeconomic variables such as inflation and unemployment.

Indeed, while the more recent rationale for the attraction of privatisation has been as a direct result of pressures of structural adjustment programmes to curb government budget deficits, and hence place some macroeconomic emphasis on the programme – much of the analysis of even this aspect has been articulated in terms of the short-term benefits of more prudent finance. Seldom has the analysis questioned the longer-term costs to society of an often quite ruthless slashing in expenditures or for that matter examined how the proceeds of privatisation have been used.

Even within the confines of the conventional static efficiency argument, contradictions abound. A frequently-held position regarding the benefits of privatisation is that management of such an enterprise is accountable to shareholders even under conditions of explicit economic regulation. This is regarded as preferable to reporting to a government minister under a soft budget constraint and with what Jackson and Price refer to as vaguely defined objectives (p.10). A possible contradiction can emerge, however, when share-ownership becomes too diffuse, thus reducing shareholder power and not guaranteeing maximum efficiency. The control over management of newly-privatised firms could thus be weakened. Jackson and Price cite some additional arguments that defy the predictions of the static efficiency hypothesis. The first of these relates to the issue of efficient profitable SOEs. Another set of arguments concerns evidence where takeovers and changes in ownership, from SOEs to private ownership or within private ownership, has not necessarily resulted in improved performance.

The above section has hopefully presented some insights into the debate regarding the meaning and rationale of privatisation. While its meaning appears unambiguous, there appears some confusion regarding its rationale. The central concern for advocates of privatisation seems to rest with short-term efficiency criteria. As such, the case for privatisation is not strong enough to be subjected to rigorous examination. Given that privatisation in many countries has only been a recent phenomenon, it may be too soon to make claims regarding the superiority of private ownership over state ownership or indeed other forms of privatisation with regard to both allocative as well as technical efficiency considerations. While evidence is suggestive it is not conclusive, and there remains the danger that if one defines success solely in terms of short-term criteria such criteria could be tautological.

In one of the few truly innovative attempts to compare efficiency and profitability for the so-called largest or *Fortune* “top” 500 companies for 1983, (which were not located in the United States), Boardman and Vining concluded that privately-owned corporations performed better than either mixed or state-owned corporations on the above criteria (1989). Their approach was critical of some earlier efforts at obtaining empirical evidence, in that these previous studies were restricted to ownership in a non-competitive environment. Using least square analysis, variable means and standard deviation tests and controlling for a wide variety of factors to simulate a competitive environment for the various enterprises, their analysis showed that mixed enterprises performed “no better and often worse” than pure state-owned enterprises on a variety of criteria (p. 26). The problem with the Boardman and Vining analysis, however, is that it is essentially based on short-

term data and does not take into account some positive externalities that may be generated by SOEs and thus impact positively on sales/turnover and profitability criteria of the private enterprise sector. In addition, the fact that these authors have only included the top performing corporations is questionable in that non-“successful” less efficient enterprises are not analysed.

4

The widespread take-off to privatisation

While definitional problems persist with regard to the accurate meaning of the concept, these have not deterred some quantitative estimates of the extent of privatisation during the past few years. There is now widespread consensus that “privatisation” has moved far beyond being a rhetorical buzzword to one of the most significant policy options of the latter decades of the twentieth century.

In fact, given that the term did not exist until the mid-eighties,² the incipient sale of British Telecom in 1984 ushered in a policy shift, the dimensions of which have proved startling.

The most profound change has been experienced in Eastern Europe and the countries of the former Soviet Union after the fall of communism. Estimates for several countries in that region show that the Gross Domestic Product (GDP) share attributable to the private sector had reached levels of over 50 per cent by the mid-nineties, compared with under 20 per cent at the onset of the decade (International Finance Corporation, IFC, 1995, p.9). The shift has not only been confined to this vast geographic area. In addition to the frequently-cited large privatisations that occurred in many industrialised countries during the 1980's, a significant feature of the more recent period has been the extent of privatisation in developing countries since then. The IFC data-base of larger non-voucher-based sales to the private sector records 2,655 transactions in 95 countries between 1988 and 1993, yielding US\$ 271 billion in revenues (IFC 1995, p.9). Industrialised countries accounted for US\$ 175 billion of this and 15 per cent of transactions, – so over the period it was estimated that developing countries accounted for over 85 per cent of sales and some 35 per cent of all revenue generated. In the developing world, the bulk of privatisations took place in Latin America and the Caribbean region, (57 per cent by value), while Europe and Central Asia accounted for some 19 per cent (IFC, 1995, p.9). Sub-Sahara Africa, the Middle East and North Africa were regarded as minimal in this total share. What is also of interest from the above data base is the fact that infrastructure transactions (telecommunications, energy, water and transportation), tended to dominate the realised revenues of such sales in the developing countries (33 per cent), particularly in Latin America – while in Eastern Europe and Central Asia industrial enterprises accounted for over half of the sales. Also in terms of the technique of privatisation, direct sale tended to be preferred – accounting for more than four-fifths of the transactions, and 58 per cent of revenues, while public offer sales accounted for 12 per cent of transactions and just under 40 per cent of revenue, in developing countries (IFC, 1995, p.10).

The above statistics tend to show that sub-Sahara Africa has tended to lag behind several other developing regions in its privatisation efforts. But more recent trends indicate that even in this region, there has been a significant policy shift with regard to the implementation of privatisation. World Bank statistics in *African Development Indicators* show that for sub-Sahara Africa the number of “public enterprises” had declined from 4669, before 1990, to 2934 in 1995. While some of this could be attributed to rationalisation, closing and merging of State Departments in several countries etc., the total number and sales value of privatisation transactions since 1990 indicates a marked upward trend with an average in excess of 250 enterprises being sold each year yielding a total of close to two billion dollars worth of sales. Angola, Ghana, Guinea, Kenya, Mozambique, Nigeria, Tanzania and Uganda dominated the number of sales, while Zambia has recently entered the fray with major sell-offs in the offing (World Bank, *African Development Indicators*, 1996, p.280).

While many could quibble with the accuracy of the above statistics, in that they are based on definitional assumptions regarding ownership transfers yielding substantive independent powers to private operators, the trends are undeniable. The widespread adoption of this policy in developing countries can be attributable to a variety of reasons. First and foremost must be the record of State-owned enterprises in developing countries which in the vast majority of cases have proved

economically inefficient and have incurred heavy financial losses, to the extent that countries have been unable to sustain these in their budgetary expenditures. This unsustainable burden has been a constant theme of attempts by international financial institutions to impose fiscal and financial discipline on Governments of developing countries. Whether this argument is sufficient to justify privatisation and transfer of control to private ownership is an issue for debate. There certainly are cases of successfully-run-State-owned enterprises (even though these may be exceptions), and there are equally cases of poorly-run private operations (which of necessity must be exceptions). In theory, a state-owned firm should operate as efficiently as a privately owned firm, if they both operate in a competitive market setting and if their behaviour is governed by the same rules and incentives. Given the latter, the issue then becomes one of competition and regulation rather than simply one of ownership. In fact, privatisation, particularly of large infrastructural projects, could reinforce anti-competitive behaviour through monopoly control. As Kikeri, Nellis and Shirley (1994,p.244) point out, the comparison of the performance of public with private enterprises (mostly based on experiences in industrialised countries) has not consistently provided evidence that ownership *per se* matters. Citing Vickers and Yarrow in their excellent survey (1988), the argument should possibly focus on making markets (including capital markets) work well.

The above argument does not provide an entirely adequate case for privatisation. When coupled with the theoretical aspects raised in the previous section regarding the lack of definition of efficiency and the possible means of attaining maximum efficiency, the issue becomes more clouded. The dominant reason for its popularity in recent times relates to the possible cumulative wide range of economic and political objectives that privatisation is capable but not necessarily guaranteed to offer. In the context of developing countries, and countries in a state of economic reconstruction in particular, such as the former communist states – such arguments become particularly attractive. When sanctioned and even sanctified by international institutions and investors, the acceptance becomes unquestioned.

A cursory glance at the marketing of the privatisation policy by, for example, the World Bank and its associated International Finance Corporation reflects this well:

That privatisation can deliver a wide range of economic benefits is now a view so widely held that it scarcely needs elaboration. These benefits can include improving enterprise efficiency and performance, developing competitive industry which serves consumers well, accessing the capital know-how and markets which permits growth, achieving effective corporate governance, and, of course, getting the best price for the sale. There are wider economic benefits, too, which spill over to the rest of the economy; developing capital markets for example, or developing models for future replication. Most of the above is attractive to governments, but governments also have more overtly political aims. When the British Government privatised British Telecom it was seeking to create a new class of small shareholders, who would make re-nationalisation politically difficult. In the former Soviet Union and Eastern Europe, the swift transfer of assets to private hands was an overridingly political aim: it was understood that economic benefits might not be immediate. Other political objectives include achieving a wide shareholder distribution, targeting certain classes of buyers (and excluding others, particularly foreigners), ensuring that enterprises do not close, reducing budget deficits/raising money and maintaining employment and other social obligations... (IFC, 1995, p.7).

In their discussion regarding the widespread acceptance of privatisation, Kikeri, Nellis and Shirley (1994, p.247) also list a range of reasons apart from the high costs of poor performance of State-owned enterprises. These include the shifting trends in thinking in development theory and ideology, the “success” (*sic*) stories of early privatisers, such as the United Kingdom, fiscal crises of many governments that have led these states to raise revenues and stem losses, the inability of State enterprises to finance much needed investment for new technology, as well as the emergence of a dynamic private sector. The above is illustrative of how much of the debate on the merits of

privatisation has shifted from its initial focus on purely microeconomic phenomena (such as efficiency, corporate governance, monopolies, consumer and producer welfare etc.) to becoming a much more widespread recipe for success. In a way the expansion of this debate to incorporate wider effects than simply efficiency criteria is a positive one – as is discussed in the introduction to this survey, where the authors bemoaned the too narrow focus emanating from the privatisation definition. But the authors fear that discussion has moved too far in the opposite direction. The concept has now become a *sine qua non* for economic advancement in that it is in danger of being elevated to a catch-all recipe for success. It is almost as if the advocates for the policy are saying that there may be (as in fact there are) problems with the materialisation of some of the benefits of the policy – but because it is capable of addressing several additional economic maladies, there must ultimately be some benefit, irrespective of the failure of privatisation to correct some of the other more urgent problems. In a sense the debate tends to be following the route that foreign aid discussions assumed during the nineteen-sixties and seventies – one has only to hope that the privatisation debate does not become as sterile as the foreign aid debate proved.

- 2 **Editor's note:** Most people would probably agree with this statement. One author – who claims to have originated the term much earlier – in 1969 – would not. He is Peter Drucker, who did so in his book *The Age of Discontinuity*, Harper and Row, Ch. 10. Drucker further discussed the concept and his claim to origination in *Innovation and Entrepreneurship*, William Heinnemann, 1985, p.167.

5

The alternative routes of privatisation

The *World Development Report* (1996) although exclusively devoted to market transition in the centrally-planned economies of Central, Eastern Europe, the newly independent states of the former Soviet Union, China and Vietnam – contains a useful discussion of some of the trade-offs involved in alternative methods of privatisation. Although some of these are quite specific to the countries under review, there are some pertinent lessons for other countries embarking on such initiatives. The World Bank admits that the privatisation of larger and even medium-sized enterprises has proved far more difficult than originally envisaged.

Policymakers have had to weigh complex and often competing stakeholders, and cope with the administrative difficulty of privatising thousands of firms in a relatively short time and without mature, functioning capital markets (pp.50-51).

Various approaches to privatisation have ranged from extensive efforts at sales to strategic owners, to insider buy-outs, to innovative voucher programmes involving the creation of large and powerful intermediaries. These were complemented (and in some cases complicated) by extensive efforts at restitution to pre-transition owners, as well as programmes of debt-equity conversion and the public offering of shares on some of the specifically-constructed and newly-emerging stockmarkets in the transition economies.

As the accompanying table (reproduced from the *World Development Report*, 1996, p.52) shows, each approach to privatisation creates trade-offs among the various objectives of the process.

Privatising countries typically want many things, to increase efficiency of asset use by improving corporate governance, depoliticise firms by cutting links to the state; create owners who will support further reform, to increase firms' access to capital and expertise; to bolster government revenues; and to ensure a fair distribution of benefits (op. cit. pp.51-52).

Using these criteria, the Bank acknowledges that various countries would have different priorities and some may wish to proceed more quickly than others.

Each of the various methods of privatisation is subjected to a detailed analysis in terms of some of the partial criteria listed in Table 1.

a) Sales to outsiders

Sales to outsiders imply the transfer of title in equity to foreign and local investors. This model, which has been successful in established market economies like the United Kingdom and in middle income developing countries, – while explicit in its intention to bring in revenue and ensure that owners would possess the expertise, knowledge and incentive both to govern the company efficiently and raise capital to restructure the enterprise, – suffers several disadvantages. It can prove costly and slow to implement, local capital may be limited and political tensions could abound if there is large dependence on foreign capital. Moreover the present and future valuation of the enterprise could prove problematical, particularly in the absence of an indication of the regulatory environment and future competition policy. The search for a strategic equity partner as well as a public stock/capital market flotation could be categorised under this heading. Countries dominated by large conglomerates could experience difficulty with the notion of privatisation leading to a “people’s capitalism” and a nation of shareholders, while at the opposite extreme, too diverse a share ownership could nullify and contradict notions of efficient corporate governance. In

addition, as Gray (1996) argues, in the case of a sellout where ordinary citizens are unable to participate, individual deals often appear arbitrary, even in some cases, corrupt – particularly as some dealings with large domestic or foreign investors, have been negotiated with packages of incentives and favourable legal regulations on an arbitrary case-by-case basis.

b) Management-employee buyouts

Management-employee buyouts involve the transfer of ownership to existing management and employees. These are considered to be more appropriate for medium- and smaller-scale enterprises that are not widely geographically dispersed. They were a widely used alternative to actual sales in Croatia, Poland, Romania and Slovenia, where employees and their families used vouchers and cash to buy major stakes in their own firms. While such a method is regarded as being relatively fast and easy to implement and while it ranks highly in terms of corporate governance, efficiency, reward for effort criteria, – in that issues of monitoring by “insiders” are easier than is the case with outsiders, – the risks and disadvantages are manifold. Benefits could be unevenly distributed between firms that vary according to their level of success. Employees in profitable companies get valuable assets while those in historically unviable and outmoded industries get little or nothing of value. Another negative is that governments charge low prices to insiders and accrue little revenue. Insiders may generally be regarded as being unable to introduce new skills and capital and could be resistant to outside interference. In some cases the lack of an efficient institutional financial framework has exacerbated these difficulties.

c) Equal access voucher privatisation

Privatisation by vouchers involves the creation and distribution of vouchers as a form of equity. The vouchers may be share certificates *qua* share certificates, or alternatively they may award the means of acquiring such certificates in exchange for the vouchers, with or without cash support. This interesting scheme, whereby vouchers are distributed across the population on an even basis among the voucher holders, is regarded as highly effective in terms of speed of implementation and equity. However, such distributions may not raise revenue for government and the implications regarding corporate governance are unclear. Mongolia, Lithuania and the former Czechoslovakia were the first to implement this form of privatisation. A variation on the “giveaway” option is that low-priced vouchers are sold, and these can be used to purchase shares in companies. This could generate or enhance domestic capital. Not to be underestimated (and an issue that was particularly pertinent in the Eastern European experience) is the ability of such initiatives, if well-designed, to stimulate the development of capital markets and stock market trading, thus fostering further ownership change as well as hastening the development of corporate control. As Gray refers to the process – “It can, in effect, privatise the privatisation process” (1996, p.190). Spontaneous privatisation would incorporate, *inter alia*, restitution, transfers to municipalities or social insurance organisations, debt-equity swaps and sales through insolvency proceedings – the overall effects of which are difficult to assess in terms of the above criteria.

Table 2 (also reproduced from the *World Development Report*, 1996, p.53) shows the principal methods of privatisation for medium-sized and large enterprises in a variety of transitional economies.

Table 1: Tradeoffs among privatisation routes for large firms

Method	Objective Better corporate governance	Speed and feasibility	Better access to capital and skills	More government revenue	Greater fairness
Sale to outside owners	+	—	+	+	—
Management-employee buyout	—	+	—	—	—
Equal-access voucher privatisation	?	+	?	—	+
Spontaneous privatisation	?	?	—	—	—

Source: *World Development Report*, 1996, World Bank, p.52

Table 2: Methods of privatization for medium-size and large enterprises in seven transition economies

Country	Sale to outside hands	Management -employee buyout	Equal-access voucher privatisation	Restitution	Other	Still in state
<i>Czech Republic</i>	owners	buyout	privatisation			
By number	32	0	22	9	28	10
By value	5	0	50	2	3	40
<i>Estonia</i>						
By number	64	30	0	0	2	4
By value	60	12	3	10	0	15
<i>Hungary</i>						
By number	38	7	0	0	33	22
By value	40	2	0	4	12	42
<i>Lithuania</i>						
By number	<1	5	70	0	0	25
By value	<1	5	60	0	0	35
<i>Mongolia</i>						
By number	0	0	70	0	0	30
By value	0	0	55	0	0	45
<i>Poland</i>						
By number	3	14	6	0	23	54
<i>Russia</i>						
By number	0	55	11	0	0	34

Source: *World Development Report*, 1996, World Bank, p.53

6

A brief case study of privatisation in South Africa - telecommunications

The first major privatisation scheduled by the post-apartheid Government in South Africa is that of TELKOM, early in 1997. This follows international trends in the telecommunications industries throughout the world, whereby the legitimacy of state-run monopolies has been eroded. The telecommunications industry worldwide has, since the mid-eighties, been vastly restructured, and is dominated by global consortia. As a result of technological advances in the industry, the “natural monopoly” status of former State-owned utilities has evaporated and historically accumulated debt in these mainly (although not necessarily) inefficiently-run corporations has tended to drain the State’s resources and inhibit the adoption of this modernised technology.

The *post-apartheid* South African Government has recognised the manifold problems of the industry. Faced by an impatient electorate demanding an improved provision of infrastructure to a vast section of the population formerly denied any access to basic modern infrastructure (for example it has been estimated that South Africa in 1995 had 8,4 telephones per 100 persons, and in many rural areas the average is substantially worse), the parastatal has however inherited a substantial accumulated debt. Before any expansion can occur, any profits generated by TELKOM must be diverted to servicing these debts. As Rix and Jardine state, there is acknowledgement that the capital needs for expansion in South Africa are beyond TELKOM’s capacity to carry extra debt on top of its existing R8,5 billion level (Rix and Jardine, 1996). Estimates regarding future capital expenditure amount to R29 billion by the turn of the century (President’s Office, 1996).

The options available to the telecommunications authority for overcoming these seemingly incompatible goals involve:

- a) searching for a strategic equity partner to help provide the necessary expertise and capital;
- b) selling the utility to the public generally or to a set of international consortia. The former would have to incorporate in its selling price a realistic evaluation of the enterprise that would incorporate the level of present and expected future debt, while the latter option could include the subjection to certain conditions such as the achievement of certain investment targets and universal service. The privatisation approach described here would involve a high degree of regulation, which should be carefully stipulated at the outset;
- c) inviting a competitor in the provision of basic services to improve penetration rates and enhance the delivery of infrastructure to areas currently in need. This latter option could involve direct competition between the current operator and the future competitor, or an arrangement whereby the two enterprises could work in liaison with each other. This approach may also require regulation to ensure that the incumbent operator does not charge the entrant excessive rates for network interconnection;
- d) opening markets by deregulation to any entrant that could service, reasonably effectively, certain niche markets;
- e) contracting out of smaller services such as printing telephone directories repairing connections, wires or cables and instruments. This option, however, would be relatively minor in its effect on capital expenditure and debt ratios;
- f) maintaining the *status quo*, whereby the Government holds on to its dominant share in the enterprise and allows a degree of managerial autonomy in setting rates and charges. The problem with this option is that rates and charges would have to escalate to such an extent that alternative forms of communication would become even more attractive and increased losses would eventuate. Alternatively, dramatic cost-saving technology could be introduced which

could be translated into lower charges. This would depend on the availability of finance to introduce this technology and the reaction of labour unions to this downsizing.

The above options are not necessarily mutually exclusive. As has been the international experience, a combination of options can be available. It appears that the first (Strategic Equity) option has been accepted by the South African Government and that the State would still maintain its dominant share in the parastatal. Sensitive to the criticisms of sacrificing control of the enterprise to foreign owners, or of incurring the wrath of trade unions, should substantial labour retrenchments without severance packages generously above the legally required minimum be effected, the State has deliberately opted for partial privatisation rather than a complete sell-off. Whether or not this option will meet the seemingly incompatible needs of the parastatal in the long-term future is difficult to express an opinion on at this juncture. Given that telecommunications represents such a critical industry, not just by itself but because of its importance to virtually every other industry – in terms of its ability to facilitate and develop the transmission of information – countries can ill afford to have an ailing industry. At the same time, the lack of co-ordination resulting from telecommunication industries which originate in countries with different socio-economic needs and cater only for niche markets based on profit motives, could be equally harmful. Perhaps the option of retaining a state majority share in TELKOM and inviting a strategic partner is the only viable one, given the present environment. Over time, when conditions change, a reprioritising of the above options may be more viable. The possibility for success or failure in what seems to be accepted policy in South Africa would revolve around the ability of a regulatory environment to achieve certain objectives. The issue is a delicate one in that over-regulation could prove detrimental to a future partner, while too little regulation could adversely impact on objectives beyond debt repayment requirements and profits. Constantly changing regulations introduce a variety of additional problems such as uncertainty, lack of credibility and short-term policies that could impact adversely on long-term goals. Given the rather unique socio-economic structure of South Africa, privatisation solutions with regard to telecommunications that have been successfully adopted elsewhere may not necessarily be optimal to the country's needs.

Conclusion

The above overall analysis, despite being relatively non-controversial, has hopefully been revealing and thought-provoking. The broad conclusion can be summarised in the following way: there is an imminent danger that if there is too widespread a set of expectations as to what is achievable through the policy and these do not, for some or other reason, come to fruition, or if some are achieved to the exclusion of other benefits, the credibility of the policy will collapse. This argument is very pertinent to the way in which privatisation is being debated in South Africa at present. Additional to some of the general reasons given above, many believe that privatisation in South Africa will act as a boost to Black economic empowerment, will encourage vast amounts of foreign investment (the latter possibly conflicting with the former), will enable the Government to pursue a policy of socio-economic upliftment through the revenue earned from the sale of such enterprises, and will help foster small and medium scale enterprises in the country. Many of these are rhetorical arguments and if other more important objectives are sacrificed in order to ensure that some of the latter objectives are reached, the process is doomed to fail. Privatisation in South Africa at this delicate stage of development has to be carefully thought out. The process has to be realistic in setting out what is achievable and attainable. It should not be construed as a universal prescription capable of rectifying the many economic problems confronting the economy in its democratic transition. The question of what industries to privatise, what form of privatisation to use, how to privatise and what kind of regulation and competition there should be are all crucial to the debate.

The essence of the overall argument regarding privatisation, universally, appears to be that much of the original *raison d'être* for State-owned enterprises is believed to have little relevance in the present state of the world economy. With the massive revolution in global technology, telecommunications, transport etc. the notion of a global village has indeed become a reality. An example of this development is the former socialist countries and the establishment of reasonably well functioning capital markets in these countries, a situation which did not exist until very recently. Alternatively, the widespread tendency in many state-owned corporations to inefficiency, in terms of management and productivity, has meant that increasing losses have occurred and that fiscally-constrained Governments have great difficulty in bearing such losses. Furthermore the rather widespread tendency towards bribery and corruption of state officials in many of these enterprises has been an enormous source of concern, the belief being that the solution is to transfer these enterprises to private hands. There may, however, be validity in the concern, in some cases, that economic liberalisation and privatisation could actually exacerbate efforts at rent-seeking behaviour by government officials as well as the newly-privatised sector, seeking to profit from these possibilities (*Institute of Development Studies (IDS) Bulletin*, vol.27, no.2, April 1996).

The above discussion has attempted to grapple with the question as to why privatisation has taken off to the extent that it has become one of the global strategies of the 'nineties in most countries. As suggested, it is not necessarily because all privatisations have proved a success, in terms of the ultimate criteria of efficiency, improved performance and enhancement of welfare. As problems have emerged with some of the specific criteria, the list of objectives has become more widespread and is presently in danger of becoming a type of catch-all recipe for economic success. To be fair to the "privatisationists", it must be emphasised that it is very difficult to evaluate the effects of privatisation separately, despite several admirable attempts at this (see for example, Galal, Jones, Tandon and Vogelsang, 1994).

As Van der Hoeven (1996,p.7) points out, privatisation is often undertaken in tandem with other economic reforms. The success or failure of privatisation is often closely related to the success or failure of the whole economic reform process. It is often difficult to develop a counterfactual scenario relating to what would have happened in the absence of privatisation, other things being equal. Along similar lines, to blame privatisation for all the countries economic ills when other Government policies have proved inimical to its possible success is unjust. Chang (1995, p.14) makes a similar point to Van den Hoeven regarding the difficulty of isolating the effects of

privatisation and deregulation from other liberalisation policies. He adds several additional assertions that are crucial to the debate. Firstly, the fact that several countries enjoyed a modicum of success from their deregulation efforts could be attributable to the possible nature of the industries concerned, in that in such industries there were few economic justifications for regulation in the first place. Examples of these include the trucking industry in the United States and the long distance telecommunications industry where technological changes rendered the old regulatory regime obsolete. In addition, Chang adds a frequently-overlooked point, crucial to the assessment of the overall success of privatisation. While there is irrefutable evidence of some sectoral success stories, it is at the national level that the impact of privatisation seems much less positive – the two leading countries in deregulation, namely the United States and the United Kingdom, have not succeeded in consistently sustaining improved economic performances after their deregulation drives. In fact as Fine (1990) points out, one of the effects of privatisation could well be a sacrificing of an overall industrial strategy and decreased overall economic performance – as certain key industries on being privatised sacrifice the need for a general industrial policy.

In summary of the above arguments, it is important to realise that any assessment of privatisation needs to be cognisant of the fact that many of the claims regarding the benefits of privatisation are at best conducted in a partial (no pun intended) manner. Extending individual sectoral success stories to a general recipe for all countries to follow is not necessarily the best policy to cope with the manifold economic problems of various countries.

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