CHAPTER II

Privatization: Concept, Rationale and Methods

2.1 Introduction

This chapter seeks to examine the theoretical background of privatization. It will first try to understand the concept of privatization including the three main approaches to it. It will then analyze the different reasons that lead governments to opt for privatization concentrating mainly on four broad areas. Next it will touch upon some of the different mechanisms that have been adopted to bring about privatization. Finally, it will attempt to examine the consequences of privatization.

2.2 Theoretical Background

2.2.1 The Concept of Privatization

Privatization is one of the most difficult terms to define essentially because it means different things to different people. As Paul Starr says, privatization is a 'fuzzy concept that evokes sharp political reactions'[1]. The definition used by Beesley and Littlechild to 'mean the formation of a Companies Act company and the subsequent sale of at least 50 per cent of the shares to private shareholders' (1992: 23) is a rather restrictive one that does not convey the full implications of the concept. Gayle and Goodrich, on the other hand, took a much broader view of privatization when they wrote that as a process, privatization denotes reducing the

[1] Starr, Paul, "The Meaning of Privatization," *Yale Law and Policy Review* 6 (1988): 6-41. This article also appears in Kahn, Alfred and Sheila Kamerman (eds.) *Privatization and the Welfare State*, Princeton University Press, 1989.

roles of government, while increasing those of the private sector, in activities or asset ownership. In practice, privatization may include 'load shedding' or divestiture, the replacement of budgeted public activity by private market mechanisms such as consumer cooperatives, co-production, variously structured public/private-sector partnerships, state management contracts such as monopoly franchises for the private supply of public services, user charges, lease-purchase arrangements, and even tax reduction, intended to stimulate private-sector investment (1990: 3).

A similar approach was taken by Cook and Kirkpatrick when they referred to 'privatization' as a term that is used to describe 'a range of different policy initiatives designed to alter the balance between the public and private sectors' (1988: 3). Kate Ascher also describes privatization as 'an umbrella term' that has come to describe a multitude of government initiatives designed to increase the role of the private sector (1987: 4).

This is also the view expressed by Reeves when he wrote that the term 'privatization' is most commonly used to describe the process of de-nationalization, i.e. the sale of all or part of a state company to private investors by means such as a stock market or private placement. However, the term extends to a host of arrangements whereby governments withdraw from the production and finance of goods and services (Chowdary, 2003: 173).

Adam, Cavendish and Mistry too indicate that the term 'privatization' has been used to describe an 'array of actions' designed to broaden the scope of private sector activity, or the assimilation by the public sector of efficiency-

enhancing techniques generally employed by the private sector (1992: 6). This is however considered a 'loose definition' which results in privatization often being viewed as a goal in itself rather than as simply a means to an end. Privatization is seen essentially as a *process*, and an 'analytically correct definition of privatisation' is therefore regarded as 'the transfer from the public to the private sector of the ownership and/or control of productive assets, their allocation and pricing, and the entitlement to the residual profit flows generated by them' (1992: 6).

In fact, most researchers have recognized that 'privatization' can be defined in narrow or in broad terms. Ramamurti, for instance, refers to the narrow definition as 'any measure that transfers some or all of the *ownership* and/or control over SOEs to the private sector' (2000: 526). This definition, according to him, treats privatization as a continuous variable, with many possible intermediate forms of public-private partnership. The broad definition, on the other hand, refers to any measure that increases the role of the private sector in the economy – for example, through *deregulation*, which permits private entry into markets previously reserved for SOEs; *economic liberalization*, which exposes them to greater competition (e.g., through lower tariffs or fewer restrictions on foreign investment); or *institution building*, which improves the functioning of private firms and markets. He, however, makes it clear that privatization in one sense does not always imply privatization in the other sense, because countries can and have privatized SOEs without deregulating their industries, liberalizing the economy, or strengthening institutions (2000: 526).

Paul Starr, on the other hand, felt that privatization had come primarily to mean two things: (a) any shift of activities or functions from the state to the private sector; and, more specifically, (b) any shift of the production of goods and services from public to private. Making a similar distinction between the broad and narrow definitions of privatization, Starr indicates that while the broader definition of privatization includes all reductions in the regulatory and spending activity of the state, the more specific definition of privatization excludes deregulation and spending cuts except when they result in a shift from public to private in the production of goods and services (1988: 5).

In fact, Starr further clarifies to say that in his view, privatization should refer to 'shifts from the public to the private sector, not shifts within sectors.' Thus he feels that corporatization whereby a state agency is converted into an autonomous public authority or state-owned enterprise is not privatization, though it may well put the enterprise on a commercial footing. He describes these sorts of 'intersectoral changes' as 'commercialization.' He, however, concedes that in the case of public agencies, commercialization is sometimes a preliminary stage to privatization (1988: 6).

Similarly, Chowdary points out that privatization, in its broader sense, stands for policies aimed at reducing the role of the state and assigning a larger role for the private sector pursuing the logic of the market in all economic decisions (2003: iv). This process would subsume several parallel activities such as dereservation and deregulation also, apart from disinvestment. In fact, according to him, the dereservation process has sometimes been described as

'Parallelization' in the privatization framework. He is of the opinion that privatization is also witnessed when governments take a decision to reduce their obligations to regulate and direct the behaviour of private actors in the economy. However, he too agrees that privatization is most often associated with transfer of public sector enterprises and services to private ownership, management and control. The privatization process, according to him, can involve steps ranging from dilution of state-held equity, to adoption of practices, sub-contracting of select activities and tasks, downsizing of workforce, and changes in the process of decision-making even without change in ownership, so that business decisions are guided by market and commercial principles of profit maximization than vague societal concerns (2003: v).

Naib, too, takes a comprehensive view of privatization. According to him privatisation refers to a 'variety of policy instruments' which can be broadly divided into partial or total ownership transfer, management transfer, and marketisation which includes distancing of SOEs from government. Thus, privatisation covers a wide spectrum of possibilities between denationalization at one end and market discipline at the other. Disinvestment, which is a form of ownership transfer, comes under the umbrella of privatization (2004: 26).

He further goes on to indicate that the wide range of privatization activities can be divided into three broad measures. The first modality, according to him relates to *ownership transfer*, which may be partial or total. The second modality is *management transfer*, which includes management contract, lease, and joint venture. The third modality is *marketisation*, which would include

distancing of state-owned enterprises from government control, providing autonomy, liberalization and deregulation. Naib also refers to the two phrases coined by Dr Y. V. Reddy, namely '*greenfield privatisation*' and '*cold privatization*'[2]. While greenfield privatization implies encouraging private enterprises in areas hitherto reserved for the public sector, cold privatization refers to measures taken to distance public enterprises from the government. According to Naib, these are included in the marketisation category (2004: 112).

The most common usage of the term, however, refers to a change in the ownership of an enterprise, wholly or in part, from the public to the private sector (Cook and Kirkpatrick, 1988). The term 'government initiatives' used by Ascher (1987: 4) is significant in the sense that it highlights two aspects of privatization, namely that (a) it refers to the transfer of state ownership in nationalised industries to the private sector, and (b) that such transfer would not happen by itself but would have to be brought about by the government through specific initiatives.

Starr too distinguishes between 'demand-driven privatization' as against privatization that is 'predominantly policy-driven'. In fact, he finds that there are four types of government policies that bring about such a shift. First, the cessation of public programs and disengagement of government from specific kinds of responsibilities represents what he calls 'an implicit form of

[2] See Sankar, T. L & Y. Venugopal Reddy, "Privatization of Activities and Enterprises in the Public Sector in India" in Geeta Gouri (ed.), *Privatization and Public Enterprise: The Asia-Pacific Experience*, 1991, New Delhi: Oxford & IBH Publishing Co. Pvt. Ltd, p. 550. Apart from these two terms, Reddy uses one more term i.e. 'distressed privatization' to refer to a situation when a loss-making enterprise is turned over to the private sector because the government can no longer support and sustain it.

privatization.' According to him, the restriction of publicly produced services in volume, availability or quality may lead to a shift by consumers toward privately produced and purchased substitute. Secondly, privatization may take the explicit form of transfers of public assets to private ownership, through sale or lease of public land, infrastructure, and enterprises. Thirdly, instead of directly providing the service, government may finance private services, for example, through contracting-out or vouchers. Finally, privatization may result from the deregulation of entry into activities previously treated as public monopolies.

These different forms of privatization further vary, according to Starr, in the extent to which they move ownership, finance, and accountability out of the public sector. The 'spectrum of alternatives,' according to him, run from 'total privatization' to 'partial privatization.' In cases of partial privatization, the government may continue to finance but not to operate services, or it may continue to own but not to manage assets. In this case, privatization may dilute government control and accountability without eliminating them. According to him, privatization in this sense diminishes the operational but not the fiscal or functional sphere of government action. Partial privatization is more likely, according to Ramamurti, when a government is not strongly committed to privatization or prefers to privatize gradually (2000: 535).

According to Starr, even asset sales sometimes involve only the transfer of a partial interest. This is because often governments sell some voting stock in an enterprise but refuse to surrender control. In these instances, he feels privatization may amount to little more than a revenue-raising measure, as there may be no

change in management, management behaviour, or the enterprise's relation to state authorities (1988: 7).

Ramamurti too suggests that sometimes government privatizes a minority stake not with a view to privatizing control later on but simply to let the SOE raise money by selling shares on the stock market or to strengthen its managerial autonomy, since listed SOEs are less vulnerable to political interference than wholly government-owned enterprises. Partial privatization is also seen as more likely where the SOE's performance is relatively good and, therefore, not urgently in need of new management. However, he feels that countries privatizing to get out of a macroeconomic crisis are unlikely to take this sort of 'gradualistic approach' (2000: 535).

Neither should privatization automatically be equated with increased competition. In fact, Starr is of the opinion that the two related processes, namely privatization and liberalization, need to be carefully distinguished. This is because he believes that it is possible to privatize without liberalizing. He gives the example of British Telecom and British Gas where the Thatcher government substituted private monopolies for public ones. Conversely, he feels that it is also possible to liberalize without privatizing, by introducing competition into the public sector without transferring ownership.

Cook and Kirkpatrick, in fact, distinguish between three main approaches to privatization, which are:

- Denationalisation or divestiture. This can proceed in several ways:
  - through sale of equity

- ◊ through sale of the enterprise as a complete entity
- ◊ through formation of joint ventures, and
- ◊ through liquidation;

- ♦ Liberalisation or deregulation, allowing the private sector to enter into activities previously restricted to PSEs; and
- ♦ Transfer of the responsibility for providing goods and services from the public to the private sector. This would include
  - ◊ Franchising or contracting out public services, and
  - ◊ Leasing out public assets to the private sector.

Writing in the same volume, Commander and Killick held that three broad themes can be outlined as 'characteristic of the privatisation process' (Cook and Kirkpatrick, 1988: 111):

- changes in ownership;
- changes in management; and
- shifts in the method of financing.

Ramanadham, on the other hand, feels that privatization covers a wide continuum of possibilities, between denationalisation at one end and market discipline at the other (1989: 4). This 'continuum' includes

- ownership measures;
- organizational measures; and
- operational measures.

He also makes a distinction between privatization of the *economy* and privatization of an *enterprise*. The former can result from

a) public sector remaining static while private sector expands;

b) public sector expanding but at a slower pace than the private sector;

c) public sector shrinking so that irrespective of the rate of private investment, the private share in the economy tends to be higher than before (Ramanadham, 1988: 4).

Gouri too makes a similar distinction when she distinguishes between *macro-privatization* and *micro-privatization.* According to her, macro-privatization again has two aspects: privatization or sale of assets, and liberalization. She indicates that privatization through sale of assets is normally a response to a general reduction of state involvement in all spheres of activity, and characterized by a straightforward sale of public sector assets. On the other hand, liberalization is seen as being associated with a more gradual shift from producer state to regulator state and then onto a facilitator state. According to her, the term 'liberalization' refers to deregulation and de-control of economies and involves a number of modalities. Firstly, it involves the use of market prices and the introduction of market competition. Such action, she feels, can be termed as 'marketisation' and has implications for a regulator state and a facilitator state. Divestiture or transfer of ownership from the public sector to the private sector is, according to her, the second modality of liberalization. Finally, many of the economic reforms in the erstwhile socialist countries are seen to signify a special form of market involvement, which is included under liberalization (1991: 41-42).

On the other hand, micro-privatization is seen as being confined to the 'operational dynamics of PEs towards incorporation of efficiency at the enterprise level.' This is aimed at: (i) better performance of the PEs given their repercussions on the efficient functioning of the economy and (ii) resource

mobilization and generation of financial surplus. Micro-privatization is therefore seen by Gouri as putting into practice the 'ideology of privatization' (1991: 46).

It must be stated that the two strands are interrelated: the acceptance of privatization as a concept is responsible for individual enterprises being denationalized. This in turn has ramifications not only for the economy as a whole but on the polity as well. Beesley and Littlechild's view of privatization being only an 'economic instrument' is clearly inadequate and a more eclectic view needs to be taken of the issue of privatization.

Ramanadham also sees a shift taking place in certain countries resulting in reduction of public investments in non-financial enterprises such as manufacturing, trading and transport, while increasing public investments in financial enterprises. This is particularly discernible in developing countries where, because of financial constraints, governments are forced to withdraw from certain activities that are perceived to be non-essential while retaining their control on others, especially financial services.

While the above might indicate an 'either/or' relationship between the public and the private sectors, it is not so in practice. Indeed, as Gayle and Goodrich point out, the concepts of the public and private sectors are not 'mutually exclusive, static, or unidimensional' (1990: 3). Instead what emerges is an increasing interdependence between the two sectors resulting in closer cooperation for mutual benefit. While private-sector productivity is seen as depending significantly on public capital investment in basic infrastructure (Gayle & Goodrich, 1990: 4), for the government too, the ability to pass on some of its

activities to the private sector enables it to focus on its primary task of governance.

2.2.2 The Rationale for Privatization

The reasons for privatization, as John Redwood indicated, are 'as varied as the styles of sale and the countries undertaking them' (Gayle and Goodrich, 1990: 54). The main reasons that he felt led to privatization included:

- raising cash;
- raising foreign exchange required for expansion programs or for debt reduction;
- raising funds for expansion;
- reducing revenue subsidies and losses being incurred by state-owned enterprises (SOEs); and
- spreading ownership more widely.

Steve Thomas, on the other hand, believes that privatization has had various objectives other than transferring assets from the public to the private sector, some stated, some implicit. According to him, the importance of these objectives have fluctuated over time and they include the creation of a share-owning democracy, generating revenue and breaking the power of large trade unions. However, he says that it is 'political antipathy towards public enterprise that sustains the continuing privatization programme' (Surrey, 1996: 41).

Other researchers have come up with other theories. Hatch, for example, felt that the objectives for privatization in UK were four-fold:

a) to increase competition and spread consumer choice;

b) to reduce the Public Sector Borrowing Requirement (PSBR)/increase government revenues;

c) to give the public and the work-force a stake in industry; and

d) to allow nationalised industry management greater autonomy (Ramanadham, 1988: 60).

Grimstone, on the other hand, was of the opinion that the British privatization programme, in common with other programmes elsewhere, had the following key objectives:

* to increase efficiency – either through competition, deregulation, or other means;
* to raise finance which could be used to fund other expenditure priorities, to reduce borrowing, to reduce taxation, or any combination of these;
* to encourage employees to own shares in the companies in which they work;
* to boost the level of share ownership in the general economy, to strengthen the capital markets;
* to gain domestic and international prestige (Butler and Pirie, 1989: 52).

Gayle and Goodrich similarly see privatization as assisting in balancing the national budget, reducing government expenditure, financing capital investment programs, decreasing foreign debt, lowering consumer prices, broadening share-ownership across the society, and altering public attitudes towards business (1990: 8).

Henry Gibbon, on the other hand, writes that in their privatization programs governments around the world commonly share three objectives:

- to promote efficiency by exposing businesses and services to the greatest possible competition, to the benefit of the consumer;
- to spread share ownership as widely as possible among the population; and
- to obtain the best value for each industry or service the government sells (1996: 2).

While it is true, as Berg and Shirley say, that the reasons why governments divest state enterprises differ among countries, if one analyses the reasons advanced by them, one would find certain common factors driving governments to privatize, whether in developed countries or in developing countries. These are:

- to reduce the managerial burden on the state;
- increase popular participation in the ownership of national assets; and
- to raise government revenues.

In fact, according to Berg and Shirley, for most developing countries, a major factor leading governments to consider a divestiture program is the desire to reduce fiscal and credit pressures (1987: 3).

While these are the objectives at the macro level, Ramamurti has examined the imperatives behind privatization from a multi level point of view. In the 'multilevel model' that he has attempted to develop to explain why and which SOEs would be privatized, Ramamurti has distinguished between 'firm-

level determinants', 'industry-level determinants' and 'country-level determinants'. Agency theory/property rights, size of the SOE, and past or present private ownership of SOEs would all form part of the firm-level determinants, according to him. The industry-level determinants, on the other hand, would include competitive pressures and potential for exploiting regulatory innovations. Finally, the country-level determinants that are responsible for a country to opt for privatization as a policy could be (a) an ideological commitment to private ownership/market forces, (b) macroeconomic crisis, and (c) the quality of market-supporting institutions. According to Ramamurti, it is rarely a single factor that is responsible for privatization; very often it is a combination of several factors that determine if privatization is to be resorted to, and which SOEs in particular are to be privatized[3].

Ramamurti, however, feels the country-level variables are the most important determinants of whether SOEs are to be privatized or not. This is because, according to him, privatization ultimately is a political rather than an economic decision. He feels that no matter what the economic advantages of privatization, it will not happen unless politicians in power are motivated to take on vested interests, such as labour unions, suppliers, or customers of SOEs, who benefit from state ownership of enterprises (2000: 532).

Further, the model that Ramamurti develops is dynamic, rather than static. He feels, and rightly so, that 'privatization is not a one-shot *event* but a *process*

[3] see Ramamurti, Ravi, "A Multilevel Model of Privatization in Emerging Economies," *Academy of Management Review*, 2000, Vol 25, No. 3, pp. 525-550 for a full discussion of the 'multi-level model of privatization'.

that can occur in stages.' He is of the opinion that 'a feedback loop is established wherein one round of privatization leads, with some time lag, to changes in firm, industry, or country variables that affect the dynamics of privatization in subsequent rounds' (2000: 527). This is a realistic scenario in which the success or failure of privatization efforts in the previous rounds determine very often the outcome and indeed even the decision to go ahead (or not) with privatization in the subsequent rounds.

Piecing together the different arguments which different researchers have put forward, one might see that the motives behind privatization fall into four broad categories:[4]

- ideological;
- economic;
- managerial; and
- financial.

2.2.2.1 Ideological

One of the three variables that stand out as drivers of privatization at the country-level according to Ramamurti was 'a change in ideology in favor of free markets.' This entailed the abandonment of the ideology in favour of central planning and state ownership. The ideological motive might be more pronounced in developed countries such as USA, UK, France, and Canada, and less so in developing countries with the possible exception of Chile. As Vickers and Wright explain, for the right, especially in Britain and France, privatization was part of the general

[4] adapted from Vickers, J., and Wright, V., (eds.) *The Politics of Privatisation in Western Europe*, 1989, Frank Cass, London, pp. 5-8. Reasons specifically related to party politics have been left out from this assessment not because they are unimportant but because they might be unrepresentative to other countries notwithstanding the significance of politics in any privatization exercise anywhere.

strategy to shift the boundary between public and private in favour of the latter. It is felt to be nourished by deep-seated anti-State sentiment. In both countries, privatization had been the focus of a campaign to push back the 'frontiers of the State' which was felt to be 'stultifying and inhibiting' that eroded personal responsibility and undermined individual incentives, by the creation of a proper environment for individual actors by tax incentives, the abolition of inhibitions (like exchange controls), the relaxation of planning regulations, and the weakening of market rigidities, notably in the labour market (Vickers and Wright, 1989: 5).

This comes out clearly from the memoirs of Margaret Thatcher where she writes that her Government's privatization programme was fundamental to improving Britain's economic performance. But for her personally it was far more than that: it was one of the 'central means of reversing the corrosive and corrupting effects of socialism' (1993: 676). Viewed from this perspective, it can be linked to the larger issue of the conflict between capitalism and socialism. However, whatever be the motivation, it presupposes a strong commitment on the part of the government or the party in power. This is evident from the statement of Mike Parker when he indicated, in the context of the privatization of the electricity supply industry in UK, that the impetus to privatization came not from public pressure for improved performance, but from a 'Government committed to moving the nationalized industries from the public to private sector and to replacing monopoly with competition' (Surrey, 1996: 296).

The ideological reason is not limited to developed countries alone, but was also responsible for the large-scale privatization that took place in the erstwhile communist countries. As Ramamurti points out, the 'power of a *change in ideology* in promoting privatization clearly can be seen in the case of the former communist countries after the collapse of the Berlin Wall.' According to him, in several of those countries privatization was part of the sweeping economic and political changes in favour of private ownership and markets (2000: 532). In some of these countries, privatization was resorted to in order to ensure that the economic and political changes made after the collapse of the Berlin wall were made irreversible. However, it was seen that ideological fervour in favour of privatization was stronger in some countries (such as the Czech Republic, Hungary and Russia) than others (e.g. Poland, Slovakia, Bulgaria). Further, he felt that the lack of this ideological commitment in countries such as Cuba and North Korea would explain the absence of privatization in these countries, despite poor macroeconomic performance.

Ideology was seen to be less of a factor in mixed economies, with the exception of Chile because, as Ramamurti says, by definition, these countries already had large private sector firms that coexisted with SOEs. Yet, even in these mixed economies, it was seen that a new generation of leaders or senior policy makers who were often Western educated, initiated privatization out of an abiding faith in private ownership and market mechanisms, even in monopolistic industries (Ramamurti, 2000: 532).

The ideological motive is underpinned by two allied arguments:

a) the belief that public industries and services limit the choice of consumers because of their monopoly nature,[5] and

b) the desire to build a 'popular capitalism.'

The latter accounts for the drive to sell shares in the denationalized industries to the general public and on occasions to the employees (Vickers and Wright, 1989).

2.2.2.2 Economic

The economic argument has centered around the belief that the public sector is '*intrinsically* less efficient than those in the private sector' (Vickers and Wright, 1989: 6). As Cook and Kirkpatrick indicate, privatization is advocated primarily as a means of improving the performance of the public enterprise sector (1988: 19). In fact, in his speech of November 1983, the Financial Secretary to the Treasury (John Moore MP) placed great importance on the objective of improving efficiency by declaring that 'Our main objective is to promote competition and improve efficiency' (Kay et. al., 1986: 93). Other objectives such as reducing the size of the public sector or funding the PSBR were seen as secondary. This point was further stressed in his speech of July 1985. This is at the crux of the neo-classical argument which views privatization as a tool for improving industry performance by increasing the role of market forces (Beesley and Littlechild, 1992).

According to Chowdary, ownership makes a difference. He points out that there is increasing number of empirical evidence on the association of

[5] see Starr, Paul, "The Limits of Privatization", in Gayle and Goodrich (eds.), *Privatization and Deregulation in Global Perspective*, London, Pinter Publishers, 1990, pp. 117-119 for a more detailed discussion of the issue of 'choice'.

increased economic efficiency with private ownership. The main reasons for increased efficiency gains as a result of privatization, according to him, are attributed to (i) less political interference in decision-making; (ii) staff remuneration being clearly linked to productivity and profitability; (iii) firms being exposed to financial market discipline as opposed to governments' support (e.g., soft budget constraints); and (iv) firms' cost-reducing efforts being higher under competitive private ownership (2003: xiii).

The starting point for this argument is the premise that the public sector is less efficient that the private sector. Gayle and Goodrich, for example, indicate that the empirical evidence for the relative economic efficiency of private, as opposed to public, production is overwhelming (1990: 7). To support their argument, they cite a 1982 World Bank study of road maintenance in Brazil which determined that contracted-out upkeep costs were on an average 37 per cent less than those incurred by the Brazilian National Highway Department. Similarly, bus operators in New York and in London found that they had achieved 10-15 per cent increase in efficiency through privatization.

Vickers and Yarrow too refer to a study conducted by the London Business School and the Institute for Fiscal Studies in 1986 which showed that local authorities in Britain using private contractors had reduced costs by 22 per cent on an average while maintaining the standard of services (1988: 111). Other researchers have reported similar findings. For example, on examination of the 1990 restructuring and privatization of Ferrocarilla Argentinos, the Argentine national freight and passenger railway system, Ramamurti (1997) found an

incredible 370 per cent improvement in labour productivity along with an equally striking 78.7 per cent decline in employment – from 92,000 to 18,862 workers[6]. However, this could very well be a stray case.

Ganesh (2001) refers to the study made by Megginson et. al. (1994) which compared the pre and post-privatization performances of a sample of 61 firms in 18 countries and came to the conclusion that after privatization, the sample firms became more profitable, increased their real sales and investment spending, and improved their operating efficiency. Similarly, another study by Boubakri and Cosset (1998) examined 79 newly privatized firms in 21 developing countries which experienced full or partial privatization during 1980-92. This study revealed that there were significant improvements in profitability after divestiture. It is indicated that as measured by the return on sales, profitability rose on average from 4.9% before privatization to 11% after privatization, while the operating efficiency on the basis of the sales efficiency ratio (i.e real sales per employee) and net income efficiency ratio (i.e net income per employee) showed significant increase following privatization.

Adam, Cavendish and Mistry seek to clarify the economic argument by suggesting that privatization is aimed at improving economic efficiency and is undertaken on the assumption that the production of goods and services is achieved more efficiently under the direction of private rather than public owners. Privatization, it is argued, will enhance *productive efficiency* (i.e. it leads to

[6] cited by Naib (2004: 193)

lower-cost production) and *allocative efficiency* (i.e. it forces down consumer prices so that they are closer to the marginal cost of production) (1992: 12).

This can be explained by using what is known as the 'property rights' theory. As Adam, Cavendish and Mistry clarify, under public ownership property rights are, by definition, dispersed and no individual owner has an incentive to bear the costs of gathering costly information and thus to exercise control over the management of the enterprise, principally because the benefits accruing to this effort cannot easily be captured by that individual alone. They indicate that the re-concentration of ownership in private hands allows the benefits of control to be internalized by the owners of the asset and thereby creates incentives to bear the costs of information gathering and management monitoring, while the tradability of these property rights (i.e. equity) allows the forces of competition to drive this level of performance monitoring to an optimal level (1992: 13).

Though the above argument is powerful, it is felt that this oversimplifies the issue, and while the creation of property rights is a necessary condition for control to be exerted over management, it is not a sufficient condition (Adam et. al., 1992: 13). On the other hand, Bishop and Kay's study of Britain's experience with privatization also indicated that privatized firms did *not* perform substantially better than public-sector firms did during 1983 and 1988. Ram Mohan refers to the study conducted by Martin and Parker on the performance of 11 British firms that were privatized in the 1980s where the authors found 'little

evidence of any systematic improvement in performance'[7]. Similar findings were reported from Germany, Chile and Honduras (Gayle and Goodrich, 1990: 8).

Thus Cook and Kirkpatrick conclude that privatization in the form of denationalisation is unlikely to significantly increase productive efficiency, while in the absence of competition, privatization in the form of asset sales is unlikely to result in gains in allocative efficiency (1988: 20). Heald and Steel's studies, on the other hand, do not point to a clear-cut superiority on either side and suggest that ownership may well be a factor of fairly limited importance in determining efficiency (Kay et. al., 1986: 70). In fact, Ram Mohan goes to the extent of saying that contrary to popular supposition, 'neither the theory nor the empirical evidence on privatization provides unqualified support for the belief that privatization leads to outcomes superior to those under public ownership' (2005: 25).

Because of the above reasons, Cook and Kirkpatrick suggest that if the principal objective of privatization is to increase economic efficiency, the policy priority should be to increase competition, not to transfer productive activities to the private sector (Cook and Kirkpatrick, 1988: 22). Indeed, most researchers agree that for privatization to succeed, competition is a necessary prerequisite.

In fact, even within the economic theory of privatization, as Starr says, there are some subtle but important differences between two approaches: the radical view of privatization as a reassignment of property rights and the more moderate, conventional view of privatization as an instrument for fine-tuning a

[7] see Ram Mohan (2005: 34)

three sector economy (1988: 8). He too feels that there is a difference of opinion among economists that corresponds to a preference for either privatization or liberalization. He finds that those who believe that efficient performance depends on private ownership *per se* favour privatization while those who see competition as the critical spur to efficiency are more skeptical about the benefits of privatizing monopolies and often put more emphasis on other policies, such as deregulation (1988: 9).

2.2.2.3 Managerial

As the *World Development Report* (1983) suggested, the key factor determining the efficiency of an enterprise is 'not whether it is publicly or privately owned, but how it is managed' (World Bank, 1983: 50). It is widely accepted that the performance of public enterprises in general, and in developing countries in particular, has been disappointing (Cook and Kirkpatrick, 1988). One of the principal reasons for this has been political interference. Coupled with that has been certain non-commercial obligations that public enterprises have been burdened with. These 'non-commercial objectives' have been described by Adam, Cavendish and Mistry to include, (a) employment maximization objectives, (b) non-commercial price setting aimed at keeping input prices low for other sectors, (c) uneconomic investments, and (d) limited product innovation (1992: 13).

Adam, Cavendish and Mistry further indicate that concomitant to the pursuit of these non-economic objectives by the owners of the enterprise is the inefficient monitoring and control of management (1992: 13). In addition, there

are the usual complaints of overmanning, lack of transparency, lack of autonomy, inadequate communications, resource constraints and rigid organizational structures.

The inefficiencies of SOEs have been analysed by Ram Mohan using both the 'property rights' theory as well as the 'public choice' theory. He refers to the study by Jenson and Meckling (1976) which indicated that managers would perform only if they were monitored and incentivised. This was seen to be lacking in the SOEs. On the other hand, as already indicated above, managers in the public sector lacked focus because they were expected to pursue a variety of objectives, not all of which were calculated to maximize profit (Shleifer and Vishny, 1996)[8]. This is at the crux of the public choice theory. The multiplicity of objectives, according to Ram Mohan, arises from the fact that public-sector managers are answerable to different constituencies, such as legislators, civil servants and ministers, each with its own objective. In particular, it was felt that politicians, who in turn were answerable to constituencies such as labour, would tend to push public-sector managers to pursue objectives, such as an increase in employment, that militate against profit maximization (2005: 27).

According to Ramamurti, others have argued that SOEs are not disciplined by the fear of takeovers, nor is bankruptcy a credible threat because they feel that government would eventually bail them out. This is referred to as the 'soft budget constraint' and often comes in the way of SOEs improving their accountability. It is generally felt that accountability is much less in SOEs as compared to private

[8] cited by Ram Mohan (2005: 27)

firms. In fact, as Ramamurti says, the agency theory provides additional arguments for privatization in the scenario in which ownership is separated from management, as is usually the case when large firms are privatized (2000: 528). He feels that because private firms have clearer goals, it is easier for owners (principals) to hold managers (agents) accountable. For the same reason, incentive schemes can be designed to motivate managers to achieve the owner's goals. In contrast, it is often seen that SOEs have vague goals, such as maximizing the public interest, which makes it harder for citizens as principals to hold managers and other agents accountable or to motivate them through incentive schemes. Finally, the absence of an 'exit policy' is a major handicap in ensuring accountability in SOEs.

While the assumption is that the switch from public to private ownership should result in more precise and more measurable objectives on the part of the owners, which in turn should create the environment and incentives to monitor and control management more effectively (Adam et. al., 1992: 13), change in ownership alone will not solve the problem: for privatization to be meaningful, it would have to be supported by deregulation and reform of the public sector.

2.2.2.4 Financial

A variety of financial reasons have been given to justify privatization programmes. Vickers and Wright have come up with five main elements that make up the financial argument. The first is specific to the UK and is linked to

the reduction of the 'Public Sector Borrowing Requirement' (PSBR).[9] The second financial reason is that denationalisation provides quicker and more direct access for the firms involved to international capital markets (although it is unclear why nationalised firms should be totally deprived of such a right). The third reason is that it fosters the growth of the stock exchange. The fourth reason that is sometimes advanced is that the sale of public assets reduces commercial risk for a government by diminishing the State's exposure to the vagaries of recession and the volatile exchange and business climate. Finally what is considered as 'the most important single reason for privatisation' is that selling State assets raises money for public sector managers and for hard-pressed governments which are anxious to reduce large budget deficits, cut personal and corporate taxes and to finance public expenditure. However, it is pointed out that asset sales improve short-term cash flow in a once-and-for-all manner: in general they do not enhance a government's long-term net worth, and may even cause it to deteriorate if profitable assets are sold off too cheaply (Vickers and Wright, 1989: 5-8).

In reality it is true that denationalisation has been largely driven by what Cook and Kirkpatrick describe as the 'anticipated alleviation of the public enterprise budgetary burden on the government' (1988: 21). However it needs to be noted that while the immediate effect of asset sales will be a once-and-for-all reduction in the government's deficit, equal to the sales revenues, if the enterprise had been profitable, its privatization means that the government forfeits the future

[9] PSBR, which is specific to the British privatization programme, is linked to but no identical with fiscal deficit (see Yarrow, 1993).

stream of income (1988: 21). Moreover, as Kirkpatrick points out, if the sales revenue is used to reduce taxation, the public sector deficit is increased in subsequent years (Ramanadham, 1988: 241).

Similar arguments have also been advanced by Adam, Cavendish and Mistry. They start by establishing as a benchmark what they term the '*neutrality result*,' namely, that under certain circumstances privatization has no net effect on fiscal balances (1992: 9). This is not only because the sale of assets will result in the public and the private sectors adjusting their relative liquidity positions that leaves their respective net worth unaltered, but also because whilst the immediate effect of an asset sale may result in a reduction in the current budget deficit, this must be offset against compensatingly higher deficits in the future caused by the loss of the future earnings stream from the asset sold (1992: 9). This is reminiscent of Cook and Kirkpatrick's argument of government forfeiting future stream of income in respect of denationalized entities.

While the above argument is primarily applicable to profitable public enterprises, Adam, Cavendish and Mistry also extend it to apply to loss-making enterprises by arguing that when a loss-making public enterprise is sold, the government pays a price to the private sector equal to the 'present discounted sum of future losses' (1992: 9). However, it seems difficult to accept this argument or Cook and Kirkpatrick's view that change of ownership of loss-making enterprises would have an 'insignificant impact on the public finances' (1988: 21). On the other hand it would appear plausible that in the case of loss-making enterprises at least, their sale would reduce the burden on the public exchequer to the extent that

while certain winding-up charges would have to be incurred by way of compensation to the workers, financial support either by way of 'cross-subsidisation' from other profitable enterprises or direct budgetary flows would be reduced.

In fact, as Ramamurti says, the second most important driver of privatization at the country level is the 'advent of *macroeconomic crises*, as evidenced by hyperinflation or severe balance-of-payments problems.' According to him, in the case of transitional economies, both a change in ideology and the onset of macroeconomic crises pushed governments toward privatization, whereas in the case of mixed economies, where no radical change in ideology occurred among the leadership, macroeconomic crisis was often the driving force. He was of the view that as long as governments could raise taxes or borrow at home and abroad to finance public spending and imports, including the need of SOEs, painful reforms like privatization could be avoided. But when the limits of taxing and borrowing were reached, as was the case in many emerging economies in the 1980s, painful alternatives like privatization became politically desirable policies for achieving economic stability (2000: 532). In fact, he finds that privatization was seen to be 'one potent method for reducing the government's budget deficit, and thereby inflation as well' (2000: 533).

According to Ramamurti, in several countries in Latin America, Eastern Europe and in the former Soviet Union, privatization was seen as a remedy for balance-of-payments crises and plunging currencies because SOEs could be sold to foreign investors for hard currency. Besides, countries in economic crisis also

faced pressure to privatize from such international financial institutions as the IMF and the World Bank. In fact, privatization and public sector reforms became part of the many structural adjustment programmes that these international agencies supported in different countries. Following the currency crises of 1997-1998, Ramamurti found that many countries in East and Southeast Asia came under pressure to privatize SOEs to bolster their foreign exchange reserves and satisfy IMF conditionalities. In fact, as he says, the evidence clearly shows that most of the countries that privatized deeply did so in response to a macroeconomic crisis (2000: 533).

2.2.3 Methodology and Mechanisms

As Redwood points out, because privatization is such a wide-ranging concept, the methods and techniques involved in selling assets and raising new private capital are also varied and numerous (Gayle and Goodrich, 1990: 48). Redwood himself examines four main styles of privatization: the public offer of sale, the trade sale, the project or venture financing of competitors, and the tender for a contract. Hyman, on the other hand, felt that the main options were:

1) a public flotation on the Stock Exchange, either by a fixed price, or by a tender offer with a minimum price;
2) a management/employee buy-out;
3) a placing with a group of investors; or
4) a trade sale, in which a company is sold to a single person or a consortium (Ramanadham, 1988).

Pirie (1988) came up with over twenty different methods of privatization, while Vuylsteke found the most commonly used methods to be:

- Public offering of shares,
- Private sale of shares,
- New private investment in an SOE,
- Sale of government or SOE assets,
- Reorganization (or break-up) into component parts,
- Management/employee buyout, and
- Lease and management contract (1988, p. 8).

Heald and Morris break privatization activity into four classes: denationalisation, substitution of customer fees for tax finance, liberalisation, and contracting out public services to the private sector (Ascher, 1987). Most of these are covered in Fuat Andic's analysis of the modalities of privatization (Gayle and Goodrich, 1990: 37-39), which is discussed below.

However, as Naib indicates, privatization has broadly two options: (a) divestiture and (b) non-divestiture. Whereas the divestiture option would involve transfer of ownership rights from public to private sector, the non-divestiture option would involve management transfer and marketisation. He further clarifies that the divestiture option may be preceded by non-divestiture techniques, which are usually aimed at 'improving the financial and/or operations of the SOE, thus increasing the potential sale value' (2004: 126).

Berg and Shirley, on the other hand, view divestiture as covering the following range of activities:

a. Liquidation, which can be formal or informal;

b. Privatization of ownership, through the whole or partial sale of assets; and

c. Privatization of management through leases and management contracts.

Naib, however, sees privatization of management as a non-divestiture option. According to him, the main types of non-divestiture options are restructuring, privatization of management (which includes management contracts, and lease or concessions), contracting out, and joint ventures. The principal methods of divestiture, on the other hand, would include (a) public offering of shares (full or partial), (b) direct private sale (full or partial), (c) new private investment in the SOE, (d) management/ employee buy-out, (e) liquidation-sale of SOE assets, (f) fragmentation/reorganization (or break-up) into component parts, (g) public auctions, and (h) mass privatization.[10]

2.2.3.1 Divestiture

Divestiture is the mechanism most commonly associated with privatization. Divestiture can include the outright or partial sale of state holdings to private-sector interests or the liquidation of the assets of some public enterprise (Gayle and Goodrich, 1990: 37). The sale of state holdings can either be through public flotation of shares, a trade sale, or a management buy-out. The difference between the public sale of shares and a trade sale is that while in the former the shares are offered on the stock exchange and are available to the general public (in keeping with the government's objective of introducing 'popular capitalism'),

[10] For a detailed discussion on the various methods of privatization, see Naib (2004: 126-133)

in a trade sale the company is sold to a single bidder or consortium. As Redwood indicates, this technique is often used for assets that do not have a good track record (Gayle and Goodrich, 1990: 51). A management buy-out, on the other hand, is where a small group of managers or employees acquire a controlling interest in the company. This, according to Hyman, has the advantages of causing minimum disruption to the company and speed of sale (Ramanadham, 1988: 122).

Researchers have also distinguished between *divestiture* and *asset liquidation.* Andic, for example, believes that liquidation of assets is in a sense not privatization because no private entity results, even though the assets themselves may become part of the stock of private assets (Gayle and Goodrich, 1990: 37).

A distinction is also sought to be made between *complete* and *partial divestiture.* Countries such as UK, and to a lesser extent, France, Germany, Japan, Chile, Mexico, Argentina, Brazil, and Honduras have focused on complete divestiture because of ideological reasons, while other developing countries have opted for partial disinvestment whereby the government offers a percentage of the equity in a public enterprise to the public while continuing to retain a part of the holding. This has the advantage of increasing the play of market forces and raising revenue while retaining an element of control. The actual amount of control would of course depend on the percentage of holding which the government continues to retain, but generally this sort of divestiture has not been found to be too successful.

2.2.3.2 Non-divestiture methods

As we have seen, non-divestiture options would include restructuring of SOEs without privatization, privatization of management (which would include management contracts, and lease or concessions), contracting out, and joint ventures.

Contracting out or granting operating concessions is increasingly being considered as one of the more feasible options for privatization, especially in Third World countries. As Andic clarifies, the state retains its authority over a sector or industry and may retain ownership of capital assets, but the contractual relationship with a private operator injects into the relationship elements of profit maximizing and cost minimizing (Gayle and Goodrich, 1990: 38). Such contracts are advantageous to both parties: the government benefits from the technical and managerial expertise that the private sector brings with it, the operation is consequently more cost-effective, the government's funds are not tied up, and the contract being renegotiable reduces the risk in decision-making. For the private company, they avoid certain risks and get to do a job often without making any capital investments. Management contracting, leasing, and franchising are all derivatives of this type of arrangement.

There has also been a growing trend in recent years for governments to utilize concession contracts not only for operating existing facilities or providing goods and services, but for infrastructure development as well. This is done through the adoption of the 'Build-Own-Operate-Transfer' (BOOT) contract wherein the Principal, usually a government, grants a concession to a private

company (known as the Promoter or Concessionaire) for the construction, financing, operation and maintenance of the facility before finally transferring it, at no further cost, to the Principal at the end of the contract period (Merna and Smith, 1994). One of the best-known examples of this type of contract was the Anglo-French channel tunnel project. While this type of contract is becoming increasingly popular with governments primarily because it leads to fresh infrastructure being created without governmental funding, according to Merna, this cannot be considered as 'real privatization' since the transfer element of a BOOT project implies that after a specified time the facility will be transferred back to the Principal or the government (Smith, 1995: 250).

2.2.3.3 Privatization by Attrition

Finally, there is what Andic describes as 'privatization by attrition' which basically means that over a period of time, either due to ideological reasons or because of resource constraints, government changes its way of initiating new projects and allows the private sector to invest in areas that were formerly the exclusive domain of the state (Gayle and Goodrich, 1990: 39). This is described as the 'least noticeable form of privatization' and one which depends largely on the lobbying skills of the private sector itself. Besides the various derivatives of the BOOT contract (BOO, DBOM, BOL and BOT), this also includes formation of joint-ventures with the private sector apart from project financing and providing venture capital.

2.2.4 Consequences of Privatization

According to Veljanovski, one of the immediate benefits of privatization, especially from the sale of state assets, is financial. It raises substantial sums of money for the treasury, which enables the government to finance expenditures, repay loans, or defer tax increases (Gayle and Goodrich, 1990: 68). This is by far the most palpable consequence of privatization and one which is significant in 'realpolitic' terms. Governments worldwide are facing resource constraints and the moves at privatizing the economy, one suspects, are propelled more by fiscal considerations than ideological. However, as Ramanadham points out, while arithmetical benefit in terms of budget balance no doubt follows privatization which brings in cash through the sale of assets, there can be long-term consequences from the angle of income (and wealth) distribution (1988: 15). As was indicated earlier, the sale of a profitable enterprise would mean that the government forfeits future income from the enterprise, while if the enterprise had been unprofitable, the change of ownership in any case would have only an insignificant impact on the public finances (Cook and Kirkpatrick, 1988).

The second point pertains to the perceived efficiencies of private sector management vis-à-vis the public sector. As Ramanadham indicates, the case for privatization essentially rests on the loss in the comparative advantage of an enterprise operating in the public sector as against the private sector (1988: 18). The consequences, as the analysis in section 2.2.2.2 indicated, were unclear both in terms of 'productive efficiency' as well as 'allocative efficiency.' The problem is further compounded when one takes into account what Beesley and Littlechild

describe as the 'non-commercial obligations' of PSEs. It is true that unlike private enterprises, state-owned enterprises have objectives that are not purely commercial in nature and which run the risk of being sidelined as a result of privatization. This is one of the arguments that critics of privatization advance that is particularly valid in respect of social services, medicare, and education.

Chowdary, on the other hand, finds a host of arguments in favour of privatization. Privatization is seen as critical to (i) the long-term development of the private sector, drawing on and contributing to efforts to strengthen market forces and competitive conditions, (ii) develop local capital markets and financing institutions, and (iii) foster an enabling environment that facilitates private initiatives and rewards risk-taking. At the same time, he believes that privatization enhances dynamic as well as static efficiency in the economy, improves fiscal balances, and leads to a smaller, more effective public sector. Further, he feels that, if implemented properly, privatization efforts can also contribute to the democratization process by encouraging greater participation by the population at large in the developing world in the economic and political life of their countries (2003: xiii).

However, as Beesley and Littlechild point out, the gains of privatization are 'not all one-way.' They accept that a privately owned company will have greater incentive to exploit monopoly power commercially, which is why even after privatization, a regulatory framework is necessary. They further accept that a privatized company will be less willing to provide uneconomic services. Thirdly, they see the elimination of inefficient production and restrictive labour

practices as resulting in the release of resources which would benefit taxpayers and consumers outside the industry, but some employees and suppliers will suffer. Finally, they point out that while privatization is often opposed on the grounds that it leads to unemployment, even state-owned firms cannot in practice finance overmanning over long periods (Johnson, 1988: 14-18).

While as Veljanovski points out, one obvious benefit of privatization is that it depoliticizes industries and gives them clearly defined goals (Gayle and Goodrich, 1990: 76), Ramanadham feels it is necessary to take cognizance of the 'unseen costs of privatization' which are broadly represented by

a) the market imperfections that tend to prevail despite hopes of promoting competition,
b) the social costs of private enterprise operations,
c) the distribution implications of the privatization processes and the long-term consequences in the context of ownership benefits, and
d) the costs and inadequacies of the regulatory framework that accompanies privatization. (1988: 20)

Because of these reasons, Chowdary feels that while privatization is one very important element of economic policy reforms, it is 'not everything' (2003: xiii).