

Political Economic Digest Series- 14

Dear Political Economic Digest Series participant,

In last series we discussed about sources of economic progress for a country. The reading was chapter from the book called “Common Sense Economics: What everyone should know about wealth and prosperity” written by three prominent economists. In this series we will discuss about Privatization.

Background

Across the world, the state is associated with the welfare of its citizen. The degree and kinds of such welfare vary from nation to nation. Countries such as Sweden, Norway, Cuba, Venezuela, etc., provide a large portion of services and facilities (i.e. healthcare, education and much more) to its people through high taxes. On the other hand, there are liberal countries where the private sector provides the most essential of services to the people and the government has limited role and scope when it comes to citizen welfare. In the Nepalese context, the government has been trying to take up the role of welfare provider for its citizens not only through attempts of providing social security but also opening up state enterprises to provide many basic service and facilities to the people. There are state enterprises for basic services which range from dairy to electricity to cigarette to medicines to aviation to educational materials to media to cement to fuel and many more. Many of such enterprises have remained a monopoly and have been non-performing. There are a total of 36 fully government owned and 39 partially owned such public enterprises in Nepal which intend to provide service to the people. According to The Economic Survey, 2000/10 shows that out of the 36 State Owned Enterprises (SOE), only 50% are in profit. However, we cannot be very satisfied with the remaining half of those which are making profit as these SOEs have been enjoying monopolies and subsidies. Except for a few, SOEs in Nepal have been known for corruption, inefficiency and financial disasters. The corruption scandals at the Nepal Airlines Corporation (NAC), Janak Educational Materials Center, Nepal Food Corporation and other SOEs make it to the headlines of the Nepalese newspapers more than often. The losses incurred by Nepal Oil Corporation (NOC) have been a huge burden on the economy. According to latest figures, NOC's estimated total loss for the month February 2012 was NRs.1,180,254,227. Some of the public enterprises have even negative net worth owing to the continuous losses over a long period of time. The state owned Nepal Electricity Authority (NEA) is only able to provide electricity eight to ten hours during the dry season. Similarly, the severe shortages of fuel are a part of the social fabric by now where the state owned NOC holds monopoly. State Owned Enterprises which are

opened based on the rationale of providing quality services at low prices to the people have been known for all the wrong reasons over the years such as corruption, sub-standard services, untimely or no delivery and utter lack of accountability. While this is the situation of the public sector, most of the functions of these enterprises are being taken up by private sector which is performing pretty well. For example, the case of state run Janakpur cigarette factory versus private Surya tobacco. Janakpur Cigarette Factory has an accumulated loss of more than a billion rupees and has been operating on loss for almost two decades now. It has more than 1100 staffs. Compare it to Surya tobacco which is one of the largest taxpayer of the country which has about 900 staffs. The scenario is not very different in the case of many of our public enterprises. On the other hand, there are example where deregulation in sectors like telecommunication and partially privatizing the state owned telecommunications corporation had turned it into one of the highest tax payers of the nation.

Hence, some important questions to ponder over would be are private companies better at providing quality goods and services at lowest rates possible when being guided by profit? What kind of incentive systems are at interplay which make private companies usually more accountable than state owned enterprises? Would privatization help Nepal's grief struck SOE's like NOC, NEA etc.? Would people enjoy better goods, services, choices and accessibility in cheaper rates with privatization ?

Privatization

Privatization can also be called denationalization or disinvestment. All three terms describe a situation where a government decides to transfer control of a government, and thus public owned, resource to the private business sector, either partially or totally. Sometimes, the government continues to exert a certain amount of control over the industry or service, called municipalization. For example the government may be able to limit prices and make certain demands through contracts, but private companies perform the work for a municipalized industry or service. The reverse process of privatization is called nationalization, when a government takes control of an industry or service from the private sector.

Privatization is a fuzzy concept that evokes sharp political reactions. It covers a great range of ideas and policies, varying from the eminently reasonable to the wildly impractical. Yet however varied and at times unclear in its meaning, privatization have unambiguous political origins and objectives. It emerges from the countermovement against the growth of government in the West and represents the most serious conservative effort of our time to formulate a positive alternative. Privatization proposals do not aim merely to return services to their original location in the private sphere. Some proposals seek to create new kinds of market relations and promise results comparable or superior to conventional public programs. Hence it is a mistake to define and dismiss the movement as simply a replay of traditional opposition to state

intervention and expenditure. The current wave of privatization initiatives opens a new chapter in the conflict over the public-private balance.

In the ideological world we inhabit, contesting interests and parties use "public" and "private" not only to describe but also to celebrate and condemn. Any serious inquiry into the meaning of privatization must begin, therefore, by unloading the complex freight that the public-private distinction carries. In this section I analyze, first, the general uses of the public-private distinction and, second, the recent political application of the concept of privatization.

Source : The Meaning of Privatization by Paul Starr <http://www.wisegeek.com/what-is-privatization.htm>

History

A long history of privatization dates from Ancient Greece, when governments contracted out almost everything to the private sector. In the Roman Republic private individuals and companies performed the majority of services including tax collection (tax farming), army supplies (military contractors), religious sacrifices and construction. However, the Roman Empire also created state-owned enterprises—for example, much of the grain was eventually produced on estates owned by the Emperor. Some scholars suggest that the cost of bureaucracy was one of the reasons for the fall of the Roman Empire.

Perhaps one of the first ideological movements towards privatization came during China's golden age of the Han dynasty. Taoism came into prominence for the first time at a state level, and it advocated the laissez-faire principle of Wu wei, literally meaning "do nothing". The rulers were counseled by the Taoist clergy that a strong ruler was virtually invisible.

During the Renaissance, most of Europe was still by and large following the feudal economic model. By contrast, the Ming dynasty in China began once more to practice privatization, especially with regards to their manufacturing industries. This was a reversal of the earlier Song dynasty policies, which had themselves overturned earlier policies in favor of more rigorous state control.

In Britain, the privatization of common lands is referred to as enclosure (in Scotland as the Lowland Clearances and the Highland Clearances). Significant privatizations of this nature occurred from 1760 to 1820, coincident with the industrial revolution in that country.

In more recent times, Winston Churchill's government privatized the British steel industry in the 1950s, and West Germany's government embarked on large-scale privatization, including selling its majority stake in Volkswagen to small investors in a public share offering in 1961. In the 1970s General Pinochet implemented a significant privatization program in Chile. However, it

was in the 1980s under the leaderships of Margaret Thatcher in the UK and Ronald Reagan in the USA, that privatization gained worldwide momentum. In the UK this culminated in the 1993 privatization of British Rail under Thatcher's successor, John Major; British Rail having been formed by prior nationalization of private rail companies.

Significant privatization of state owned enterprises in Eastern and Central Europe and the former Soviet Union was undertaken in the 1990s with assistance from the World Bank, the U.S. Agency for International Development, the German Treuhand, and other governmental and nongovernmental organizations.

Source: <http://en.wikipedia.org/wiki/Privatization>

Why Privatize?

By Reason Foundation

As this is written in 2010, a recession is causing fiscal trauma in many states. The 50 states face a combined budget gap of approximately \$200 billion. Many local governments are in desperate straits due in part to declining property tax revenues. "Creative budgeting" is no longer sufficient to hide the need to cut spending.

Government managers and concerned citizens can use privatization to achieve a number of other goals:

- **Cost Savings:** A Reason Foundation review of more than 100 privatization studies found savings ranging from 20 percent to 50 percent.
- **Access to Expertise:** Contracting gives governments access to expertise they do not have in-house on an as-needed basis. It is cheaper to retain architects, engineers, and lawyers on an as-needed basis than to hire them as full-time employees.
- **Better Quality:** Competition brings out the best in competitors, whether it is in sports or in the business of providing public services. Bidders have incentives to offer the best possible combination of price and service quality to beat their rivals.
- **Improved Risk Management:** Contractors, rather than the government, are responsible for cost overruns, strikes, delays, and other risks.
- **Innovation:** Competition to win and retain contracts spurs the discovery of new, cutting-edge solutions. Without competition, even top-notch employees may stop looking for ways to improve how they meet customers' needs.

- **Meeting Peak Demand:** The cost of providing a public service can be raised considerably by the capital and manpower needed to satisfy demand at peak periods, even though those peaks may last only for a few hours a day, a few days a week, or a few months a year. Contracting allows governments to obtain additional help when it is needed so that services are uninterrupted for residents.
- **Timeliness:** "Time is money" if you are a contractor footing the bill, or if your contract with the city or state includes penalties for delays. Contractors can recruit additional workers or provide performance bonuses to meet or beat deadlines, options that often are unavailable to in-house staff.

If badly executed, privatization like any other policy can fail. Taxpayers are no better off, and may be worse off, if a service is moved from a government agency to an incompetent or inefficient private business. But we have the experiences of governments in the United States and around the world to learn from. The 10 principles of privatization that follow in this report capture the best practices that have emerged from those experiences.

How to privatize ?

There are many ways to privatize public services. The four most common methods, listed in order by how much responsibility to oversee or subsidize the service the government entity typically retains (from most to least), are:

Contracting out: Governments contract with private-sector service providers, either for-profit or nonprofit, to deliver public services for a fee.

Franchises: Governments award private firms exclusive rights to provide public services or operate public assets, usually in return for annual lease payments or a one-time, up-front payment and subject to meeting performance expectations outlined by the government agency. This is also sometimes called leasing or concessions.

Vouchers: Governments give consumers vouchers or certificates that can be redeemed for a specific service provided by a participating private business or nonprofit. Vouchers are used in several states to expand school choice (Walberg 2010).

Service Shedding or Divestiture: Governments shed responsibility for providing a service, activity, or asset entirely, often through outright sales. Local governments routinely sell off aging or underutilized land, buildings, and equipment, returning them to private commerce where they may be more productively used.

Privatization vs. the State

by Chris Woltermann

Bertrand de Jouvenel wrote that history "is the picture of a concentration of forces growing to... the state, which disposes, as it goes, of ever ampler resources, claims over the community ever wider rights, and tolerates less and less any authority existing outside itself."

We should remember his words in assessing the progress of privatization of state-owned assets in Eastern Europe and the various Republics of the Soviet Union. The need for privatization is urgent, but unless ex-communists disabuse themselves of the notion that government should administer the transfer of state properties to private hands, privatization will remain an empty promise, and enervated state systems will lumber on indefinitely.

So far, the efforts in those countries resemble that of a witless counterfeiter who copies other counterfeiters' work. Such a bungler will produce a product twice removed from the genuine article.

In theory, the policy of governments to divest themselves of socialized properties should reverse the historical trend toward the distension of public authority. Privatization should augment private interests in civil society while reducing both the scope and the intensity of governmental activity. This reasonable theory, however, proves practically inoperable. It only serves to mask--and thereby facilitate--the state's growing subjugation of private interests.

Western privatizers take an action-oriented, empirical perspective: privatized enterprises are desirable because they yield tax revenues. and the proceeds from the sale become available to finance new governmental programs. Then, too, the welfare state's "mandated benefits" can be expanded to newly private firms. In contrast, government-owned businesses require subsidies that divert public spending from other objectives. Thus privatization serves the welfare state by both funding it and relieving it of some of its burdens, freeing resources for the state to meddle yet more intrusively in the lives of its subjects.

State-sponsored privatization does not reverse the welfare state's pernicious conflation of public and private interests. Instead, all property takes on an air of conditionality: it becomes a species of "social grant," something analogous to an entitlement whose beneficiaries retain their positions on condition that they fulfill social democratic pods.

Everything denoted by proprietorship has come to subsist at the will of those who staff the government's apparatus. Under penalty of the state's sanction, property owners must manage their possessions so as to satisfy the demands of egalitarian victim groups. If two hallmarks of ownership are, as Aquinas taught, exclusive possession and the right to control, then today's proprietors appear increasingly to be mere stewards of public property.

This is precisely the conundrum of privatization in Eastern Europe and the Soviet Union. These efforts are already floundering and causing a public backlash against privatization by bureaucracies and international agencies. Only in former East Germany is privatization taking hold, but there again in its social democratic variety, and with the help of a "rich uncle" to stand surety for their future.

If not through a state-run program, how, then, to privatize? If it happens, it will be through a radical privatization from below--an authentic dismantling of the state--rather than from above, where the state disingenuously divests itself of costly socialized property.

No blueprint exists for privatization from below, yet the history of the Western Roman Empire's dissolution provides an inkling of what workable privatization might look like. Russian-born historian, Mikhail Ivanovich Rostovtsev, provides suggestive analysis in his *Social and Economic History of the Roman Empire*.

The reforms of Diocletian and Constantine, explains Rostovtsev, brought productive activity nearly to a standstill. Although this was hardly the emperors' intention, their ruinous taxes, which systematically despoiled the private sector, made disaster inevitable. No longer could men employ their creative energies and ideas--and what was left of their capital assets--to generate wealth. The only path to personal enrichment was state employment, where the corrupt cunning exploitation" of one's position enabled one to plunder both the people and the government. The entire situation, like today's collapsing communist societies, was extraordinarily unstable.

That's when privatization got underway. Roman officeholders appropriated state lands as their private property. Other officials used ill-gotten liquid wealth to purchase real estate of newly-impooverished merchants and landowners. Rome's erstwhile "public servants," having acquired vast estates where they ruled amidst mercenary retainers, came to devote their time and energy to private concerns. By default, the Roman state withered away.

Nor were the officeholders the only practitioners of crude privatization. Barbarian invaders seized much property. And Romans who were not officials, provided they were energetic and unscrupulous, also grabbed public and private lands.

The late Roman Empire's process of privatization was chaotic, lawless, and often violent. Yet despite the untold suffering it involved, it swept away the abominations wrought by Diocletian and Constantine. Thus in some ways it worked splendidly. Moreover, it was--and remains in both retrospect and prospect--the only conceivable means to reverse statism.

If replicated in lands blighted by communism, the Roman precedent would have government officials and/or ex-communist party members privatizing--that is, seizing for their private purposes the lion's share of public properties. Ambitious civilians, certainly including common criminals, would also grab quite a bit. The role of barbarian invaders would fall to foreign investors intrepid enough to invest without guarantees. The entire affair would be an enormous upheaval, the sort of epochal event which gives birth to epics and tragedies.

What about the necessity of orderly change? It is commonly suggested that the first step towards orderly dismantling communism is the creation of laws that respect private property. In fact, private property is chronologically and logically anterior to laws that respect it. Private property must exist before there can be laws enshrining it as a right. In our example, the property rights established amidst the debris of the Western Roman Empire became the basis of new civil codes cobbled together with Roman jurisprudence. Laws by themselves do little or nothing to alter their social contexts. Private property must be established before it can be legalized and protected.

If Western privatization enthusiasts are right to be optimistic about the future of former communist societies, it will be the first time in history that internal revolutionary change significantly diminished state power. The ghosts of Diocletian and Constantine will always demand their revenge.

"Revolutions liquidate weakness and bring forth strength," said de Jouvenel. That's why, short of the solution laid out here, a gambling man would require steep odds to bet in favor of authentic, state-run privatization.

Is Privatization Necessary?

John Nellis

The answer is a decided "yes." Privatization is necessary and not simply to improve the performance of public enterprises—though the evidence is striking that it can and does improve performance. Privatization's essential contributions are to "lock in the gains" achieved earlier in reforming public ownership or in preparing a firm for sale, to distance the firm from the political process, and to inoculate it against the recurrence of the common and deadly ailment of public enterprises: interference by owners who have more than profit on their minds.

Performance and ownership—the debate

Market forces

Neoclassical economic theory suggests that the relationship between ownership and performance is tenuous; efficiency is seen mainly as a function of market and incentive structures. In theory, it makes little difference whether a firm is privately or publicly owned as long as:

- It operates in a competitive or contestable market without barriers to entry or, just as important, barriers to exit.
- The owner instructs management to follow the signals provided by the market and gives it the autonomy to do so.
- Management is rewarded and sanctioned on the basis of performance. Evidence shows that the theory does indeed apply in practice—with two crucial qualifications. First, the full set of necessary conditions is only rarely met. And second, even when it is met, it tends to stay met for only a while; the necessary conditions cannot be made to endure.

Principal and agents

There are a number of modern amendments to neoclassical reasoning that attempt to establish a clearer relationship between ownership and efficiency. These come mainly from public choice theory and the literature on principal and agents. Operationally, this reasoning says that private ownership will produce superior efficiency outcomes because of five factors:

- Private ownership establishes *a market for managers*, leading to higher-quality management.

- *Capital markets subject privately owned firms to greater scrutiny and discipline than they do public enterprises.* Public enterprises often operate on Janos Kornai's famous "soft budget constraint." Because of explicit or implicit guarantees from the state, public enterprises can borrow capital at less-than-market interest rates, and they often enjoy outright subsidies and other concessions from the state (meaning that they don't pay their taxes, their utility bills, their accounts payable to other public enterprises, customs duties, or the like).
- *Private firms are subject to exit much more often than public enterprises.* Private firms are more subject to bankruptcy, liquidation, hostile takeover, and closure than public corporations. When exit is a real possibility, there is a greater likelihood that owners and managers will take active, efficiency-enhancing measures to avoid it.
- *Politicians interfere less in the affairs of private than public firms.* Political interference is a major cause of efficiency-reducing conditions in public enterprises; it manifests itself in overstaffing, undercapitalization, inappropriate plant location, wrong use of inputs, and many other costly acts.
- *Private firms are supervised by self-interested board members and shareholders, rather than by disinterested bureaucrats,* and are thus more likely than public firms to use capital efficiently and to maintain it.

Practical solutions

The problem with all five of these arguments is that one can readily conceive of mechanisms to correct the perceived deficiency—without changing ownership. For example, if finding and rewarding excellent managers is the issue, enterprises could recruit outside the public sector, or even internationally, and offer incentive packages equal to private sector scales. If the soft budget constraint is the problem, governments could eliminate all guarantees and stipulate that public enterprises must turn to commercial capital markets and act, and be treated, like any private sector borrower. If exit is the constraint, governments could liquidate persistently poorly performing public enterprises. If political interference is the difficulty, then the owner and the enterprise could sign a performance contract specifying their mutual obligations and responsibilities of the principal and the agent; or the owner could constitute and empower a new and more independent board of directors and give it explicit instructions to maximize commercial profitability; or the owner could name a powerful and independent chief executive officer, and give him or her a free hand. The fifth factor—better representation of the interests of capital—is more difficult to resolve without some change in ownership, or at least some privatization of management—through management contracts, leases, franchises, or concessions. But even here performance agreements and other mechanisms to create surrogate capitalists are imaginable: for example, establishing a holding company or companies and instructing them to act like private owners, or fragmenting ownership among several different levels of government or state agencies and making them dependent on the income generated by the enterprise. Both institutional approaches would presumably diminish the saliency of noncommercial objectives.

Tried and tested?

All of these theoretically applicable solutions have indeed been tried, or are presently being tried, around the world—with some highly positive responses. New Zealand's "corporatization" efforts of the mid-1980s achieved efficiency and financial gains in ten of eleven enterprises studied by Duncan and

Bollard in *Corporatization and Privatization: Lessons from New Zealand*.¹ Korea's performance evaluation system for twenty-six of its government-invested enterprises reduced, for a time, financial losses to zero. These financial gains were accompanied by a declining ratio of costs to sales, indicating efficiency gains. Korea's reform program relied heavily on a goal setting and review system—complete with rewards—and a massive change in the boards of directors that reduced civil servant membership to a small minority. The most powerful recent empirical evidence to support the thesis that reform can work without ownership change comes from China. There are now about 1.3 million township and village enterprises employing 90 million people. They account for more than 20 percent of China's industrial production and are growing far more rapidly than the traditional state-owned enterprise (SOE) sector. Their financial and economic performance surpasses that of the traditional SOEs by two or even three times. They are a stunning example of how positive performance can be achieved by firms that are not privately owned—but that are made to act as if they were.

Added to these positive cases are the findings of a fairly extensive literature, most of it dating from the early 1980s, which tried to measure public versus private performance. This was done basically on a "with and without" basis; that is, comparisons were between roughly similar public and private enterprises in operation. The conclusions reached were by no means unanimous, but more often than not the literature suggested that, after correcting for market structure, there are no real differences between public and private ownership. The policy implication is that perceived deficiencies of public enterprise performance can be corrected by changes in policy, incentives, and institutions, and that ownership change is not necessary.

In light of all this, how can one still reasonably contend that ownership matters?

Why ownership matters

Probability

The first strand of the case is probabilistic in nature. While private firms do not always outperform public enterprises, the evidence shows that *they usually do*. For example, over the years, the World Bank has noted that rates of return on equity invested in industrial or commercial public enterprises often are about a third of those in the country's industrial-private sector. The overall contention is that there are two spectra of performance from good to bad—one for public enterprises, one for private firms.

There is a fair degree of overlap between the two. But the private sector performance spectrum extends somewhat to the right of the public enterprise performance spectrum—and mean performance for private enterprises is also somewhere to the right. That leaves a variance to explain—and ownership is a strong candidate for a good part of the explanation.

Empirical work

The second strand of the argument is empirical. It is based on several recent and rigorous studies that have looked at firms before and after privatization. These recent studies show generally, and impressively, improved performance after sale. A *Journal of Finance* article²—by Megginson, Nash, and van Randenborgh—compares the pre- and post-privatization financial and operating performance of sixty-one companies from eighteen countries in thirty-two industrial sectors. The study shows strong post-sale performance—increased real sales, greater profitability, increased investment spending, improvements in operating efficiency, and, most surprising, a slight increase in work forces.

A second study, on the welfare consequences of selling public enterprises, was conducted by the World Bank in collaboration with Boston University economists. This study looked at pre- and post-

sale performance in profitability and productivity in twelve firms in four countries. It went on to construct an elaborate counterfactual, to determine what would have happened had the enterprises *not* been privatized. The authors then were able to say “here is what was actually happening before sale, here is what actually happened after the sale, here is what we reason would have happened under continued government ownership.” In constructing this scenario, they did their best to isolate and neutralize the gains and losses due to factors other than divestiture. They then subtracted the hypothetical from the historical, and thus derived a measure of the gains due to ownership change. This study quantifies the welfare gains and losses of the various actors in the process; that is, the costs and benefits to the selling governments, purchasers—domestic and foreign—workers, consumers, and competitors. The results are as follows: in eleven of twelve cases studied, there were *positive* welfare effects for society because of the sale, and improved performance at the level of the firm.

Compromise and backsliding

The third and final strand of the argument for private ownership is political and organizational in character. The idea is twofold. First, as noted, most governments find it difficult if not impossible to apply the entire package of qualifying conditions that are essential for reforms short of ownership change to work. The landscape, particularly in developing countries, and now in ex-socialist countries as well, is littered with partial attempts to impose reform where the government owners hadn't the will or the fortitude or the knowledge or the capacity or the luck to impose the whole of the reform package—and the results were minimal, modest, or nonexistent. There are innumerable examples in which government owners kept prices for the products of supposedly reformed public enterprises too low to cover costs, out of fear of the political consequences of price increases. Governments may shut off direct budget flows to public enterprises, but few then go on to block concessionary transfers from the banking system. Governments grant operational autonomy to managers, but not with regard to hiring and firing, or plant location, or from whom to obtain inputs. Technically innocuous board of director reforms have been halted in Kenya, Morocco, and elsewhere because board membership is a lucrative core part of the patronage system. The list is endless, and the point is obvious: most governments have noneconomic objectives for their public enterprise systems. While they want them to be profitable and productive, they are most often unwilling or incapable of allowing these commercial aims to take clear precedence over the noncommercial. Thus, their reform efforts tend to be partial.

Second, in the few cases in which governments do establish and maintain the precedence of commercial over noncommercial aims, the results are, as we have seen in China, very good. *But they tend not to last.* In most instances there is pronounced backsliding. The common story is that bad times make for good policies—in crises governments do establish the precedence of commercial objectives, they do impose a harder budget constraint, and they do give autonomy to public enterprise managers to achieve commercial aims. But again and again, when the crisis fades, or when the regime changes, or when some major political claim arises, commitment to the priority of commercial aims and to noninterference in day-to-day management of the firm fades with it. Examples of backsliding include the New Zealand Post Office, the Japanese National Railway, Pakistan public industrial enterprises, and some of the Korean government invested enterprises.

Conclusion

Based on this reasoning and evidence, it is clear that ownership matters—that it is a significant determinant of the profitability and productivity of an enterprise. Political and organizational factors are

fundamental to the reason why. Ultimately, as Oliver Williamson is fond of saying, “politics trumps economics.”

Question to think about

1. What do you think about the public enterprises in Nepal?
2. Should Government involve in business or work to improve the business environment?