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The What, Why, and How of Privatization: A World Bank Perspective

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THE WHAT, WHY, AND HOW OF PRIVATIZATION: A WORLD BANK PERSPECTIVE

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Ms. Shirley outlines privatization, defining the concept and suggesting why privatization should occur and how it can be best implemented. She first defines privatization as the transfer of ownership of assets to the private sector. She then discusses why a government should privatize, as opposed to why governments often want to privatize. Finally, Ms. Shirley discusses various steps governments should take in effectuating privatizations.

INTRODUCTION

PRIVATIZATION is much in the news today—and well it should be. The acceleration of interest in privatization evident in the last two to three years is striking. Governments of very different political and ideological streams are bent on privatizing, and governments that are already privatizing are moving from selling small retail outlets and industries to selling larger mining and infrastructure enterprises. The World Bank's interest in privatization stems from its fundamental goals—to help its borrowers achieve efficient growth with equity, while reducing poverty and protecting the environment. Privatization can be an important means to these ends.

Three questions about privatization should be addressed. The first question is twofold: what is privatization and what is happening in privatization? The second important question with respect to privatization is, why should you privatize? Finally, the question of how to privatize must be addressed.

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I. THE "WHATS" OF PRIVATIZATION

There are two "what" questions on privatization: What is privatization? And what is currently being privatized?

A. *What Is Privatization?*

There are as many definitions of privatization as there are analysts. For our purposes, privatization is the transfer of ownership of assets to the private sector. Increasingly, countries are experimenting with ways of transferring management without transferring ownership—through management contracts and leases—and are trying to simulate privatization—by making public enterprises act as if they were private. Both are interesting, but both differ in real ways from the transfer of property rights over assets to a new, private owner.

All types of privatization have the potential to increase so-called *static efficiency*—what economists like to call *X-efficiency*—which means pushing enterprises to operate cost effectively on their production frontier. Only by privatizing property rights, however, can you bring *dynamic efficiency*—in other words, new investment, or innovation. Leases and contracts do not stimulate dynamic efficiency, because they do not create stakeholders with a clear interest in putting their own funds at risk.

B. *What Is Being Privatized?*

There are virtually no limits on what can be privatized. This is evidenced by the number of enterprises recently privatized. Graph 1 shows that almost 7,000 enterprises have been privatized since the early 1980s.[1] These privatizations are liquidations and sales that transfer assets to the private sector. The graph excludes re-privatizations (the return of nationalized enterprises to their former owners, which was important in Chile and Bangladesh), as well as management contracts, leases and the sale of minority shares. Also excluded are the sales of small retail outlets in Eastern Europe that number in the thousands and would make the graph look very different.

As the graph shows, the former East Germany takes the lead with 4,500 enterprises privatized.[2] Among developing regions, Latin America is an important privatizing region; it has sold or liquidated over 800 firms.[3] Within that region, Mexico (433) and Chile (261) are the most active in privatization. Eastern Europe—excluding East Germany—has privatized some 805 enterprises. Africa is next (373), followed by Asia (122).

Of course, examining the numbers of enterprises privatized says nothing about the magnitude of the sales. Instead, consideration must be

1. *See* app., Graph 1.
2. *See id.*
3. *See* app., Graph 2.

given to the cumulative gross proceeds as a percent of 1990 Gross Domestic Product ("GDP") to comprehend the magnitude of these privatizations. Although these numbers are available for only a handful of countries, they are quite revealing.[4] Graph 3 shows that Chile reduced the number of enterprises by seventy-five percent, and the proceeds were a whopping twelve percent of GDP. Jamaica, by selling fourteen percent of its firms, raised the equivalent of 5.8 percent of GDP. By contrast, Mexico sold almost forty percent of its enterprises, but the gross proceeds were only 3.5 percent of GDP. The disparities in the proceeds of privatization as a percent of GDP can be explained by the fact that Mexico has been selling small firms; only recently has Mexico begun to sell larger enterprises such as airlines, banks, and the telephone company.

What do sales mean in terms of total state-owned assets? Graph 4 shows that the United Kingdom has reduced its state-owned assets by thirty percent; Mexico by only half that.[5]

II. Why Privatize?

A. *Reasons Why Governments Should Privatize*

Although there are many reasons why governments may *want* to privatize, the focus must remain on why they *should* privatize. Specifically, there are three reasons why governments should privatize.

1. Privatization Improves the Use of Public Resources

Nations can privatize in an attempt to improve the use of public resources. The Finance Minister of Mexico uses a very telling example to illustrate how privatization can improve the use of public resources. Although only two percent of the Mexican population has ever flown, the Mexican government, in an effort to upgrade the fleet of its national airline, paid an amount that could have covered the cost of paving over half of the nation's unpaved roads. In addition, he goes on to note that the accumulated losses of Mexico's large public steel mill now exceed ten billion dollars. With a fraction of that amount the state could provide potable water, sewerage, hospitals, and education to the poor in every community in Southeastern Mexico.

These examples are not unusual or in any way peculiar to Mexico. The situation is similar in virtually every developing country. Public enterprises divert the scarce resources of public money and public management skills from high-priority uses. Privatization would free those resources for other, more important tasks such as education, health, and nutrition.

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4. *See* app., Graph 3.
5. *See* app., Graph 4.

2. Privatization Improves Operating Efficiency

In addition to improving the allocation of public resources, privatization often improves the operational efficiency of the privatized entities and thus results in more efficient uses of resources. After privatization, a Latin American telephone company saved ten million dollars just by asking its workers to show a picture ID when they came to pick up their pay checks. Similarly, a Chilean company saved eighty-eight thousand dollars a year by reducing the theft of electricity. These stories can be repeated again and again. Even more telling, an in-depth study conducted by the World Bank on the efficiency effects of privatization in Mexico, Malaysia, Chile and Great Britain shows consistent net improvements in efficiency in the companies studied.

There are two factors at the root of this change. One is competition. John Vickers and George Yarrow argue quite convincingly that if public enterprises are not unfairly supported, then the efficiency of public and private companies under competition is the same. In developing countries, however, public enterprises tend to be unfairly supported. Often, support takes the form of a monopoly. Public enterprises may be monopolies even in markets where the potential for competition exists. In those rare cases where competition is allowed, the playing field is not a level one. Support can be obvious: subsidies, loans, loan guarantees, or tax exemptions. But support can also be "hidden:" in one African country, the enterprises were several years behind in paying their taxes and their utility bills. They faced no fee or penalty for this behavior. This "hidden" subsidy would interfere with free competition if the enterprise's competitors have to pay up and cannot run up arrears.

While some public enterprises are unfairly supported, others are unfairly burdened. Recently, a Pakistani manager of a public manufacturing company stated that he must train five workers for every one worker hired. It appears as if he were running a vocational training school, making it difficult for him to compete and hard for the government to insist on a competitive performance. Similarly, in one East Asian country, where most of the boards of directors of public enterprises are former military, the public enterprises are unfairly burdened. While these former members of the military offer little in the form of managerial assistance, the public enterprises that employed the former generals and admirals are strapped with supporting their expensive tastes and lifestyles.

These burdens are important in preventing competition because governments are reluctant to let their public enterprises go bankrupt despite the direct impact on a national budget from losses sustained by public enterprises. Rather than sustain these losses, governments attempt to prevent them by eliminating competition. Privatization ends this vicious circle. By allowing competition, privatization creates pressure for enterprises to perform or fail.

The existence of private property rights is a second reason why privatization results in better performance. Typically profit-oriented owners push their companies to perform better at lower costs and to be more service- and client-oriented. Unlike the public owner, private owners are usually quicker to change management and faster to respond to opportunities. This is due in part to the fact that private owners are motivated by their own stake in the company and in part to the fact that they are free of the political constraints that bind government.

3. Privatization Improves Dynamic Efficiency

The effects on dynamic efficiency are a third reason for advocating privatization. The Chilean telephone company increased the number of phone lines by seventy-two percent in the three years after it was sold. The newly privatized Mexican phone company, TELMEX, is laying down 8,400 miles of fiber-optic cable to link Mexico's fifty-six largest cities. These are not isolated examples. Research shows that privatization has almost always caused an increase in investment and innovation. The deals themselves are designed to encourage investment—TELMEX pays ten percent taxes if it invests; twenty-nine percent if it does not. Moreover, private stake holders have a strong incentive to recognize opportunity more readily and seize it more aggressively than public bureaucrats. By contrast, public enterprise managers are rarely rewarded for taking risks, even those that are successful, while the penalty for unsuccessful risk-taking is often high. At one point, a Latin American country jailed the chief executive officers of enterprises that made wrong investment decisions—wrong from a commercial point of view. Finally, dynamic efficiency is improved by the simple fact that the private sector is also free from the political constraints that can make it hard for public companies to raise the finances needed for new investment.

B. *Reasons Why Governments Often Want to Privatize*

As previously stated, there are legitimate reasons why governments *should* privatize. Often, however, privatization of government services are motivated by other concerns. The most important concern motivating privatization is an attempt to increase available public resources. Although this is often a reason why governments *want* to privatize, it may not be a valid reason why they should.

If priced properly, the sale of a public enterprise will only generate income in an amount equal to the discounted net present value of any future income the enterprise would have generated for the government, plus the scrap value of the enterprise. By selling an enterprise, however, the government may forfeit some revenues in the future, although it is quite possible that the taxes collected from the private company will exceed the resources the public firm would have generated. Thus, in a theoretical sense, the argument that privatization creates additional public resources is illusory.

Furthermore, an over-emphasis on generating resources can lead to sacrifices in efficiency. For example, government may not use privatization to foster competition if it will reduce the price of the sale. After all, a buyer will pay more for a monopolistic enterprise that guarantees profits than for a competitive firm that may or may not be profitable. Thus, although selling or leasing an unprofitable firm may reduce or eliminate a fiscal drain, where special concessions and protections are extended to the buyer, the burden on the economy can be considerable and may outweigh the benefits of removing the fiscal drain. Attempts to sell non-viable firms as going concerns may not only invite special protection or subsidies, but may also lead to subsequent government bail-outs. The closing and liquidation of firms that do not meet the market test of viability provide a better solution.

For the same reasons, selling enterprises through debt/equity swaps as a motive for privatization should not be overemphasized. This has proven an effective way of reducing the debt in Argentina, where the sale of TELECOM reduced the foreign debt by five billion dollars. It should not be forgotten that debt/equity swaps give the buyer a discount on the face value of the asset. Under some circumstances, governments may be just as well off selling enterprises and using the proceeds to buy back the debt—something Mexico plans to do with the fifteen to twenty billion dollars it has raised through privatization. Here again, if the government focuses on maximizing the proceeds from the sale or the amount of debt retired and loses sight of the efficiency effect, the impact on the economy could be adverse.

III. How to Privatize?

The beneficial effects from privatization flow only from correctly implemented privatizations. Effective privatization can be difficult to accomplish, especially for institutionally weak developing countries. A key concern is how to privatize. There are three fundamental steps in properly effectuating a privatization.

A. *Governments Must Create a Conducive Environment*

New Zealand, Britain, Mexico, and Chile are all successful privatizers, and an important reason for that success is their emphasis on creating an environment that encourages competition. Chile is one of the most successful privatizers, not just in terms of number of enterprises sold but in terms of the efficiency effects of privatization. This has not always been the case.

Chile's first attempt at privatization resulted in the sale of enterprises to groups controlling large banks. The banks subsequently made high-risk loans to their own companies, and when the economy went through a downturn, Chile suffered a crisis similar to the recent United States savings and loan crisis. The government eventually was forced to intervene and re-sell the companies in conjunction with appropriate financial regulation.

Typically, privatization works best when it is only one part of a larger program of reforms designed to create an environment that promotes efficiency. Such a program usually includes: trade reforms encouraging competition and export; price reforms liberalizing markets; regulatory reforms safeguarding competition by removing obstacles to private entry and exit; and legal reforms assuring proper disclosure, enforcement of contracts, and due process. In one developing country, sales of public enterprises have been conducted despite the fact that they violated the nation's constitution. In another, the deals concluded ran directly counter to a recently passed law. Such behavior not only bodes ill for the future performance of the company and the sustainability of the privatization, but also undermines respect for the rule of law, a critical element for the development of an efficient private sector.

B. *Governments Must Streamline the Privatization Process*

Mexico has successfully sold thousands of enterprises, including some very large enterprises, with only seven people conducting transactions. These people held and exercised much power over the enterprises once they were earmarked for sale. Relying heavily on outside expertise, mainly from Mexican banks and international investment banks, the decision-making process was centralized in their hands, with the economic cabinet of the government acting as watchdog. Such a centralized system might seem subject to abuse, but the check in Mexico was transparency. Much effort went into explaining why and how privatization was being offered to the public. The enterprises were sold through auctions, where at least three bidders were needed for a sale to take place. The terms of the sale were advertised in the paper. At auction, the government officials would try to sell a company three times, and if they could not obtain the minimum accounting price they had established, they would liquidate the company and sell the assets. Not all circumstances or companies lend themselves to this approach, of course. But the underlying features of the process are well worth emulating: a clear central focal point with responsibility for the sale, the power to match that responsibility, a lean process without a lot of actors, and a transparent process that cannot be easily corrupted or diverted.

An important factor in transparency is valuation. A realistic valuation is necessary to set a floor price as a basis for negotiations and as a check that the deal is legitimate. Thus, when outsiders judge the privatization process they often compare the sales price with the so-called "value" of the enterprise. Determining the value of a public enterprise, however, may be difficult.

A privatizing enterprise can be thought of as a commodity that has never before been on the market. Therefore, how do you decide its value in the absence of a market test? Even in the United Kingdom, there has been much controversy over the sales prices of public enterprises. The situation is far worse in developing countries, where the accounts may be out of date and inaccurate—the one telecom company was sold without even having a balance sheet for the year prior to sale. Often, the book value of a company bears no resemblance to the company's market value, especially if the company has a poor track record, redundant layers of employees, and a host of operating problems. Governments often are forced to rely on an independent body to assess the value of the company, leading sometimes to very unrealistic results. For example, an independent government agency valued an African shipyard at $6.2 million despite the fact that 1990 profits only amounted to $3600. Surely, the government would encounter many difficulties in an attempt to sell this enterprise for six million dollars. Therefore, it is crucial to establish an accurate and realistic value as a floor price.

Expert advice plays an important role in the privatization process. Interestingly, government officials everywhere, even in developed countries such as Canada, report difficulty in using technical expertise properly. This is due in part to the unrealistic expectations governments have about what advisors can and should accomplish. An investment banker active in the Mexican and Argentine privatization programs suggested that in his view, the role of the investment bank in privatization is to give a signal to the client government of what the market will or will not tolerate, thereby establishing a sort of market test to help privatizing governments negotiate the best deal. Governments, however, often do not envision the role of investment bankers the same way. Governments tend to expect their advisors will both tell them what the market will bear, as well as advise them of what is best for the welfare of the public at large. That, however, is not the role of a successful investment banker.

Investment bankers cannot be asked to protect the broader public interest. Governments must do so. This may require close scrutiny of the advice received from investment bankers. For example, investment bankers have suggested raising the tariffs charged by Canadian-regulated state enterprises to a level above the efficiency price as a way of attracting buyers and getting a higher price for the enterprises. Had this advice been followed, the customers of these Canadian companies, Canadian consumers, and investors would have suffered adverse consequences. Advisors play different roles. Governments of privatizing countries must assess what technical advice is necessary, and hire a team of different kinds of advisors, including people who can help them design regulatory and policy frameworks to maximize the benefits from privatization to the economy as a whole.

C. *Governments Must Prepare the Enterprise for Privatization*

To attract buyers who are willing both to pay a reasonable price for an entity and to invest in improving the efficiency of the entity, governments must make the public enterprises more attractive. This may require much preparation by the involved government. Though this does not require new investment in the company, it may require eliminating debt from the enterprise's balance sheet.

Many public enterprises are burdened with debt as a result of previous ill-advised investment programs. Few buyers want to put money into debt repayment when they are buying a company. Contingent liabilities, such as pension funds, large severance pay agreements, or claims for environmental damage, are greater deterrents to privatization due to the inestimable scope of these liabilities. Removal of some of these liabilities has proven advantageous to privatization in East Germany, where the Treuhand has paid ninety percent of previously incurred damages.

Though painful, layoffs are another form of preparation. Successful privatizers have tended to lay off redundant workers before sale. The work force of British public enterprises was sharply reduced before any sales and increased afterwards. In preparation for the franchising of the Argentinean rail freight system, 90,000 people, one-third of the employees, are being laid off. Government must deal with redundant labor because many buyers will shy away from enterprises where they must undertake layoffs. In addition, government can better develop a social safety net to help ease the social costs of unemployment. Although unemployment is sometimes cited as a result of privatization, it is not. Rather, unemployment results from the reduction of redundancies and the shut-down of non-viable enterprises. Any reform program that aims to increase efficiency, whether it changes ownership or not, may lead to layoffs of redundant workers.

Government must also work with the labor force to win acceptance of the sale. Jamaica and Chile used sales of shares to workers partly as a way to increase worker acceptance of the sales. Chile sold between five and ten percent of the shares of enterprises directly to workers—who could get an advance on their severance pay to buy shares—at a discount with a repurchase guarantee at the time of retirement. Some analysts suggest the sale to workers may have earned a higher price for Chilean companies sold because investors felt that a worker stake in the company reduced the risk of re-nationalization.

A third form of preparation that governments must contend with is the break-up of monopolies. The East German privatization agency, the Treuhand, started out with 6100 firms to privatize. A year later, after 1300 companies had been sold, the Treuhand had 9000 companies to privatize—largely as a result of the breakup of monopolies. Clearly, governments will want to assure that large monopolies and oligopolies that could discourage competition are not sold intact. Only government can accomplish this. No private buyer would gratuitously relinquish its monopoly position.

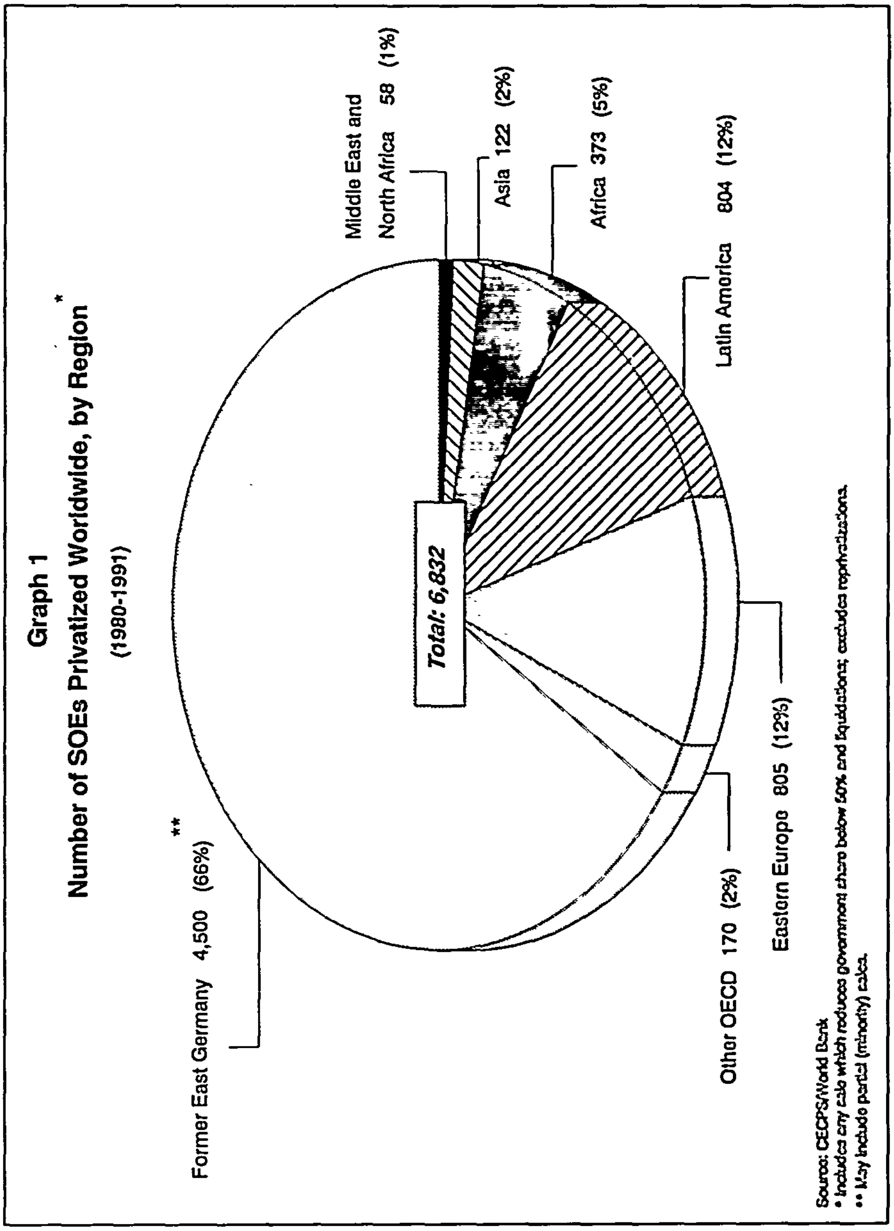
CONCLUSION

The present interest in privatization is no fad. What we now see is a restructuring of the balance between the public and private sectors. During the 1960s and 1970s, there was reliance on government and considerable faith in what government could achieve. Development strategies assumed that there were many failures in the market that government could address in addition to means by which the public sector could accelerate development. As a result, public enterprises were created to run the "commanding heights" of the economy. Public enterprises were also created to deal with social ills by generating employment, investing in backward regions, and by charging "reasonable" prices to poorer consumers. Lessons have been learned, however, and today's strategies reflect these lessons. Markets fail, but so do governments. The public enterprises were unable to meet all their ambitious goals; instead, they sometimes undermined the very objectives they were created to serve. Low fixed prices set to help lower income people led to enterprise deficits. The deficits in turn led to government bail-outs, financed either through taxes or inflation. Both taxes and inflation hit the poorer citizen harder than the rich. "Model" employment practices led to high wages, well above the average wage, for public enterprise employees and entrenched labor forces who were often not employed productively. If higher labor costs were passed on as higher enterprise prices, it often crippled downstream enterprises in the country, thereby reducing new investment and job creation elsewhere in the economy. Many public enterprises created secure, well-paying jobs for the few at the expense of the many.

Developing countries have recognized the flaws in the earlier approach and are creating a new division of labor between the public and private sector. Privatization of assets is one way to achieve this new division. Privatization should be designed to further three goals: (1) improving the use of public resources, (2) improving operating efficiency, and (3) improving dynamic efficiency.

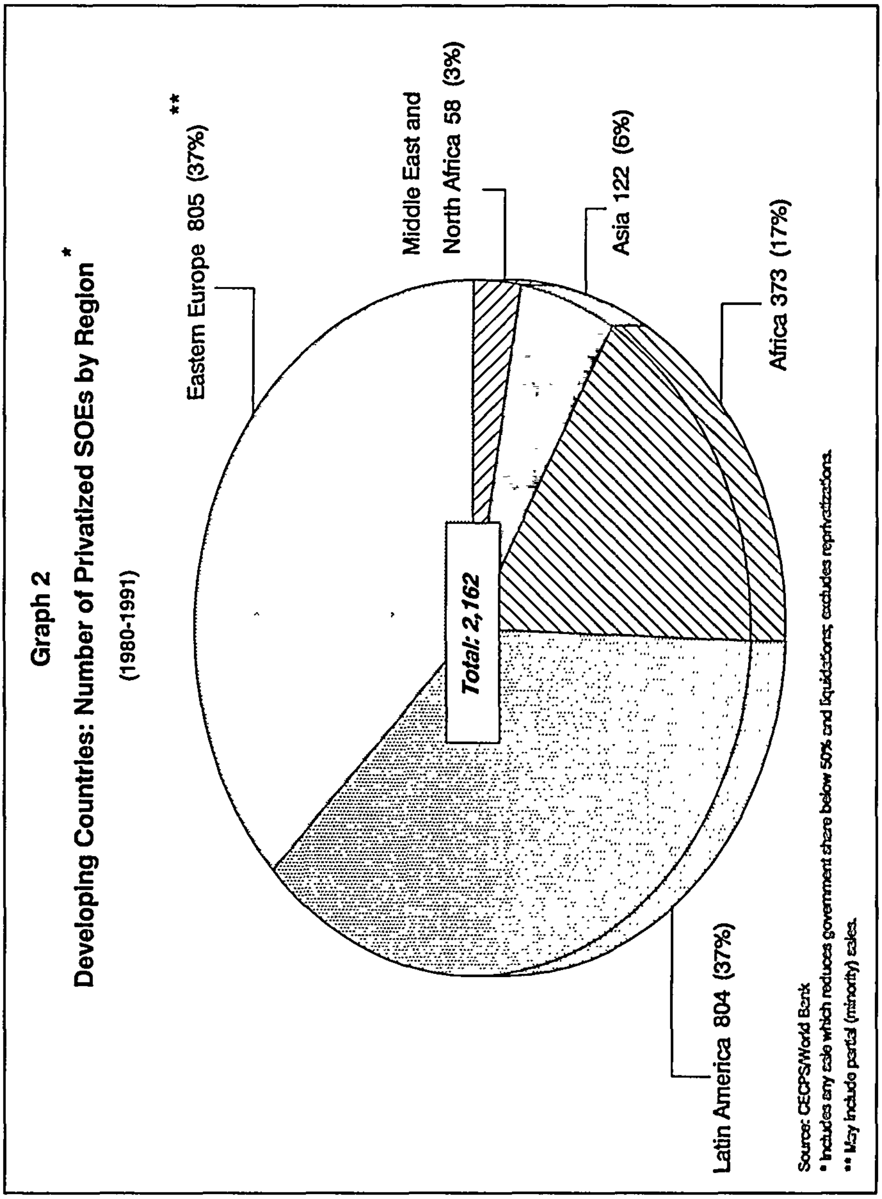
These goals are not automatic results of privatization; governments will need to focus on how they privatize. Specifically, they will need to: (1) create the right environment by undertaking other reforms designed to encourage competition and growth; (2) create a strong, lean, centralized, and transparent process by setting up a small yet effective focal point to privatize while keeping the process public and fair; and (3) prepare the enterprises for privatization by making the necessary changes to assure that the privatization works to enhance efficiency, while at the same time working to cope with any unemployment that may result.

The World Bank aims to help developing countries that are attempting to increase efficiency and cost effectiveness through privatization to do so successfully. It has approved and supported over 140 projects in member countries. The World Bank acts as a catalyst for privatization, helping to finance the technical advice. It also helps countries put privatization in its context and supports a broader program of reforms.

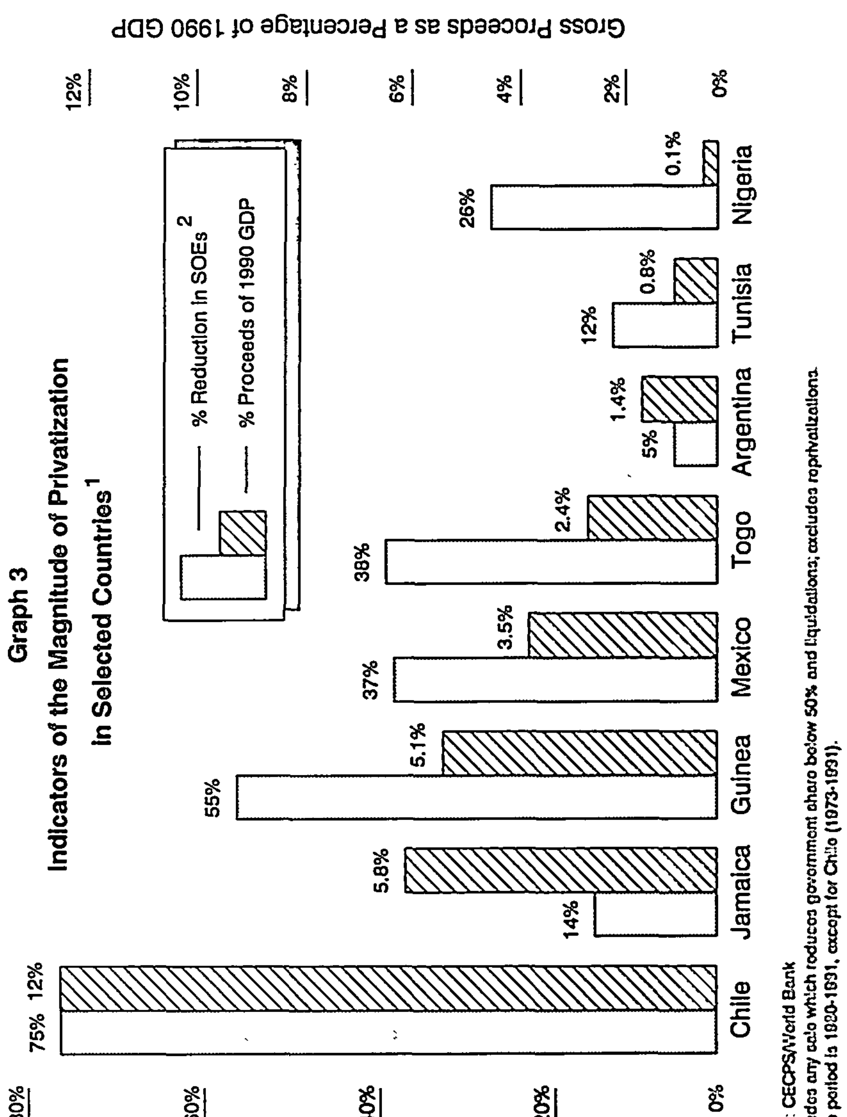


Graph 1
Number of SOEs Privatized Worldwide, by Region *
(1980-1991)

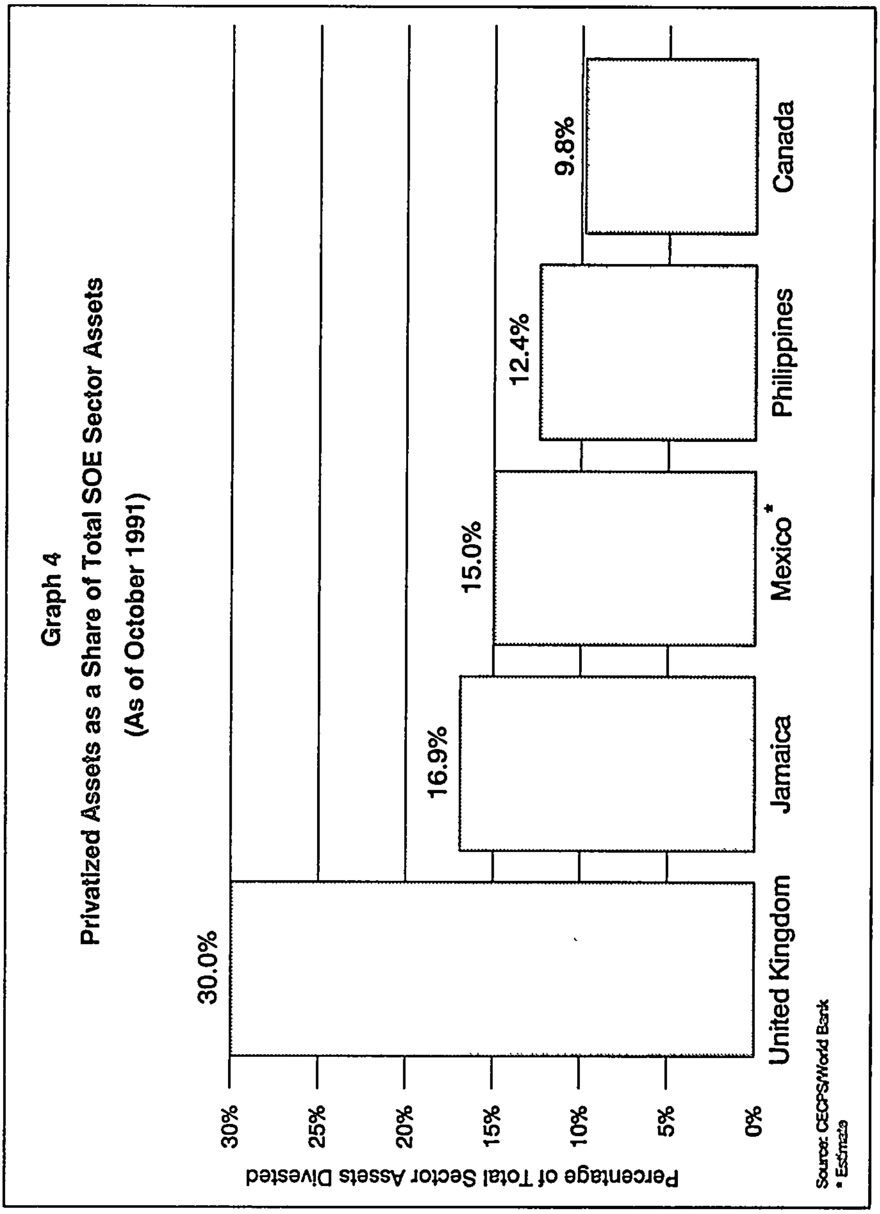
Source: CECPS/World Bank
* Includes any sale which reduces government share below 50% and liquidations; excludes reprivatizations.
** May include partial (minority) sales.


Graph 2
Developing Countries: Number of Privatized SOEs by Region*
(1980-1991)
Eastern Europe 805 (37%)**
Middle East and North Africa 58 (3%)
Asia 122 (6%)
Africa 373 (17%)
Latin America 804 (37%)
Total: 2,162
Source: CECPS/World Bank
* Includes any sale which reduces government share below 50% and liquidations; excludes reprivatizations.
** May include partial (minority) sales.

Graph 3
Indicators of the Magnitude of Privatization
In Selected Countries[1]



Source: CECPS/World Bank
1) Includes any sale which reduces government share below 50% and liquidations; excludes reprivatizations.
2) Time period is 1980-1991, except for Chile (1973-1991).


Graph 4
Privatized Assets as a Share of Total SOE Sector Assets
(As of October 1991)
Percentage of Total Sector Assets Divested
30%
25%
20%
15%
10%
5%
0%
30.0%
16.9%
15.0%
12.4%
9.8%
United Kingdom
Jamaica
Mexico*
Philippines
Canada
Source: CECPS/World Bank
* Estimate