THE PRIVATISATION PHENOMENON AND ITS RELEVANCE TO DEVELOPING COUNTRIES

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"Free Enterprise was born with man and shall survive as long as man survives."

—A. D. Shroff

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Forum of Free Enterprise

THE PRIVATISATION PHENOMENON AND ITS RELEVANCE TO DEVELOPING COUNTRIES

By

JIBAN K. MUKHOPADHYAY*

I — THE GENESIS

The global wave of privatisation has become so sweeping and overwhelming a process that it will be perhaps no exaggeration to call this new found economic strategy to be a significant socio-economic revolution in the making. It has come as if to counter the previous wave of nationalisation which was vigorously pursued in Great Britain.

The doctrine of socialism became popular first in Great Britain and France in around 1830 and then evolved and developed further. All schools of socialism have urged the transferance of large scale industries from private to public ownership. However, the British Labour Party's idea of nationalisation was borrowed from the Fabian brand of socialism, developed mainly by Jeavons, John Stuart Mill and Sidney Webb, and not necessarily Karl Marx.

In Great Britain, Herbert Morrison (later Lord Morrison of Lambeth), popularly known as the father of nationalisation, deviced the norms of public ownership of industries. Based on Morrison's norms a spate of nationalisation of industries was done in Great Britain after the World War II. Almost simultaneously many countries in Western Europe started experiments by nationalising industries.

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In the communist block, led by the Soviet Union, it was, of course, a different story, All industries there had to be owned and managed by the state.

Lord Morrison had assumed that the public sector would work hard for public good and that competition was a waste of resources. But evidence in many countries shows that he was eventually proved wrong on both the scores.

After the four decade old experiments with nationalisation in many countries of the world, a new world-wide experiment has started during the 1980s in the form of privatisation. Many countries are moving away from nationalisation out of sheer economic compulsions viz., the wide-spread failure of the public sector enterprises, high pressure on government budgets, particularly due to the subsidising of the public sector 'white elephants' and various other major macro-economic problems like slow economic growth, unemployment *et al.*

What is Privatisation:

Since the term privatisation has been recently coined there is no single definition yet universally accepted by one and all. Some experts interpret it narrowly, while some others broadly,

Interpreted in narrow sense, the term privatisation mainly implies divestiture, which means the sale by the state of the whole or part of its holding of the equity shares of a government owned enterprise to private share holders and denationalisation, which broadly means a change of ownership from the state to the private sector.

In a broad sense, however, privatisation would imply much more than divestiture and denationalisation.

Mr. D. R. Pendse, an eminent economist, has synthetised the broad scope of the privatisation process relevant for a developing country like India. According to him, the broad definition of privatisation should include:

1. Divestiture.
2. Denationalisation.

3. Under our (India's) Industrial Policy Resolution (IPR), certain industries are exclusively reserved for development in the State sector. Any relaxation in respect of such an exclusive reservation would be a part of the privatisation process.
4. Closure of liquidation of any State Owned Enterprise (SOE)
5. Leasing of an SOE to a private sector party.
6. Transfer of management and control of an SOE to a private sector individual or agency, more so if it includes a share in profit...
7. Abandoning or postponing proposals (a) to start new SOEs or (b) to expand or diversify activities of any of the existing SOEs.
8. Farming out to private contractors or agencies the function of supplying various goods and services needed by the SOE, instead of these being provided or produced departmentally by the SOE itself.

It is in this broad sense that the term privatisation has been used in this essay.

Where and How did it Start:

Mrs. Magaret Thatcher pioneered this new drive towards privatisation with an ideological zeal in Great Britain when she launched the Conservative Party's election manifesto in 1979. The Conservative Party's manifesto of 1979 introduced privatisation by saying: "The British people strongly oppose Labour's plans to nationalise yet more firms and industries such as building, banking, insurance, pharmaceuticals and road haulage. More nationalisation would further impoverish us and further undermine our freedom."

Transferring public enterprises into private ownership was, however, not a new policy. Conservative governments in Great Britain used to practice this in bits and pieces. But Mrs Thatcher introduced this programme with such a decided dynamism that it has become, in the words of Mr. John Moore, Financial Secretary at the British Treasury, as one of the "most radical economic changes since 1945."

II — A GLOBAL SURVEY

The concept – nay the reality – of privatisation has been, and is being, implemented in many industrially advanced countries like Great Britain, West Germany, Italy, the socialist Sweden and Spain and in France in the Western Europe; the USA and Canada in the North American continent and Japan in Asia.

Even communist-block countries like the Soviet Union and China are in the midst of different stages of opening up experiments based on the basic tenets of the market economy, which could be broadly called the privatisation process.

Many developing countries in Asia, Latin America and Africa also have realised the pragmatism behind the programme of privatisation, some sooner, while some followed it later.

In Developed Countries:

Mrs Thatcher's **Great Britain** of course is the pioneer. She started denationalisation of British industries after coming to power in 1979.

Great Britain has raised $ 23 billion (bn.) by selling all or part of 13 companies ranging from utilities like British Telecom and British Gas to industrial companies like Jaguar, aircraft manufacturer British Aerospace, the state oil producer Brit oil, etc. The British Government has unloaded the giant utility British Gas for $ 7.9 bn., so far the largest stock offering in the country's history. The sale drew 4.5 mn. buyers, dwarfing the popular success of the British Telecom sale in 1984.

By June 1988 more than one million (mn.) jobs are expected to be transferred to the private sector. The proportion of GDP accounted for by the state industries will almost be halved from 10.5 per cent in 1979 to about 6.5 per cent before the next election. The number of British shareholders has doubled from about 2 mn. before the British Telecom (BT) sales in November 1984 to over 4 mn. after sale of one billion British Telecom shares. The British government favours a wider share ownership for checking, *inter alia*, the monopoly power of companies.

However, in the light of the crash of world share markets in Oct. 1987 Great Britain made an assessment of its privatisation programme and decided to continue with it with renewed vigour.

France is the latest and most enthusiastic pursuer of privatisation. The former French Prime Minister, Mr Jacques Chirac, a great advocate of the privatisation process, recently said: "...the state was not meant to be a producer; when it tries to be one, it does expensively and badly." A former conservative French Prime Minister, Prof. Raymond Barre, described the nationalisation programme pursued by the Socialists in 1981 and 1982 as 'nonsense that threatens to become a long-term burden'. Now efforts have been made to denationalise banking and insurance sectors, and some profit making industries and sell off one or more of France's four state-owned TV channels. Most of the 39 banks and 4 major industries that socialist President Mitterand had nationalised in 1981, will be gradually privatised.

France has a plan to sell 65 companies worth as much as $ 45 bn. by 1991. The French government sold $ 1.9 bn. shares of Saint Gobain, a profitable diversified industrial group, which was privatised in 1986 by using a high pitch $ 6 mn. advertising compaign. It is expected to be followed by AGF, an insurance company, and Paribas, an investment bank. The new socialist government that came to power in the middle of 1988 without clear-cut majority has also decided to continue with the privatisation process launched by the Chirac Government.

Similarly, in *Italy, Spain* and *Sweden* also experiments with the privatisation process has started. A large number of shares of the vast Italian government holding company Instituto per la Recostruzione Industriale (IRI) and Ente Nazionale Indrocarburi (ENI), a number of smaller companies and the state airline Alitalia have already been sold. The Italian government has given IRI's Chairman, Romano Prodi, a free hand regarding the privatisation of IRI.

Spain's Socialist Prime Minister, Felipe Gonzalez, calls his country's public sector a "white elephant graveyard". He also started some privatisation process by reducing government holding in the state-owned Institute Nacional de Industria (INI).

West Germany is to privatise most of 958 companies in which government equity holding is more than 25 per cent including IVG, Lufthansa and Volkswagen. The government has already unloaded 14 per cent stake in Veba, the huge energy combine.

In *Sweden*, the late Olof Palme had issued an order to public sector firms to start making profit and also to sell off $ 170 mn. in state-owned industry. Sweden plans to sell a 30 per cent stake in SSAB, the nationalised steel company. In *Netherland, Finland* and *Austria* also the privatisation programme is being pursued.

Japan has one of the most dominant private sectors. Despite this, there is a move towards privatisation in Japan, of most of whatever is in the hand of the government. During the next five years, Japan's already small public sector, will become smaller still as the Japanese government sells all, or part of its shares in Nippon Telegraph and Telephone (NTT), which will be the largest sale surpassing the British Gas, which offered the largest equity issues so far in history. Japan National Railways, Japan Tobacco and Japan Airlines will also be privatised.

The Communist Style Privatisation:

In the *Soviet Union*, the Supreme Soviet Parliament passed a law on 'individual work activity' in November 1986 permitting a degree of private enterprise by allowing individuals to produce goods on a co-operative basis for the private sector. These organisations, until recently illegal, should account for between 10 to 12 per cent of the Soviet national income in ten years and would constitute a new sector of the economy.

The main thrust of the reform is to keep central planning for heavy industry and public utilities, but to allow a broad measure of private initiative in the manufacture of consumer goods, the service sector and agriculture. "This in the home land of

Marxist-Leninism", aptly comments the editorial in the Financial Times "is a minor revolution." Even according to the state newspaper Pravda, the new liberalisation measures indicate a 'deep transformation of Marxist theory'.

In June 1987, the Central Committee of the Soviet Communist Party approved Mr Gorbachev's radical proposals, to be introduced over the next few years, for ushering in Russia's "Second Revolution". The proposals based on "Glasnost" and "Perestroika" (restructuring), include a massive decentralisation of economic management and decision-making, higher wages based on productivity, setting up of prices through competition, allowing private enterprise in selected areas *et al.*

In *China* also there has been an open-door policy and a process of privatisation based on the basic principles of the free-economy under the leadership of Dang Xiaoping. China was considering selling of high-street shops and small industries with profits less than 20,000 yuans in Shanghai. About 30 SOEs in Shanghai alone have already been leased to individuals and a further 200 have been changed from government ownership to collective ownership. In China the share of private ownership plus others including foreign joint venture has moved up from nil in 1978 to 0.8 per cent in 1982 and further to 1.9 per cent in 1985. The share of the state ownership of industry, accordingly, has fallen from 80.8 per cent to 70.4 per cent during this period, and ownership by 'collectives' rose from 19.2 per cent to 27.7 per cent. China is now aiming at forming a 'socialist commodity society'.

The same is the story in a host of East European countries, like *Yugoslavia, Rumania, Poland et al,* where an open economic policy has seen the light of the day and where foreign capital is allowed to be invested.

In Developing Countries:

Witness some further evidence in developing countries, where the privatisation programme has been, or is being pursued, mainly because of fiscal problems like budget deficits, through a variety of ways viz., divestiture — total or partial, de-nationalisation, closure or liquidation of perpetually loss making SOEs, transfer of management, selling through auction etc.

Nearly 100 companies including most of the jute, textiles, chemical and engineering industries have been sold off to private sector in *Bangla Desh* since the announcement of the New Industrial Policy in 1982.

Pakistan has de-nationalised some 200 rural rice, flour and cotton mills as well as transferred maintenance of small wells and irrigation projects to private contractors. On top of this, selective SOEs in basic and heavy industries, as well as air lines will be divestitured in the near future. The government has forecast income of US $ 120 mn. in the budget estimates for 1986-87. The most important divestment scheme in Pakistan will be the partial selling of Pakistan International Airlines (about $ 65.7 mn.).

Thailand and *Malaysia* have been steadily privatising their telecommunication sectors and have sent representatives to Britain and Japan to study their experiences with privatised telecommunications. In Thailand 33 public sector companies have been privatised and the country's Sixth Plan (1987-91) emphasises the role of the private sector and proposes reduced role of public sector companies. Malaysia has already floated the state air line MAS on stock market and Guthrie on the London Stock Exchange. Singapore has also privatised its national flag carrier, Singapore Airways.

During 1982 and 1983 the government of *South Korea* divested itself of all nationwide commercial banks, certain manufacturing industries and public sector services together with the introduction of an effective performance evaluation scheme for controlling the SOEs.

In *Brazil,* the Government prepared a list in 1983 of 89 industries to be privatised. Out of this, 20 had been privatised and 27 more had been merged or handed over to local authorities. Brazil's President, Jose Sarney, recently declared: "Leadership of the economic development process should now pass to a private sector freed from the shackles of statism". He now wants to privatise the remaining 42 firms plus add another 12 firms in the list for privatisation. The shares of very large companies like Petrobras would be offered to the public.

Mexico, Peru and *Argentina* have put certain SOEs on the auction block. Although about 250 public sector companies have been planned to be sold to private sector in Mexico, only 34 were sold so far. In Argentina, President Alfonsin also has preferred privatisation as a part of restructuring of the state enterprises.

Chile has undertaken a programme for complete 'destatisation' of the very dominant state sector by 1989.

In *Venezuela* about 80 companies are being considered to be privatised in various ways. Of the total $ 3.4 bn. in stake, $ 2 bn. worth of shares are likely to be offered to the private sector.

In *Togo*, the injection of foreign private capital into its moribund steel industry has rescued the country's only steel mill and at the same time been acclaimed as a model for privatisation.

Mali, Benin and *Senegal* are also looking forward to arrange privatisation deals, while Tanzania is returning some sisal estates to the private sector.

Early Signals in India

As is well-known, certain loosening up of controls in the area of industrial licensing, liberalisation of import control policy, reduction of income and corporation tax rates and a long term fiscal policy have already been introduced in India. Roughly speaking, over 50 liberalisation decisions relating to industries have been taken since Mr Gandhi became the Prime Minister in January 1985.

It is expected that these measures will usher in a new liberal era of industrialisation in India where productivity, efficiency, cost consciousness, competitiveness and a new management ethos are likely to be the bench-marks. These will of course make life easier for Indian private sector industries. Perhaps these measures do provide early signals for the privatisation process in the strict sense. Some official panels and private experts also have recommended privatisation of Indian SOEs.

III — WHY PRIVATISATION?

Why is it that most countries of the world are interested in privatisation? Why many of them are either actively pursuing the privatisation process, *albeit* in varying degrees, and/or seriously thinking, examining and debating it?

The Public Sector V/s Private Sector:

The most important reason for considering privatisation lies in the grossly unsatisfactory performance of State-Owned Enterprises (SOEs) based on any criteria and the rapidly growing belief that business are managed best by the private enterprise. But any global comparison between the performance of SOEs and private enterprises is an extremely difficult exercise because of the various socio-economic objectives of SOEs and that SOEs are often dominated by slow-growing basic industries.

However, economists have been conducting these exercises. In one such very recent interesting work done by Mahmood A Ayub and Svan O Hegstad, it has been pointed out that 'within the sample countries, and sometimes within the same industries, public enterprises have generally been less profitable than private ones'. They have studied the performance of both these sectors in 13 countries mainly based on three qualities, viz.:

1. degree of competition that public enterprises are exposed to;
2. the degree of financial autonomy and accountability under which public enterprises operate; and
3. the extent and manner in which managerial autonomy and accountability are ensured;

all of which are difficult to assess statistically.

According to them, only in the rare cases where all these three factors exist, "the performance of public enterprises is significantly better than in those cases where most or all of these factors are absent."

Profitability (!) of Indian SOEs:

At this stage let us take a close look at the performance of Indian SOEs, the 'Commanding Heights', as a case study. The overall profitability of Indian SOEs, far less independantly ran than most SOEs in developed countries, has increased in recent years as measured by net profit as a percentage of capital employed, viz., from 0.8 per cent in 1983-84 to 2.7 per cent in 1985-86 and further to 3.4 per cent in 1986-87. But this is too small a return on a huge investment of Rs. 51,931 crores as on end March 1987 for 214 central public industrial enterprises.

The net profit after tax also significantly increased from Rs. 240 crores for 201 such SOE in 1983-84 to Rs. 1,651 crores in 1985-86 for 211 SOEs and further to Rs. 2,142 crores for 214 such SOEs in 1986-87.

But this is not the full story. If the profits of 12 public sector petroleum companies are taken out, the rest non-oil SOEs have recorded a net loss of Rs. 208 crores (for 195 such companies) in 1984-85 which was increased to Rs. 373 crores (for 202 SOEs) in 1986-87.

This, again, is not the whole story. To this must be added the losses of various other undertakings of both the central and State Governments to have an idea about the total loss of Indian SOEs in any particular year. Unfortunately overall financial figures are not easily available.

Though some of the **SOEs** mainly non-industrial SOEs, may not be expected to earn very high profits because of various unquantifiable socio-economic objectives, the annual loss of the Indian non-oil SOEs will be of staggering **proportions.** The accumulated losses over the past four decades, however, must be many, many times more. Perhaps one may be tempted to call this huge loss, a financial "black-hole"

Private Sector Companies in India:

As against this, private sector companies in India have been earning attractive profits. For example, according to a survey of 541 large public limited companies (each with paid-up capital of Rs. 1 crore ($ 0.82 mn. or above) conducted by the Reserve Bank of India for the year 1985-86, gross profits showed marginally higher growth rate of 20.6 per cent in 1985-86 compared with 20.3 per cent in 1984-85, whereas profit after tax and retained profits showed lower growth rate of 27.3 per cent and 35.3 per cent respectively in 1985-86 compared with 30.4 per cent and 41.3 per cent in 1984-85. If the Indian non-oil SOEs would have earned half as much profit as those of non-government companies, the pressure on the budget would have been much less.

Some Questions:

The questions that therefore come to one's mind are:

Can these huge investments in SOEs be not made more productive or profitable?

How long these loss-making SOEs should be subsidised even when the fiscal situation of developing countries like India is precarious and at whose cost?

Is there any alternative available?

Should ideological commitments based on half-baked ideas prevail over financial common sense?

Cannot the industrial SOEs be made more efficient and profitable? If so, how?

In answer to these questions, *inter alia*, comes the quest for the privatisation process, not as an absolute panacea, but as one of the pragmatic remedial measures. While on this, it will be relevant to quote the Amex Bank Review's eminently readable article on privatisation: '...there is an increasing respect worldwide for the achievements of privately managed companies in higher efficiency, technical and managerial innovation and in service to customers. Associated with this is an increased support for the free market view that markets are better at achieving economic rationality than governments. In some developing countries it is reasonable to argue that privatisation now makes sense for industries which have been successfully introduced and nurtured under state ownership."

SOEs Contribution to Higher Deficit:

By and large the experience all over the world is that SOEs in most countries, more so in developing countries, have been, and still are big drawer of governmental resources. They contribute to these relatively poor countries' budget deficits in a big way. In many cases SOEs in most countries are inefficiently and unprofitably run. Most often they also fail to fulfil their non-financial socio-economic objectives for enunciating the so-called lofty ideals of an eqalitarian society.

Mr R. P. Short of the International Monetary Fund (IMF) has pointed out in an interesting paper, one of its first kind, that the average overall public deficit in the 25 developing countries studied by him rose to 5.6 per cent of GDP in the mid-1970s, an increase of 2.5 per cent points. since the mid-1960s. He has also estimated that the budgetary burden of SOEs averaged 3.3 per cent of GDP for another of 34 developing countries compared with 4.4 per cent for the central governments' overall budget deficit in these countries. This means that public enterprises accounted for three-fourths of the central government deficits in the countries in question.

It is no wonder that Mr A. W. Clausen the former President of the World Bank, recently observed: "Governments in many developing countries overtaxed themselves, especially when they get involved in the direct management of industry. Furthermore, governmental procedures, which inevitably find their way into the management of government enterprise, are often the wrong procedure for managing productive activities. *The consequent burden on budgets and demand for credit have been important causes of economic difficulties in many developing countries.* With domestic and external resources currently so constrained, the pursuit of efficiency and domestic resource mobilisation is more critical than ever. *And that is why there is such an urgent need to expand and release the energies of the private sector."*

This can only be done if the chronic lack of mutual confidence between developing country government and business is reduced, if not finally eliminated. The participation of the private sector in the development process "is not an option; it is an essential".

Recommendations of Donor Organisation:

Because of the dismal performance of SOEs all over the world, especially in the developing countries, coupled with host of other problems associated with the economies of the developing countries, the international financial organisations like the IMF, World Bank, Asian Development Bank *et al* have recently been prescribing a relevant dose of privatisation medicine as a correcting device so as to reduce the excessive and unproductive governmental control over the ailing SOEs in some of the deserving aid-recipient developing countries.

New Management Ethos:

Apart from the primary argument of budget deficit and resource crisis the introduction of privatisation is also justified by the understanding that there is a cultural difference between the running of the industrial SOE, which is usually over-administered and less managed, and the private enterprise, which is more dynamically and matter-of-factly run. In many countries like Brazil and Spain the new management ethos of running a business enterprise has been accepted on its own merit. Evidence shows in many countries that privatised companies have improved their performance.

The justification of privatising Indian SOEs, because of the budget pressure needs to be supplemented by the understanding of the new management ethos of the private sector industries. Some better managed Indian SOEs have already raised, and many more will be raising, large funds from the expanding capital market of India. It will be reasonable to argue that shortage of resources will not be the major problem for the profit making Indian SOEs like the petroleum and some power and telecommunications companies, if they are permitted to be privatised. The case for their privatisation needs to be supported by the new and dynamic management ethos rationale.

It is interesting in this context to note that the concept of joint sector, originally based on the socialist idea of the state partners' superiority, has of late undergone a sea-change. In the new joint sectors in India, the role of the private partner had to be made more important. The state is also not likely to expand business in new areas in any big way in India. But the big question remains for the financially retarded Indian SOEs.

Economic Pragmatism and Privatisation:

Introduction of privatisation measures can also be done based on economic pragmatism. It is not always necessary to correlate privatisation with the ideological fundamentalism of the laissez-faire theory. For example, the privatisation programme of South Korea has been based not on ideological consideration, but on the economic realities of the country, the structure of which according to Mr Bon Ho Koo, is "far from the strict free market model". Mr Koo has crisply explained the South Korea's privatisation approach by saying: "If the market works, fine, if not, there are other ways of accomplishing the public purposes."

In many developing countries, the privatisation programme has spontaneously gained ground and has been by and large free from the right-wing ideological rhetorics. Countries like South Korea, Thailand, Malaysia, Bangladesh, Sri Lanka, etc., have launched privatisation programme largely because of its need and usefulness, even though in certain cases difficulties of its implementation have to be faced.

The views expressed in this booklet are not necessarily the views of the Forum of Free Enterprise.

"People must come to accept private enterprise not as a necessary evil, but as an affirmative good."

—**Eugene Black**

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FORUM OF FREE ENTERPRISE

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