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Privatization in Developing Countries: A Review of the Issues

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Summary. — The theory and early experience of privatization in developing countries are reviewed. Privatization has been spurred by widespread dissatisfaction with the performance of public enterprises and the need to cut government expenditures. Unless it is accompanied by liberalization measures, privatization of public enterprises is unlikely to result in significant gains in economic efficiency. The sequencing of privatization and liberalization reforms will often determine their impact on efficiency, but the correct order of implementation is not clear. Political opposition to privatization is likely to be limited to the state bureaucracy, which will often be able to mobilize in order to limit the impact of reforms. Early implementation experiences suggest technical difficulties are as constraining as political factors.

1. INTRODUCTION

Just as the 1960s and 1970s were characterized by the rapid expansion of the public sector in the developing world, the 1980s have seen widespread attempts by policy makers to curtail the state's economic role. The divestiture, or privatization, of public enterprises has featured prominently in these attempts, just as an earlier generation of policy makers had emphasized direct state intervention to redress perceived failures in the operation of private markets. Privatization first gained prominence in Great Britain under the leadership of Margaret Thatcher's government. It quickly spread to the developing world, under the impetus of strong support by the international donor community, the need to cut government expenditures in the face of fiscal crises after the oil shocks of the 1970s, and an intellectual and ideological climate increasingly hostile to state intervention in the economy. A recent study estimates at some 1,400 the number of privatization efforts underway at the end of 1987. Over 80 developing countries are involved in these efforts, including countries like China, Tanzania and Algeria, which have traditionally favored a prominent role for the state in the economy.[1] Moreover, these experiences have spawned a voluminous and growing scholarly literature, as the references listed at the end of this essay make clear.

It is perhaps an appropriate time to take stock of and assess the issues which have emerged in relation to the theory and experience of privatization in the developing world. This paper will undertake that task. We define privatization as "a transfer of ownership and control from the public to the private sector, with particular reference to asset sales."[2] Equity sales, as well as management, leasing and franchising arrangements between a public enterprise and the private sector are considered examples of partial privatization. We define public enterprises as revenue-generating entities owned or controlled by the state, and our analysis focuses on proposals concerning their reform. These fairly narrow definitions seem most analytically useful, given limitations of space. In particular, it is appropriate to draw a clear distinction between privatization thus narrowly defined as a class of institutional reform, and liberalization, defined as a change in the relative prices operating in the economy. Thus, we do not follow the lead of those who define privatization as any reform that increases the unhindered play of market forces in the economy. A process of agricultural marketing reform that reduces input and output price distortions is a case of liberalization; privatization does not necessarily imply any changes in

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relative prices. Liberalization and privatization reforms have been linked in the economic policy *Zeitgeist* in recent years, but their impact and the constraints to their implementation are likely to be quite different. It is analytically useful to distinguish their respective effects, as this will allow us to determine the circumstances in which privatization or liberalization reforms alone are likely to be effective, as well as the circumstances in which they should be combined. Many of the benefits ascribed to privatization are, in fact, the result of liberalization.

A major theme of this essay is that ownership changes are rarely appropriate instruments with which to improve economic regulation in developing countries, whether they come in the form of nationalization as they did for the first 30 years after World War II, or of privatization as in recent years. In economic terms, privatization is unlikely to generate major gains in efficiency, unless it is accompanied by other reforms which alter the relative prices prevailing in the economy. The privatization of public enterprises in developing countries may well be justified under certain circumstances, however, and we will examine the relationship between privatization and liberalization policies in order to determine the ways in which these two kinds of reform can be combined to maximize efficiency gains.

The political impact of privatization is more difficult to predict. In most developing countries, the economic distinction between public and private is blurred, and the extent of regulatory failure is little correlated with patterns of ownership. The incentives to engage in rent seeking, corruption and patronage do not depend on the number of public enterprises in the economy, but rather on the extent to which prevailing prices do not reflect the scarcity value of goods and services. Moreover, the distributional impact of privatization reforms on different social groups is unlikely to be significant, although some employees may lose their jobs and specific groups of the population may be hard hit. On the other hand, the ideological and symbolic impacts of privatization may be significant in reshaping perceptions about the state's rightful place in the economy.

The analysis begins with a brief review of the reasons for which public enterprises have become a privileged target of economic reformers in recent years. Section 3 analyzes the theoretical justifications for privatization which have been developed in the literature. In the absence of accompanying liberalization measures, the potential impact of divestiture is shown to depend on the extent to which the public enterprise has demonstrated productive inefficiencies. Section 4 evaluates the constraints on the implementation of privatization reforms; it is argued that administrative and managerial difficulties are likely to be as constraining as political opposition. Establishing effective regulation of the privatized firms may prove more demanding of the state's administrative capabilities than outright ownership. Throughout the text, references will be made to the burgeoning literature on privatization implementation experiences in developing countries.

2. PUBLIC ENTERPRISES AND THE NEED FOR REFORM

A pervasive dissatisfaction with the performance of public enterprises (PEs) is at the heart of the appeal of privatization to policy makers in developing countries. It is thus useful to briefly examine the record of public enterprises there. We skip over their characteristics and number, which have been well described elsewhere.[3]

PEs were created for complex and varied reasons. First, it was widely thought that nationalization and PEs in general would provide governments access to much needed revenues. Governments mistakenly believed that PEs would generate large profits with which they would be able to finance investments in priority sectors of the economy. Second, public production corresponded closely to an ideological climate in which the private sector was held in low esteem and a large public role in the economy was seen as necessary for rapid and sustained development.[4] Control over a few strategic industries was justified as needed to help steer the economy and overcome critical bottlenecks. National security reasons were sometimes added to these justifications, particularly regarding heavy industry.

Third, local private entrepreneurs were in short supply, did not have access to adequate levels of capital, or were linked to unpopular minorities and foreign powers. In part because of political restrictions, as well as the anti-business climate that government policy created and that constituted disincentives for investment, there was sometimes no alternative to public production. In many countries of sub-Saharan Africa, for example, accusations of hoarding, speculation and unfair trading practices by foreign-born businessmen and middlemen led governments to nationalize marketing and distribution operations, or to tax them so heavily that the private sector disinvested from these areas.

Fourth, in political terms, PEs constituted important resources for state elites to be developed and harnessed in the form of potential rents, jobs and the servicing of constituencies. Patronage and technocratic considerations combined to make public production a popular policy outcome. In some instances, distributional considerations played a role; for example, states justified investments to lesson regional inequities or to enhance employment creation. They invested in social services and housing, and in capital-intensive agricultural schemes to modernize poor regions.

In sum, regulating or controlling certain markets was an objective of many nationalization measures. Improving market efficiency was not a major preoccupation, however, and PEs were rarely created to handle market failures, as is sometimes implicitly argued on their behalf today. There may well be efficiency arguments for PEs,[5] but there is little evidence that these weighed heavily on decision-making in developing countries.

Thousands of PEs were created in the developing countries between the mid-1960s and the early 1980s. On average, they accounted for over a quarter of gross fixed capital formation in developing countries in the early 1980s.[6] Their performance is generally considered to be unsatisfactory, albeit with important exceptions. PEs lose money, or do not make as much money as they should, given that they often benefit from privileged access to capital, various subsidies, and protection from domestic and foreign competition.[7] One author has summarized common weaknesses of PEs: unclear, multiple or contradictory objectives, bureaucratic meddling, overly centralized decision making, inadequate capitalization, managerial ineptitude, excessive personnel costs and high labor turnover.[8]

Governments' patience with PEs has worn thin in recent years, as economic conditions have worsened and fiscal crises have become endemic in the developing world. In addition, the ideological climate has changed and turned against the public sector in favor of the private sector, in the kind of policy cycle described by Hirschman.[9] Faced with burgeoning deficits, governments are less tolerant of financial losses and economic inefficiency, even though the PEs continue to pay political dividends. Moreover, the distributional justifications for PEs have rarely been borne out in practice. Many of the normative rationales for PEs have become less convincing to policy makers, who are now more likely to see the disadvantages of the public sector than its advantages or available alternatives.

3. THE IMPACT OF PRIVATIZATION

Unhappiness with PEs is not, by itself, sufficient reason for their privatization. The litmus test for any economic reform must be that it will result in improvements which would not have occurred in its absence or because of an alternative reform. It is not enough that improvements occur, a causal relationship between the policy and the outcome has to be established. This condition makes evaluations of policy reform often ambiguous and should be remembered throughout the discussion.

In practice, several justifications have been formulated on behalf of privatization. For developing country policy makers, the major impetus for the divestiture of public enterprises to the private sector has been its potential impact on public finances. In addition, however, it has been justified in economic efficiency terms, mostly within the donor community but also within academic circles, albeit more ambivalently. Critics of privatization have, in addition, pointed to its negative impact on the poor. We discuss each of these issues in turn.

(a) *Fiscal impact*

For governments in the throes of economic stabilization efforts, tangible increases in revenues or decreases in expenditures weigh much more heavily than the less tangible prospect of greater economic efficiency some time in the future. Divestiture will cut government expenditures and help restore budgetary balance. Cutting back is not only linked to the current stabilization plans, it is perceived as a long-term structural requirement. This fiscal justification for divestiture is certainly plausible, particularly for the poorer developing countries. In sub-Saharan Africa, for example, it is increasingly believed that the revenues available to the state in low-income countries are structurally inadequate for developmental needs in infrastructure, social services, and basic public goods such as research and agricultural extension.[10] As external sources of finance have dried up and deficits are no longer sustainable, the state has to establish tighter priorities and cut back in areas where its presence is not essential. Rather than do a lot of things badly, it is better for the state to do a small number of things well. The argument is convincing, but perhaps more so in the long run. In the immediate future, savings in government expenditures in most developing countries often will go to servicing debt. The proceeds from privatization programs cannot be expected to result in increased expenditure for high priority areas anytime soon.

In any event, the impact of privatization on public finances is ambiguous. In the simplest, ideal-world theoretical case, a PE's sale price should be exactly equivalent to the discounted stream of expected profit remittances the state would have received if the PE had remained in the public sector, as long as it assumed that the private and public sectors face the same tax liabilities, and perform at the same productivity levels. If this is the case, then only the composition of state assets changes, but their level does not; the fiscal impact of the privatization, strictly speaking, is nil.[11] The ideal-world theoretical case applies whether or not the PE is profitable; in the more interesting case, the PE loses money and the state then has to pay the buyer the discounted value of the PE's foreseeable losses. This is not so far fetched; in practice, governments often rehabilitate a PE prior to putting it up for sale, or they provide privileges to the buyer in the form of subsidies, tariff protection and statutory protection from competition.[12] Such concessions suggest that there may well be a tradeoff between budgetary and efficiency gains from privatization. To maximize the sale price, the government may be induced into legislating more protection for the newly private firm than the PE had enjoyed. Indeed, in several instances, the generous conditions granted to private investors have been the source of considerable controversy, notably in Chile, Togo and Bangladesh.[13]

In practice, different assets are not perfect substitutes and liquid assets may be more useful to the government than equity in a PE. If so, privatization has a real fiscal impact. Moreover, if the private sector is expected to run the firm more efficiently, that expectation will be reflected in a higher sale price, which will then further exceed the PE's discounted income stream. The theoretical case assumes perfect information and foresight. In fact, the extent to which the private sector is able to run the firm more efficiently than the public sector will be a matter of conjecture and debate during the course of the negotiations between government and buyer. These factors suggest that privatization will have a real fiscal impact, but the simple theoretical case is useful in pointing out that many of the alleged gains are illusory, and reflect the substitution of present for future government consumption. It is the short time horizon of hard-pressed state officials which has made the fiscal impact of privatization seem so appealing.

(b) *Efficiency gains*

The fiscal gains from privatization have probably weighed most heavily on developing country governments attempting to balance public accounts. International Monetary Fund (IMF) stabilization plans have systematically included PE reform with the explicit aim of short-run public expenditure reduction.[14] In addition, proponents of privatization have argued that it can have an important impact on economic efficiency. Early advocates of privatization assumed the general gains in economic efficiency to be important, based on the alleged superiority of private production, but did not attempt to clearly identify the gains. Grand claims were made on the basis of ideology and conjecture that privatization could greatly enhance overall economic efficiency and thus have a strong impact on national output.[15] This view has not resisted scrutiny. A more tempered view has emerged in the mainstream literature, which suggests that efficiency gains from privatization will in fact be modest and limited to reductions in productive and regulatory inefficiencies.[16]

Three kinds of efficiency gains have been identified as potentially arising from privatization. First gains in allocative efficiency can result if relative output prices in the economy more closely reflect scarcity values because of the reforms. Second, gains in productive efficiency can arise from a more optimal use of inputs within the enterprise after divestiture. Finally, if we accept Stigler's model of regulatory failure or Wolf's of nonmarket failure, inefficiencies arise specifically from public intervention in the economy and it is argued that privatization will reduce them.[17]

(c) *Gains in allocative efficiency*

How well markets function will determine privatization's impact on allocative efficiency. PEs operating in competitive markets should be privatized, since there is no first or second best rationale for public intervention of any sort. In these cases, gains in efficiency will be minor, since the PEs will have already been exposed to a competitive environment. These PEs will typically be found in the service or manufacturing sectors in areas where there are no scale economies, and where the market can support several firms.

It would appear that the potential for important efficiency gains is to be found in imperfect markets, or in potentially competitive markets where public ownership is the result of unwarranted intervention. In either case, however, gains in allocative efficiency from privatization are unclear. In competitive markets, public ownership is sometimes associated with inefficient intervention: a statutory public monopoly established in a market that could support several firms; a PE granted protection from competition; or perhaps public ownership subsidized to support state distributional objectives. In such cases, greater efficiency gains can be expected from regulatory reform than from privatization itself, even though in practice the two often come together.

The likely gains in imperfect markets are similarly modest. As Mansoor and Hemming argue, "allocative efficiency is a function of market structure rather than ownership."[18] In the absence of other reforms that affect the pattern of relative prices in the economy and increase competition, the privatized enterprise still faces the same prices as the PE before it. Privatization by itself will not change the nature of the market in which the firm operates, and the environment which shapes its pricing decisions. A public monopoly makes way for a private monopoly, for example, but monopoly pricing will remain in effect.

(d) *Gains in productive efficiency*

With some important exceptions, the gains in allocative efficiency from divestiture are likely to be modest. The case for privatization then rests with the gains in productive efficiency it will bring about within the firm. Privatization advocates argue that PEs are more likely to exhibit greater internal inefficiencies than private firms for several reasons. First, PEs tend to misuse production inputs because they are protected from competition and thus allow considerable slack or "x inefficiencies" to develop in their production processes.[19] PEs in many countries have easy access to capital, often at subsidized levels, and can thus be expected to undervalue capital in their investment decisions. Subsequent to privatization, an enterprise would compete with other firms for access to capital, and use it more efficiently.

Second, the property rights school argues that managerial incentives to maximize profits and minimize costs are undermined by public ownership and regulations;[20] public managers are given numerous and inconsistent objectives by government overseers. Unwieldy bureaucratic controls and the absence of shareholders with a direct interest in profits lessen the pressure on managers to maximize company performance, and may indeed put a premium on "not rocking the boat."[21]

How important are these inefficiencies in production? There are few estimates. While x inefficiencies are assumed to be important in some cases, it is not clear in what proportion they result specifically from public ownership rather than from protection from competition more generally. In addition, because PEs are saddled with noncommercial functions, criteria for performance are more ambiguous and difficult to monitor effectively. In many countries, PEs have been burdened with employment creation or overt redistributive functions; in such situations it is difficult to distinguish technology-induced inefficiencies from those brought on by government social welfare objectives.

(e) *"Nonmarket" efficiency gains*

Almost 50 years ago, Oskar Lange argued on behalf of public production that there are numerous ways in which the state can mimic the workings of the market and send signals to economic agents to ensure their efficient behavior.[22] Reforms of PEs in the past typically emphasized streamlining procedures, and establishing new lines of authority and sophisticated information processing systems that were supposed to help the state better mimic the market. The principle of divestiture was long resisted because of a widespread belief that PEs were not inherently less efficient than private firms. In recent years, however, it has been argued that certain problems result specifically from state intervention; these are referred to as "nonmarket" or regulatory failures. The central argument is that the state can never adequately replicate the market's ability to process information in a decentralized fashion; government intervention will overlook certain crucial aspects of the market, will fail to adjust to new and changing circumstances, or will bring about unforeseen side effects. Thus, nonmarket failures after state intervention will be worse than the market failure the government set out to correct.[23] Moreover, public intervention in the economy typically involves assigning various social and political objectives to the PE and meddling with its daily management on behalf of these diverse objectives.

The nonmarket failure argument was first developed with reference to developed countries. A slightly different justification for privatization has extended the argument to take into account the special weaknesses of state capacity in developing countries. This is the view that governments in developing countries have overstretched their limited managerial and administrative capacities with too many peripheral activities, and that as a consequence performance in the most important areas is being undermined. Privatization of PEs will lessen these managerial burdens and allow the state to focus on its essential functions with increased human as well as financial resources.[24] There is some truth in this view. In many developing countries, the most serious constraints on policy are not to be found in its design, but rather in its implementation by extremely thin administrative hierarchies with limited means and capabilities. Policy objectives are undermined and altered during implementation.[25] States in the developing world are increasingly hampered by the budget cuts which austerity has imposed in recent years, but they have always been characterized by inadequate managerial capacity. The impact of divestiture on government capacities should not be exaggerated, however. Some managerial capacity will be privatized along with the PE, as public managers will move to the better-paid private sector. More importantly, the regulation of the privatized PEs, notably those operating in imperfectly competitive markets, will require the development of public bodies and generate new administrative burdens. Once again, limited state capacity is more an argument for liberalization and greater reliance on the market than it is for divestiture.

(f) *The distributional impact*

Some critics of privatization have argued that its impact is likely to weigh disproportionately on certain groups of the population, and that these groups will typically be the relatively underprivileged in society.[26] The potential distributional impact of privatization is twofold. First, it may have an impact on the employees of the PE if, subsequent to the privatization, the firm goes bankrupt, government operating subsidies decrease, or there are layoffs by the new owner. The evidence suggests that PE employees are not typically among the poorest in most of these countries, however, and privatization is unlikely to make them so, even if it may bring about real hardship for certain laid off employees.[27]

Second, privatization may affect the poor if the goods and services provided by the PE becomes less accessible to them. Here, the evidence is more compelling; PEs providing social services of a public good nature such as public transportation, health and education may service groups which a private sector provider may not find sufficiently profitable. Some transportation routes to remote regions may no longer be serviced. Prices for services may increase dramatically after privatization, notably if cross-subsidization practices common to PEs are abandoned. In the agricultural sector, private input distribution and marketing agents may pay less attention to smallholders than did public institutions, and concentrate instead on the bigger commercial farmers. Provision of such public goods as research and extension may falter — these services tend to benefit the smaller farmers more.[28]

These effects should not be exaggerated. In many countries, PEs have not had a very good record of reaching the poor. Agricultural institutions in many countries have long been beholden to large farmer interests.[29] PEs often reflect an urban bias and inadequately serve rural populations, where there may be larger pockets of poverty.[30] A case study of the privatization of public transport in Rabat, Morocco argues that privatization dramatically improved the quality of service, without decreasing the number of routes serviced by the different companies.[31]

In some cases, privatization may have a negative effect on the poor. This, however, is an argument against reform only if it can be shown that public provision is the most effective and efficient manner of reaching the poor. If not, poverty alleviation measures that target the poor directly are likely to be more cost effective than maintaining the PE. Rather than subsidize an entire transport system, for example, the government can subsidize only the lines that cover the poorer regions. Moreover, subsidies and tax breaks can induce private agents to service the poor.

There are few *a priori* reasons to believe that privatization will necessarily result in greater inequities or increases in poverty; when it does, other cheaper policy instruments can usually be found to compensate adequately. An empirical question, as yet unresolved, concerns whether policy makers engaged in privatization campaigns have in fact used these instruments to compensate the poor when the need arises. In the ideological climate in which privatization is carried out, there may be a tendency to underestimate negative distributional consequences.

4. PRIVATIZATION AND LIBERALIZATION

It is rarely denied that privatization will help reduce productive and regulatory inefficiencies. The debate in the literature concerns how large the reductions will be, and the extent to which they will occur without concomitant increases in competition through various liberalization measures. In terms of our original litmus test, the debate concerns whether other reforms are more likely than privatization to bring about the desired improvements. We have argued that many inefficiencies are less a function of ownership than of government regulation and market structure. Private monopolies may well be more efficient than public ones, but how much more will depend largely on the effectiveness of the regulatory environment. If the public monopoly was statutory, but did not reflect market structure, then the possibility of competition may keep the enterprise honest, and output prices close to marginal cost even if new firms do not enter the market. The state may have to regulate the industry, however, in order to prevent anti-competitive or predatory behavior.[32] If the industry is a natural monopoly and entry is unlikely, the government must regulate it or accept monopoly pricing. Similarly, the government must decide whether to allow foreign imports into the country to compete with the privatized firm.

Privatization should thus be seen as an instrument of competition policy, to be accompanied by other measures which promote efficient markets. The proper sequencing of privatization and liberalization is emerging as a critical issue for policy makers, as is the extent to which one can substitute for the other. The evidence on these matters is varied and ambiguous, as we shall see.

Proponents of PE reform argue that public ownership obstructs liberalization reforms, and that a return to private ownership will help facilitate their implementation. They argue that governments support PEs for socio-political ends, and that this leads to various subsidies, tariffs, and taxes. The success of privatization efforts may well create support for more fundamental reforms and make them politically more palatable.[33] The evidence from Western Europe suggests, however, that privatization may not be a prelude to deregulation. As Kay and Thompson have demonstrated with relation to Great Britain, managers of PEs being privatized can successfully lobby for an anti-competitive regulatory environment to protect their privileged positions after the reform.[34] It can be argued, however, that the privatized firm will have less political influence than the PE before it and that it will be more difficult for bureaucrats to meddle in a firm that is not formally under their jurisdiction. In the short run, the regulatory environment would limit the gains in allocative efficiency; in the long run, however, various advantages would wither away and the private firm would not be able to lobby as effectively as the PE for their resumption.

The American context shows the extent to which various private sector dominated industries have been able to "capture" the regulatory process, and extract rents from the state. An information asymmetry between the firm and the state's regulators regarding production technology and costs will always favor the former. This has in practice led to abuses and inefficiency. Indeed, some scholars argue that adequate regulation of an industry requires so much information about that industry's costs and technology that outright ownership is likely to be more efficient.[35] Information costs are likely to be higher for state regulation than for state ownership. These precedents are particularly inauspicious for developing countries, where administrative capabilities and standards of probity are lower and the safeguards of a free press and active consumer groups are often nonexistent.[36]

In certain instances, divestiture serves as a political palliative for liberalization. Brittan explains that the Thatcher government's privatization program is at least partly the direct consequence of the government's inability to make good on its electoral promise to reduce public spending and levels of taxation: privatization, in this view, was promoted as an "ideological substitute" for liberalization policies.[37] In developing countries, donor pressure to reduce the state's role in the economy has led some recalcitrant governments to promote privatization rather than directly attack various economic privileges. Commitment to privatization has been at times halfhearted. Still, in Chile, the two types of reforms were implemented concurrently by a reform-minded government.[38] Similarly in the communist countries which have experimented with economic reforms, divestiture of PEs has been seen as an instrument of liberalization.[39]

One lesson from this discussion is that it is useful to evaluate the two kinds of policy reforms together. The government's true intent in privatizing a PE can probably by gauged by examining its recent record, or probable actions in the near future, with regard to deregulation. It may well be true that governments that are committed to liberalization and competition need privatization much less than those which are not, while those least committed to privatization are unlikely to feel a need to improve the prospects for competition.

5. OBSTACLES TO PRIVATIZATION

Answers to some of these hypotheses and theoretical disputes can be expected from the privatization experiences currently underway. The most thoroughly researched experiences are those of Great Britain, perhaps because of the importance of privatization efforts there since the end of the 1970s.[40] More recently, privatization experiences in developing countries have been the subject of research as well.

Several scholars have noted that implementation has lagged well behind stated intentions, and that privatization programs have been slow, uneven, and plagued by unforeseen obstacles. A few countries, like Bangladesh or Chile, have gone ahead with ambitious and comprehensive programs. In most countries, however, privatization has been limited to small PEs of the manufacturing and services sector which were previously under private ownership. Admittedly, privatization is a novel and complicated process that would take time in the best of circumstances, but a review of the country experiences reveals that two kinds of constraints have consistently undermined privatization efforts: first, a number of implementation issues have proven salient; and, second, political constraints on reform-minded governments have helped slow down the rate at which they can bring about privatization. In many instances, these two sets of constraints are not only undermining the process of privatization, they are also lessening its impact on economic efficiency.

(a) *Implementation constraints*

Technical constraints on implementation are related to both managerial deficiencies within the state and weaknesses within the economy. Privatization requires a level of administrative capacity possessed by few developing countries. Problems have emerged in some cases because of the absence of well-established, competent management consulting groups, accounting firms, and investment banks to provide technical advice and arbitrate between competing claims regarding the value of the PE being privatized. As a consequence, foreign experts often have been summoned. The valuation of the PE's assets is subject to lengthy delays, often exacerbated by the poor records kept by the PE. Governments are sensitive about the results of the valuation exercise not only because they want to get the highest sale price, but also because it may raise questions about past public management and investment decisions.[41] The process is thus prone to political controversy, bringing about further delays. Once the PE's assets have been evaluated, administrative capacity is needed to assess buyers' bids, arrange finance and insurance, as well as to deal with the complex legal issues raised by the divestiture. In many cases, a comprehensive rehabilitation plan for the PE has to be designed, evaluated and financed before divestiture is possible. Moreover, governments will want to set up the appropriate regulatory structures around the newly privatized firm, particularly when it retains monopoly power or is meant to carry out specific social functions. Several case studies suggest these issues can paralyze privatization programs for long periods of time, or undermine their smooth implementation, given the state's limited administrative and planning capacity.[42]

Capital markets in developing countries are typically weak and unable to assist in the transfer of PEs to the private sector. Because stock markets are small and poorly regulated, or simply nonexistent, large investments in equity are unusual and privatization has to take place through outright sale of assets. The private sector and local banks may not be able to finance purchases of PEs, often among the biggest enterprises in the country,[43] and governments may be unwilling to sell assets to potential foreign investors. High savings ratios in many countries and vibrant activity in certain speculations suggest that the private sector should not be underestimated. Several case studies indicate that investors can be found quickly for certain businesses, particularly when they are of modest sizes.[44] One should not forget, however, that public ownership of the large natural monopolies was originally resorted to, at least in part, because the private sector would not or could not undertake such large investments. Many governments have maintained a policy mix that has contributed to the backwardness of capital markets and the weakness of private entrepreneurs.[45] Moreover, private investors may initially look upon privatization programs with considerable suspicion, given unfulfilled government promises of reform in the past, or they may decide to wait for policy changes in the regulatory environment, without which investments in PEs may not be considered sufficiently lucrative.

(b) *Political constraints*

There are several political constraints to privatization. We should distinguish those which are common to all types of economic policy reform from those that are specific to privatization. Like all economic reforms, privatization has distributional consequences and favors certain groups within society at the expense of others. The losers can be expected to organize against privatization, particularly if the negative impact of the reform is spread over a relatively small group.[46] If privatization itself has little effect on the pattern of relative prices, then its macroeconomic and distributional consequences are likely to be less tangible and less important in scope than, for example, the termination of certain consumer subsidies or import tariffs.

Privatization can be distinguished from other classes of economic reform in that its costs will be borne intensely by a small number of people and its benefits will be spread out over a large number. Public choice theory suggests that in such situations collective action will be easier to organize against the reform than for it.[47] This has typically been the case for privatization. It has enjoyed increasing ideological support among the technocratic elite in many countries, but has so far failed to mobilize popular support. Business groups might have been expected to be among its leading supporters, even when they were not likely to benefit materially from the reform, because privatization holds out the possibility that the private sector's position will advance. In fact, there are few countries in which the business establishment has actively promoted privatization. This may change as the benefits of reform become clearer, but it shows that privatization programs have not yet enjoyed much popular support.

Opposition to privatization has been much more concerted. In some cases, privatization has been expected to lead to cutbacks in personnel costs, and labor groups have organized against it. Of course, governments can resort to a full arsenal of techniques to overcome such opposition. Berg and Shirley are probably correct to argue that "mothballing" of PEs, where they are allowed to sit idle and waste away over long periods of time, is used as a viable strategy to diffuse labor unrest over privatization.[48] In any event, short of liquidation, privatization will usually not include dramatic labor compression insofar as the new owners of the firm can be expected to keep a large proportion of the work force; the government can compensate the proportion of the labor force concerned, or can extract an agreement concerning layoffs from the new owners. In some cases, of course, rehabilitation prior to divestiture has included important reductions in labor, without which the firm would not have been profitable. In general, there have been few parallels in developing country privatization experiences with the massive restructuring of highly-unionized mining concerns in Western Europe, which laid off tens of thousands of employees and depressed the economies of entire provinces. Major layoffs in the course of structural adjustment programs have been more common in the state bureaucracy itself, or in non-commercial parastatals. In Brazil, only one of the 17 PEs privatized as of 1985 had more than 1000 employees, and the 18 firms being considered for privatization in Costa Rica employs less than 1% of the labor force.[49]

So far, we have implied that the political impact of privatization will be unimportant. Quite the opposite may be true, however, for several reasons. Privatization may have a powerful effect on the balance of economic power between the public and private sector, at least symbolically. In some sense, it may be seen as changing the "rules of the game."

Corporatist patterns may be upset by such rule changes. Privatization is likely to undermine trade union power, as it is typically concentrated in the public sector. Unions may react strongly against the reform, not only because of its direct impact on employment, but also because of a fear that the union's political power will decrease in the private sector, and a sense that a longstanding *modus vivendi* with the government is being upset.

In many countries with ethnic, religious or regional tensions, political stability has rested on a delicate social contract, in which certain groups are implicitly granted economic power as long as they do not compete for political power, or vice versa. Privatization disturbs such arrangements by altering the balance of economic and political power. The groups to which the PE might be sold if privatized have posed serious problems in many countries. In Kenya, it is well known that the scope of privatization policies is limited by the fact that the most likely purchasers would be Kikuyu or Asian business groups, an eventuality which is considered politically unacceptable. Ethnic considerations are also important in Cameroon, where fear of Bamileke dominance recently led the president to block the privatization of a major bank.[50] In other countries, fear of foreign business groups has slowed down privatization programs. This is the case with Syro-Lebanese and South Asian businessmen in much of sub-Saharan Africa, and with ethnic Chinese in many countries of East Asia.

The political impact of privatization will depend in part on the state's ideological investment in public production in the past. Countries like Algeria, Mexico, or Tanzania which have promoted a large social, redistributive and economic role for the state under the flag of socialism or nationalism are likely to find such reforms more politically sensitive. Similarly, regime discontinuities, such as coups d'etat or elections, are likely to provide governments windows of opportunity in which to promote privatization programs. This clearly happened in Chile in the mid-1970s, for example, and in Jamaica with Seaga's electoral victory in 1980.[51]

Much of the political opposition to divestiture will be generated within the state apparatus, and will revolve around the prerogatives of the bureaucracy. A number of case studies have shown that opposition to privatization has crystallized among the management of the concerned PE and has extended to the line ministry overseeing it. In some cases, they have been able to block privatization. In other cases, as we discussed above, these groups have been able to coopt the privatization process and limit its impact on competition and economic efficiency. For example, they have exerted influence on the regulatory environment, making sure they will continue to play a managerial or regulatory role over the private firm.[52]

Within the state elite, privatization has engendered bitter conflict. Such conflicts are related to the benefits and power that accrue to particular elements of the bureaucracy, which oversee the PEs and are thus envied by other, rival elements. They are also related to sincere ideological differences within the state elite over the role the state should play in economic development. The interplay between individual interests, ideological conflicts and bureaucratic politics in the Philippines has been well illustrated by Haggard.[53] The Aquino government's privatization efforts have been led by technocrats with a sincere desire to cut government expenditures and expand the role of the private sector. At the same time, the large PE sector is dominated by interests closely linked to the Marcos regime, and remains a vexing irritant to the new regime. Privatization efforts thus combine the partly inconsistent motives of restoring fiscal balance and increasing economic efficiency with those of wrestling control over vast political resources away from hostile groups. Economic liberalism has been undermined by the exigencies of regime consolidation, and bureaucratic conflicts over ministerial jurisdiction appear to have added to the confusion. As a result, implementation has slowed to a crawl, and the original momentum for reform has abated.

Even if some of the PEs being privatized are running losses, many are potentially quite lucrative because of their physical assets, or because the state has granted various anti-competitive advantages, such as a statutory monopoly or protection from foreign imports. Thus, the sale of the PE can generate extensive influence peddling, rent seeking, and graft by business groups.[54] To some state elites, the PE being privatized represents a valuable political resource to be dispensed with care. Case studies from Zaire and the Ivory Coast indicate that the presidents of these countries personally intervened to make sure that PEs were sold at advantageous terms to political allies.[55] In other instances, state elites have been loathe to disturb the PE sector, because their political support base runs through its labor force. This appears to be the case in Tanzania and Turkey,[56] countries in which PEs account for a large proportion of the formal economy's labor force. Those elites will contemplate reform only when the present political economy is no longer sustainable and political survival is contingent upon reform.

6. CONCLUDING REMARKS

We have reviewed a number of issues relating to the privatization of PEs in developing countries. Policy makers in developing countries invested PEs with many ambitious objectives in the decades that followed World War II; many of them were not reached and PE performance has been considered disappointing in recent years. Today there are widespread calls for privatization, and equally ambitious reasons are given for returning these institutions to the private sector.

Privatization is unlikely, however, to overcome the kinds of economic and political forces that undermined public production. Unless it is accompanied by a liberalization program, the effects of privatization on both economic efficiency and government expenditures are likely to be modest. Its psychological impact is conceivably more important, as a way of preparing the way for more fundamental liberalization measures, but in many cases we see that governments undertake privatization to prevent further reforms. Large-scale privatization may have an effect on an intangible balance of power between the private and public sectors. As such, it can arouse much more popular opposition than its modest distributional consequences might lead one to expect. The most likely opponents to privatization will probably be found in the state apparatus itself, wary of losing valued rents and prerogatives.

Of course, the analytical distinction made here between liberalization and privatization may be largely academic for countries undergoing ambitious structural adjustment programs that incorporate a host of economic policy reforms in a short time. Indeed, if economists cannot readily distinguish them, it is understandable that the relative impacts of privatization and liberalization efforts are confused by the countries undergoing austere stabilization measures. In these cases, privatization, a policy with more tangible results than liberalization, may bear the brunt of the people's discontent. Governments have helped the privatization cause in such circumstances with information campaigns, or by labeling what are effectively privatization efforts with some more neutral term.[57]

In any event, the most important obstacles to divestiture so far have been implementation difficulties, which largely explain the slow progress of most programs. The pace of implementation will presumably accelerate with the development of precedents and experience.

Ultimately, it is difficult to reach definitive conclusions regarding the relative impacts of liberalization and privatization. Since the two reforms have been promoted together in practice, it is hard to distinguish their relative effects. Because the political circumstances under which policy is implemented can vary so much, and because it is impossible to determine outcomes in the absence of the policy change, the evaluation of specific policies is fundamentally ambiguous. Claims made on behalf of privatization can rarely be proven or disproven. What can be suggested is that, in at least some cases, liberalization or regulatory reform is better able than privatization to bring about gains in economic efficiency. In other cases, such reforms must accompany privatization if it is to have any impact. There can be no general presumption that privatization is a *sine qua non* for a successful liberalization campaign, or vice versa. In certain circumstances, privatization may turn out to be the prerequisite for other reforms; in others, liberalization alone will make subsequent privatization redundant. In yet other cases, privatization will not be effective until after liberalization measures have been implemented. In the absence of other policy reforms which increase competition in the economy, the impact of privatization on economic efficiency is likely to be modest.

NOTES

1. See Vuylsteke (1988), p. 41. This study, along with its companion volumes, Nankani (1988) and Candoy-Sekse (1988), provides a wealth of information on the progress of privatization implementation efforts.

2. The definition is quoted from Hemming and Mansoor (1988b), p. 1.

3. See Short (1984), Nellis (1986) and Jones (1982) for such discussions.

4. See Killick (1981) for a discussion relating to Africa.

5. See, for example, Rees (1984), pp. 1-9.

6. See Short (1984), pp. 117–120.

7. See Borcherding *et al.* (1982), Millward (1982), and Yarrow (1986) for discussions and somewhat ambiguous evidence that public sector firms tend to be less efficient than their private sector counterparts.

8. See Shirley (1983).

9. See Hirschman (1982).

10. See Anderson (1987).

11. This discussion draws on Heller and Schiller (1988) and Hemming and Mansoor (1988b).

12. See Vuylsteke (1988) and Nankani (1988).

13. See Yotopoulos (1988), D'Almeida (1986) and Lorch (1987), respectively.

14. Thus, for example, a recent IMF evaluation of its stabilization plans justified the PE reform included in 25 different programs between 1980–84 only in terms of the resulting savings in expenditure. See Fiscal Affairs Department (1986), pp. 29–31.

15. See, for example, Goodman (1985), Hanke (1987) and Butler (1985).

16. See, for example, Kay and Thompson (1986), Rees (1986), and Hemming and Mansoor (1988b).

17. See Stigler (1975) and Wolf (1979). Their work is of course more a critique of government regulation than of public ownership.

18. Hemming and Mansoor (1988b), p. 13.

19. The term was coined by Leibenstein (1966).

20. See Demsetz (1968), and Furubotn and Pejovich (1972).

21. See Aharoni (1982).

22. See Lange (1964).

23. See Savas (1982) and Wolf (1979).

24. See Hyden (1983) for example.

25. See Grindle (1980).

26. Though there are few analyses of the distributional impact of privatization specifically, a large literature exists on the distributional consequences of structural adjustment in developing countries, including privatization; see for example UNICEF (1987), Helleiner (1987), Addison and Demery (1985), and Green (1987).

27. Heller and Tait (1984) provide statistical evidence and comparisons of public sector salaries in developing countries.

28. On privatization issues in agricultural marketing, see Christiansen and Stackhouse (1987), Abbot (1987), and Maddock (1987).

29. See Bates (1981) on sub-Saharan Africa; Grindle (1986) on Latin America.

30. See among many others Lipton (1977) for a discussion of urban bias.

31. Damis (1987).

32. See Vickers (1985).

33. Brittan makes this argument to suggest that privatization amounts to "slightly better than nothing" rather than "slightly worse than nothing" (1986), p. 38.

34. See Kay and Thompson (1986).

35. Sappington and Stiglitz (1987) make this argument.

36. It is ironic that the literature on regulatory failure cited above in defense of privatization has largely been inspired by the perceived weaknesses of the regulatory environment in the United States, a country which has traditionally eschewed public ownership.

37. Brittan (1986), p. 35. See also Brittan (1984).

38. See Yotopoulos (1988).

39. On the Chinese reforms, for example, see Kelliher (1986).

40. On the British experience, see Ascher (1987), Beesley and Littleshild (1983), Brittan (1984), Hastings and Levie (1983), Kay (1987), Kay and Thompson (1986), Klein (1984), and Vickers and Yarrow (1985).

41. See Berg and Shirley (1987).

42. Lorch (1987), and Leeds (1987) provide two interesting case studies; see also Vuylsteke, pp. 97–101 and passim.

43. See Aylen (1987).

44. See the case studies of Jamaica, Morocco, and the Ivory Coast by Leeds (1987), Damis (1987), and Wilson (1987) respectively.

45. See, for example, Elkan (1988).

46. The political constraints to all forms of economic reform in the developing countries are well analyzed in Bienen and Gersovitz (1985, 1986), Nelson (1984), and Lal (1987).

47. Bates (1988) provides several interesting essays on political economy issues in developing countries using a public choice approach.

48. See Berg and Shirley (1987).

49. See Berg and Shirley (1987), pp. 4–5.

50. Personal communication, Yaounde 1988.

51. The Chilean case is well documented in Foxley (1983). On Jamaica, see Leeds (1987).

52. Kay and Thompson (1986) describe this process for Great Britain.

53. See Haggard (1988).

54. On rent seeking, see Krueger (1974).

55. See Wilson (1987) and Callaghy and Wilson (1988). In the early 1970s, large sectors of the Zairian economy were similarly nationalized, and handed over to be managed by barons of the regime, indicating if nothing else that the distinction between the public and private sectors can be a fine line.

56. See Leeds (1988) on Turkey. On this general point, see Bienen and Gersovitz (1985).

57. See Berg and Shirley (1987).

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