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Abt Associates Inc.
Suite 500
4250 Connecticut Avenue, N.W., Washington, D.C. 20008-1173
Telephone (202) 362-2800

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AGRICULTURAL POLICY ANALYSIS

PRIVATIZATION OF LDC AGRICULTURAL MARKETS: OPTIONS FOR REDUCING THE ROLES OF AGRICULTURAL PARASTATALS

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By: Dr. Jennifer Bremer

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Dr. Phillip E. Church
U.S. Agency for International Development
S&T/AGR, SA-18
Room 403
Washington, D.C. 20523

PRIVATIZATION OF LDC AGRICULTURAL MARKETS: OPTIONS FOR REDUCING THE ROLE OF AGRICULTURAL PARASTATALS

Abstract

Poor performance of agricultural markets dominated by state-owned agricultural enterprises (parastatals) is now seen as a major barrier to LDC agricultural development. This paper reviews options for privatization of such markets, once the basic decision to do so has been made. It argues for a broader definition of privatization as "a process of reform intended to create a competitive market environment, primarily but not exclusively by reforming parastatals and reducing the role of the state in regulation, ownership, and operation of firms providing goods and services." The paper explores four basic approaches to privatization: 1) sale, including full or partial divestiture, formation of a joint venture, and leasing arrangements; 2) break-up, including restructuring the parastatal into multiple firms along geographical or functional lines, franchising, and contracting; 3) close-down, including formal and "silent" liquidation; and 4) marginalization, involving gradual replacement of the parastatal with private firms in a competitive environment.

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FOREWORD

This publication is one of a series of staff papers that are part of the continuing effort of the Agricultural Policy Analysis Project (APAP), sponsored by the Office of Agriculture in AID's Bureau of Science and Technology, to disseminate the experience it has accumulated in the area of agricultural policy analysis. Through interaction with policy makers, country analysts, and AID missions in Africa, Latin America and the Caribbean, the Near East, and Asia, APAP has identified and concentrated its technical resources on the following themes:

- Developing agendas for an informal mission-host country dialogue on economic policies constraining progress in agriculture.
- Defining food aid strategies and programs that foster and support food security.
- Identifying input and output price reform programs that stimulate agricultural production and productivity.
- Fostering private sector participation in input supply and product marketing and redefining the role of parastatal institutions.
- Developing the indigenous capacity of host country institutions to provide the information needed to analyze, formulate, and implement policies conducive to agricultural development.

This paper examines alternative approaches for reforming agricultural markets dominated by state-owned enterprises. Its focus is on options for privatizing both the parastatal and the market itself, once the decision to do so has been made. It does not attempt to review international experience with parastatals or to define the conditions under which parastatals are more or less likely to perform effectively, although such analyses are much overdue. Parastatals can and do serve valid government purposes, particularly as a supplement to private enterprise, but it is not the aim of this paper to analyze when and under what conditions parastatals can be effective, nor to analyze in any depth the reasons for their successes and failures. Future APAP staff papers are planned in this series examining policy barriers to privatization in the agricultural sector and ways to privatize in the presence of policy-based distortions.

The need for brevity has also limited discussion of specific privatization experiences in this paper. Over the next two years, the APAP staff hope to prepare a number of case studies discussing LDC privatization initiatives to fill this gap. Most privatization programs implemented to date have been in developed countries or have focused on small, specialized firms, such as hotels, and thus this experience is not necessarily relevant to the challenge posed by the large agricultural parastatals.

We hope that this and forthcoming APAP Staff Papers in the series will provide useful information and analysis to all those involved in the continuing agricultural policy dialogue between AID and host country governments. We welcome comments, criticism, questions, and suggestions from our readers.

PRIVATIZATION OF LDC AGRICULTURAL MARKETS: OPTIONS FOR REDUCING THE ROLE OF AGRICULTURAL PARASTATALS

Introduction

The era of wholesale expansion of public sector enterprises in LDC agriculture is drawing to a close, replaced by encouragement for private development and, in many cases, a drive to privatize existing parastatals. Methods must be found to complete this difficult transition as efficiently and painlessly as possible. Both donors and LDC governments, from Costa Rica to Mali to Sri Lanka, are experimenting with ways to scale back the involvement of state-owned enterprises (parastatals) in rural markets and transfer their functions to private firms. Whether approached on a case-by-case basis or wholesale, privatization is a challenging but often necessary step to accelerate agricultural development.

In all of these countries, parastatals and the state itself will continue to play a role in agricultural development, but their function will increasingly be limited to three areas: 1) filling in the gaps where private sector activity by itself will not meet the government's objectives, such as subsidized food sales to low-income groups; 2) creation of an environment where private firms can flourish, requiring measures ranging from trade liberalization to road-building; and 3) regulation of market performance to ensure that competitive conditions prevail, such as operation of a buffer stock for grains or supply of market information.

This paper examines the options for moving from a situation dominated by parastatals to one where the private sector takes the lead role in the supply of goods and services. It thus starts from the point where the decision to privatize has been taken, whether out of dissatisfaction with parastatal performance, budgetary strictures, or a shift in ideology. The decision itself, which is by no means an easy or automatic one, will not be discussed here.

Neither the reasons for privatizing nor the reasons for creating the parastatal in the first place can be ignored in designing a privatization program, however. The decision to privatize in no way implies that earlier motives have been abandoned, nor is privatization an end in itself. While the shift toward greater reliance on private enterprise clearly has political implications, the primary motivations to date have been largely pragmatic not ideological. LDC governments rightly desire efficient, effective economic institutions at an affordable cost, whether their ownership is public or private.

This paper focuses on the options most relevant to the major agricultural parastatals. With few exceptions, these are not state farms or other enterprises engaged in agricultural production, but rather state-owned or state-controlled marketing institutions that distribute inputs, provide credit, and market agricultural products. Ranging from specialized marketing boards to state-sponsored "cooperatives" and development banks, they derive their importance from their controlling influence over the environment within which farmers, especially small farmers, must operate.

The paper's primary purpose is to encourage consideration of approaches other than sale of the parastatal to private investors (divestiture). For reasons discussed below, some of the most important LDC agricultural parastatals can be sold intact only under conditions that would not lead to true privatization, and others, realistically, cannot be sold at all. The paper also urges a broader approach to privatization, whether or not sale is ultimately included in the program, to give more recognition to the link between competitive market conditions and privatization that is successful from a developmental, as well as commercial, viewpoint.

The paper is organized into three sections. The first section makes the case for a broad, market-based definition of privatization that includes but goes well beyond divestiture of the individual parastatal. The second section briefly reviews the motivations that have led governments to create parastatals and assign them such a large role in agricultural development, reasons that in many cases closely parallel those underlying the current drive to privatize. The third section focuses on the main options available to privatize agricultural marketing institutions, briefly discussing each of four main strategies--sale of the enterprise, break-up into several entities, liquidation, and marginalization.

This paper does not include examples of successful and unsuccessful privatization programs, because it is not possible to do justice to these complex situations in the space available. Moreover, the mythology of privatization has spread more rapidly than the reality; very few cases can be cited where important agricultural marketing functions performed by a parastatal have been successfully passed back to the private sector, although the many efforts now in the planning stages or underway (in Mali, Niger, Bangladesh, Pakistan, and Jamaica, for example) will hopefully invalidate this statement in the near future.

I. Privatization: A Definition

Privatization, as used in this paper, is defined as:

> a reform process intended to create a competitive market environment, primarily but not exclusively by reforming state-owned enterprises (parastatals) and reducing the role of the state in the ownership, operation, and regulation of firms providing goods and services.

This concept is broader than two classes of reform sometimes referred to as privatization.

a. Privatization of firm ownership: full or partial transfer of ownership and management control over state-owned enterprises from the state to the private sector, foreign or domestic ; and

b. Privatization of firm management: introduction of efficient management and operational procedures into publicly-owned firms, such that they operate in a manner equivalent to private sector firms.

Neither of these reforms is inconsistent with the definition provided above; indeed, transfer of ownership of a powerful parastatal to private hands may be a central element of a privatization program and a precondition to successful privatization of the market in which the firm operates. By themselves, however, these reforms are inadequate and may even be counterproductive, as further discussed below.

The developmental benefits of privatization are based on using the marketplace to achieve more effective and efficient production of goods and services. The marketplace can, in some circumstances, function effectively with one or more public firms entering into the competition or providing services that are complementary to those of for-profit firms, but the market cannot perform its role where policies or other outside conditions make competition impossible or severely limit it, regardless of whether government-owned firms are present.

For this reason, public enterprise management reform rarely constitutes privatization, as defined in this paper, and certainly cannot be considered privatization if the other conditions for a competitive market are not met. (It may be a good idea anyway, of course, if it reduces the deficit or improves service delivery.) Without the pressure of the marketplace to force efficiency, training, capital improvements, and other investments aimed at raising parastatal productivity are often wasted. By themselves, they do not address the fundamental problem of the parastatal: absence of a link between efficiency and survival.

It should be noted, however, that even when the parastatal appears to operate in a competitive environment, management reform programs often deal with inefficiencies imposed on the parastatal from outside--such as regulatory controls, overstaffing, corruption, and political interference in management. Failure to achieve a lasting improvement in parastatal performance should therefore not come as a surprise.

Where the public enterprise currently enjoys a monopoly (de facto or de jure), sale alone will rarely if ever be sufficient to establish a competitive market. On the contrary, sale may simply replace a public monopoly with a private one. This switch benefits no one but the purchasers and possibly the government purse: a monopoly in private hands is no less likely than a parastatal to abuse its power, albeit in a different manner.

On the other hand, where public sector firms have a relatively small share of the total market, their sale may not be necessary to achieve a competitive situation (although, again, it may be desired for other reasons altogether).

Whether the public firm is large or small, a focus on the parastatal can be counterproductive. Overemphasis on the enterprise rather than the total market may divert policy-makers and donors from addressing other, more important barriers to the establishment and growth of competitive firms.

Clearly, an effective state-protected monopoly will in and of itself prevent the growth of private firms, but other policy barriers ranging from economy-wide price controls to specific import regulations may be equally fatal to private initiative. Since these policies will doom an efficient state-owned firm or its privately owned successor, the need to look beyond the parastatal itself when designing and implementing privatization programs is evident.

The case for focusing on the market as a whole is especially strong in agriculture. Agricultural parastatals are often an important source--sometimes the only source--of services critical to development of the agricultural sector, such as provision of credit and fertilizer or marketing of a major export crop. Effective and efficient provision of these services is a prerequisite for agricultural growth and is therefore a key concern to governments and the donor community. The disappointing performance of parastatals as an alternative to competitive market-based provision of these services is the fundamental motivation for privatization in agriculture. Even when complementary motives such as reducing losses to the treasury are also on the agenda, these concerns must take second place to ensuring that farmers have access to the services they need to increase production and national incomes. LDC experience with parastatal based markets and competitive markets strongly supports the conclusion that the latter approach is preferable in most cases, despite the weakness of agricultural markets in many situations.[1]

It is reasonable to expect that competitive markets can be established even in remote rural regions, but it cannot be assumed that such markets will arise automatically without further government action once a para-

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[1] An important distinction must be made between a competitive market and a free market. The latter is an economic ideal that is rarely realized. Competition, on the other hand, exists or will arise in most situations, once regulations are removed. Two points deserve emphasis:

a. Developing-country agricultural markets rarely meet the textbook requirements for perfect competition (free entry, perfect information, etc.), but they nonetheless often exhibit sufficient competitive characteristics to ensure that no trader or group of traders can establish an effective monopoly or determine prices artificially.

b. When competition breaks down and traders or others are able to set prices collusively or establish a monopoly, government policies that restrict private operations are often the root cause of the market's failure, but other factors, such as absence of adequate transport, poor communications, a political or social organization, can also prevent competition.

statal monopoly is ended. Further investments, particularly in improving the flow of goods and information, may well be needed. In those few cases where a natural monopoly exists, continued government monitoring and regulation may be needed to protect the public interest.

Even where competitive markets can be induced, their operation almost assuredly will not meet the government's many overlapping objectives for the rural sector, particularly the non-commercial goals. Conversely, the failure of a parastatal to perform effectively in carrying out a given policy, such as food assistance to low-income families, does not imply that the policy itself is unjustifiable or that another, less distorting mechanism might not be found to implement it at an acceptable cost.

II. GOVERNMENT OBJECTIVES IN THE AGRICULTURAL PARASTATAL SECTOR

Design of an effective privatization program must therefore be rooted in an understanding of why the parastatals in question were created in the first place, why they were assigned or assumed their current role in the agricultural economy, and how they relate to government food and agricultural policies. This understanding provides a basis for determining whether private or privatized firms will be more or less effective in meeting the government's objectives, and for identifying policy and non-policy measures that must accompany privatization to ensure that those objectives are met. Analysis of government intentions is particularly vital where the parastatal serves what may be called non-commercial objectives, that is, social, economic, or political purposes that cannot be assumed to follow from the operation of for-profit firms in a competitive market.

A. Motives Underlying Creation of Parastatals

The creation of a parastatal can rarely be assigned a single motive, either commercial or non-commercial. Five basic motives underlie the creation of most parastatals:

i. Revenue generation, through the expected operating profits of the enterprise;

ii. Ideological commitment, exercising a preference for state ownership of productive enterprises or a belief that private firms will not deliver services as equitably or efficiently as public firms;

iii. Economic expansion, in the belief that the most effective means for the state to promote the production and delivery of goods and services is to undertake these activities directly;

iv. Economic control, to ensure government control of a function believed to be critical to the national economy, security, or society at large;

v. Policy execution, using the parastatal as a means to implement market interventions, whether price controls, taxes (e.g., on an export crop), subsidies, or others.

Governments have often turned to state-owned enterprises in search of a short-cut to economic development. Planners may view existing private firms as too disorganized or primitive to achieve economies of scale or adopt improved technologies, for example, and believe that creation of a parastatal is easier than reforming what already exists. Where capital markets are undeveloped, it may seem simpler to create a new firm with funds on hand, rather than trying to set up new channels to mobilize private and public capital. Parastatals also offer a direct and highly visible route to creation of new jobs in the modern sector.

These various purposes are often found mixed together inseparably. Developing-country governments have frequently created parastatals as a means of gaining total control over an important agricultural market, such as that for food grains. By gaining this control, the governments have sought to attain complex and sometimes contradictory economic and social aims, such as high prices for farmers and low prices for consumers. Unrecognized or unresolved conflicts within these aims and between them and prevailing market conditions have been an important underlying factor when parastatals have failed to discharge their duties efficiently.

Where the government has loaded the parastatal with non-commercial objectives, decisionmakers are often completely justified in believing that the private sector cannot or will not meet these aims. Unfortunately, parastatals have not necessarily been able to come much closer than the private firms, particularly given the additional burdens under which most of them must operate--overstaffing, and inefficient management for example. In order to make privatization work, however, the government must be willing to resolve these conflicts, either by shifting its policy aims to a set more consistent with market conditions or by taking other measures outside the marketplace (such as direct subsidies) to achieve its aims. Otherwise, the private firms will do no better than the parastatal.

The problem is further complicated by the desire of many governments for improved equity and their low estimate of the ability of the marketplace to meet the needs of low-income and other disadvantaged groups. It can scarcely be denied that the laws of the marketplace favor those with the most resources. At the same time, the poor record of many parastatals in using non-market mechanisms to allocate subsidized commodities or ration scarce services only serves to underscore the difficulty of overcoming inequality without fundamental changes in the distribution of wealth.

The policy and ideological concerns outlined above are often combined with various subsidiary purposes, including:

i. Promotion of investment, whether as a means of using government investment funds and mobilizing off-shore resources or as a method to demonstrate to private investors the benefits of expanding into a new area of economic activity;

ii. Donor support, whether as a means of implementing a project, as an alternative to a line ministry, or as a reflection of the donor's preferred mode of operation;

iii. Political control, whether to reduce the economic power of potentially competing groups (e.g., large landowners) or to reward supporters; and

iv. Corruption, to take advantage of the opportunities for personal gain created by a parastatal.

Finally, LDC governments may acquire enterprises almost accidentally. Many state-owned enterprises were created by the colonial power for one reason or another, and are simply inherited after independence. Several of the marketing parastatals in Africa, for example, had their origin as marketing associations created by colonial farmers. Shaky enterprises may fall into government hands when private owners default on government-guaranteed loans. More rarely, the state may serve as a buyer of last resort for a private enterprise in financial difficulty. This is most likely when the firm is seen as vital to the domestic economy or national security, is owned by powerful interests, or is failing as the result of policy changes for which private owners successfully demand redress in the form of a bailout.

Donors must bear a large share of the responsibility for the spread of parastatals into areas better left to private sector activity. When a problem has been identified (poor farmer access to inputs, for example), donors have been no less eager than LDC governments to see a parastatal as the answer. Both ideological concerns on the donor side and the donors' operating style have played a part in these decisions; it is generally easier for the donor to fund a single parastatal than to direct its funds to a multiplicity of small private firms. Donors therefore must assume responsibility for helping LDC governments out of difficulties that are in no small part the donors' own making.

B. Motives Underlying Privatization

Initial experience with privatization indicates that its sources of support within LDC governments, donors, and the private sector are as varied, and in some cases conflicting, as the reasons underlying the establishment of parastatals. By and large, however, LDC government motives are primarily practical and parallel the reasons for relying on parastatals in the first place:

i. Reduction of fiscal drain, by selling enterprises that are losing money;

ii. Recovery of investments and generation of funds, by selling the assets of unprofitable parastatals;

iii. Attraction of private investment capital, whether off-shore or domestic, when the owners of such capital will not invest in parastatals; and

iv. Donor encouragement, or donor hesitancy to continue funding the parastatal.

Donor support for privatization is proving to be a significant impetus behind government willingness to reduce the role of state-owned firms. In some cases, the International Monetary Fund or another major donor has insisted on privatization as a means of reducing national deficits and, it is hoped, adding dynamism to the growth process. In other cases, donors have simply refused to fund (or continue funding) a parastatal that has performed poorly, forcing the government to choose another strategy.

These motives are essentially the same as those underlying privatization in developed countries as well, where financial considerations have been at least as important as ideology and policy in speeding privatization. Other motives in the mix include:

i. Ideological commitment to an expanded role for the private sector;

ii. Economic expansion, through greater reliance on the private sector to deliver vital goods and services, as a reflection of dissatisfaction with the performance of parastatal enterprises or a belief that the market can outperform the planner in allocating and using resources efficiently;

iii. Market maturation, so that there is no longer a need for the government to invest in an area to encourage private entrepreneurs to follow;

iv. Economic decontrol, to increase the efficiency of the economy through freer operation of the market for goods and services;

v. Policy changes, ending support for the noncommercial purposes previously served by the parastatal (e.g., removal of a consumer subsidy); and

vi. Political reasons, such as a desire to weaken centers of support that previous regimes had built up within particular parastatals, to turn enterprises over to political allies (or the original owners), or to block corruption.

As a result of the predominance of financial motivations in LDC government support for privatization, there has been a marked tendency for privatization programs to rely heavily on the following two activities:

i. attempted sale of money-losing companies with little potential for profitable operation; and

ii. liquidation of small firms that were effectively non-operational already.

Neither of these activities is likely to result in the privatization of important agricultural markets, either because the effort will not be successful (the buyers for money-losing companies being scarce) or because the liquidated firms played an insignificant role in the agricultural economy anyway.

Privatization of state-owned enterprises performing critical economic functions is inevitably a complex, politically costly activity with short-term losers as well as long-term winners. Political will thus emerges as a critical ingredient, but one that is difficult to measure. In particular, a general commitment to private sector growth may not translate into serious support for tackling the tough problems posed by major agricultural parastatals, nor does a willingness to offer for sale a few small, money-losing parastatals imply government readiness to transfer important functions to the private sector or the marketplace. The options discussed in the following section offer methods that may reduce the cost of privatization or diffuse the opposition, but the difficulty of moving from centralized control of a major agricultural function to competitive market operations cannot be overemphasized.

III. APPROACHES TO PRIVATIZATION OF AGRICULTURAL MARKETS

The market-based approach to privatization opens up the range of options in three ways:

a. It encourages analysis of options that do not necessarily maintain the parastatal "intact" as a single firm, particularly where this would continue a monopoly or run counter to the development of a competitive market and efficient operation of the firm after privatization;

b. It opens up possible solutions that depend on private alternatives to the existing parastatal, rather than simply restructuring or selling the existing state-owned firm; and

c. It underscores the need to consider the impact of divestiture on the entire spectrum of firms in the market, including potential entrants after privatization, and to examine policy changes necessary to ensure efficient, competitive operation of the markets directly and indirectly affected (e.g., the impact of privatizating an agricultural bank on the market for agricultural inputs).

This section discusses four basic approaches to privatization:

a. Sale of the parastatal, maintaining it as a single entity;

b. Breaking up the parastatal into several different firms, whether horizontally (geographically) or vertically (by function);

c. Closing down the parastatal, whether fully or partially, replacing it with wholly separate private firms, and

d. Marginalization, in which the parastatal may continue to exist, but operates in a competitive market where private firms increasingly take the lead in service provision.

Several alternatives exist under each option, but the scope of this paper does not permit detailed exploration of each and experience with it, much less any attempt to predict which ones, if any, will be feasible in a given instance.

A. Options Based on the Sale of the Parastatal

This section reviews options based on the sale of the parastatal as a single entity, with the intention that it will continue in operation more or less in the same form after sale. The specific method used to complete the sale, the share if any retained by the government after divestiture, and the conditions attached to the sale are all decision factors and can vary greatly from case to case.

Sale of a parastatal can be handled in a great variety of ways. The selection of an appropriate methods depends primarily on the financial condition of the parastatal before sale, including:

1. its solvency (i.e., whether its assets exceed its liabilities);

2. its profitability (i.e., whether its income exceeds its costs);

3. the relationship between its financial condition and policies governing its operation before and after divestiture,

4. the nature of domestic capital markets, and

5. the options available regarding the parastatals' workforce.

Parastatals may be grouped into four categories, based on their financial condition and how it relates to existing policies:

1. Fundamentally sound and profitable: The parastatal is solvent and profitable and its profitability is not dependent on special policies related to its parastatal status;

2. Sound, but not profitable: The parastatal is currently losing money because of special policies (e.g., price controls) or problems such as overstaffing, but it is not insolvent and would probably be profitable if it could be operated in a competitive environment without undue restriction;

3. Profitable, but not sound: The parastatal is currently profitable, but only because of special policies that favor it, such as a state-granted monopoly, subsidized inputs, and special tax status;

4. Neither sound nor profitable: the parastatal is currently losing money and would continue to do so in a competitive environment.

Only parastatals in the first category, and in some instances the second category, are good candidates for sale. Parastatals in the third category may be attractive to investors if they are assured that the special privileges will continue in effect (a condition that is difficult to meet). But simply selling the parastatal without other reforms is likely to be inconsistent with the aim of privatization as defined above, because the profitability of the firm is dependent on its special privileges, making it both difficult and unlikely for other firms to enter in competition with it. Firms in the last category will rarely find a market at all, unless changing market conditions offer renewed potential for profitability.

Although these categories appear straightforward on the surface, in fact it can be quite difficult to classify a given parastatal, particularly if it has been operating for years in a policy-distorted environment. Not infrequently, the parastatal's environment is heavily influenced by policies that both favor the firm and restrict it, so it is difficult to determine whether the firm would be profitable as a private entity subject to some, but not all, of the same policies. The situation becomes doubly tricky when the reform package includes other policy changes that will affect the profitability of the newly private firm.

In addition, parastatals that have operated unprofitably for years have often accumulated a huge debt to the central government or state-owned banks, giving them a low or negative net value. Even if the underlying business is potentially profitable, the firm may not realize operating profits sufficient to attract investors, unless the government is willing to write off much of this debt off, which few governments are eager to do.

Even in the most favorable of circumstances, few LDC investors have the capital to purchase large parastatals outright. Even where such investors exist, their ethnic or political background often makes them unacceptable to the government. The government may envision selling the parastatal to large numbers of small, local investors, but LDC capital markets can rarely meet the challenge of organizing such a sale. In all but a few developing countries, individual experience with purchasing shares or other instruments is nearly nonexistent, and formal or informal market institutions do not exist to manage the transactions required.

In this situation, simply issuing stock is unlikely to raise enough capital to meet the government's price. Alternatives must be sought, such as sale of some of the stock to the employees on favorable terms; a negotiated sale in which an independent intermediary is retained to identify and organize potential purchasers, whether foreign or domestic; and formation of a joint venture, with or without state participation.

Another practical barrier to sale of the parastatal as a going concern is the likely difference between the book value of its assets and their actual value. If the government wishes to recover the full initial investment in plant and equipment that have become seriously deteriorated, it is likely to be disappointed. Yet few governments are eager to admit that the parastatal is worth less than the nation paid for it.

B. Options Based on Breaking Up the Parastatal

The most important agricultural parastatals--those responsible for agricultural credit, input supply, and output marketing--frequently have a highly integrated structure, both vertically (by function) and horizontally (across regions and/or crops). Typically, they combine a wide range of services and operate nationwide. Even if the primary function is limited to marketing a single commodity (such as coffee), the parastatal's operations may well extend from the farm-gate to the port or final consumer and incorporate extensive processing and retail operations. The facilities involved at each step (such as trucks) may well be owned by the parastatal, rather than hired from separate firms in the public or private sector.

This high degree of integration can be traced to several factors that are likely to influence privatization. First, LDC governments share the widespread misconception that a large operation is inherently more efficient than several smaller operations. This belief is rarely justified for most agricultural marketing operations, where full economies of scale are reached quite quickly. (Exceptions exist, of course, particularly where the total national market is too small to permit multiple firms to reach the minimum size for technical efficiency.) Indeed, diseconomies of scale may well be more common than the converse: given the lack of skilled managers and difficulties of internal communication in many LDCs, several operations of the minimum economic size may well be more efficient than a single large firm.

Second, a large scale of operation may result from political or institutional factors, such as empire-building by parastatal managers, a desire to promote national integration, improved possibilities for corruption, or a decision to implement key economic controls or policies through the parastatal in a way that requires integration. The pressure to hire college graduates can be a powerful force pushing the parastatal to expand.

Third, the history of large parastatals may reveal that diverse functions were combined in hopes of cross-subsidizing money-losing operations with activities expected to be profitable. For example, subsidized sales of low-quality food items to urban consumers may be financed by overpricing luxury goods imported by the same parastatal, or the farm-gate price in remote areas may be held above its true market level at the expense of farmers closer to market.

Whatever the origin of the firm's size, there are many reasons for breaking up a nation-wide parastatal as part of the privatization process. Primary among these are the following:

i. Creation of a competitive environment: Domination of an entire marketing channel by a single firm is not conducive to the entry of private firms into the channel, since it is difficult to begin operations on many fronts at once.

ii. Management skill requirements: Even if there are technical efficiencies in integration, the higher level of management skills required by a large-scale operation may lie beyond those available among domestic entrepreneurs, while the more basic skills required by smaller units more closely resemble the mix of skills already present, and permit the market itself to fill much of the coordination function.

iii. Sale price: By breaking up the parastatal into several separate units along geographic or functional lines, the investment required may be brought within reach of local entrepreneurs.

iv. Differences in profitability: Some parts of the parastatal are likely to be more profitable (actually or potentially) than others, so that parts of a parastatal may be saleable even if the whole is not.

v. Differences in technical requirements: wholesaling into an established international market requires very different skills and equipment from retail sales to consumers in rural areas and, in consequence, the various component parts of a large parastatal may fit more easily than the parastatal as a whole into existing activities of local entrepreneurs.

vi. Noncommercial objectives: Entrepreneurs may not be willing to continue unprofitable operations regarded by the government as socially or politically necessary (e.g., sales of staple foods in poor neighborhoods or input supply in remote rural regions). Break-up of the parastatal permits such services to be continued under state ownership, while making their cost much more visible and placing it squarely on the government's own shoulders, both desirable outcomes from a policy standpoint.

vii. Staged implementation of the reform: Where a government is unwilling to divest itself of a major parastatal all at once, break-up offers an alternative strategy for privatizing within one region or one function on a trial basis, while allowing the government to retain considerable control of the market.

There is no single optimal pattern for restructuring a major parastatal into several smaller firms. The analysis of options to break up a parastatal requires careful attention to the technical nature of the operation involved and the commercial environment in which the privatized firms will operate. Whereas the integrated parastatal relies on its internal management structure to coordinate different regions and functions, delivery of services after the reform will depend on the marketplace to make these necessary connections. The conditions required for effective operation of these markets must therefore be examined with care to determine whether policy and nonpolicy measures must accompany the break up. Four questions offer a useful guide to beginning this analysis:

i. What is the structure for similar in-country operations that are currently in the private sector? For example, if the parastatal imports grain, how do other imported bulky commodities (milk powder, lentils) move through local market channels?

ii. What is the structure for the same operation in other countries, both LDCs and others? For example, if grain importation is handled directly by large retailers in neighboring countries with similar population, geography, and income level, it is reasonable to expect a similar system to work in this country.

iii. How is the parastatal itself organized (regionally? functionally?) and what information is available, if any, to indicate which divisions are currently profitable?

iv. How are firms that are potential customers for the parastatal organized? How can the parastatal be restructured so that its components fit most easily with existing operations?

Although many marketing activities seem to have a "natural" structure, based on their technical requirements, in other cases a number of viable alternatives exist, each with advantages and disadvantages. As argued above, the importance of economies of scale has frequently been exaggerated; small, independent operators may have flexibility and local knowledge that makes them more efficient than larger competitors. If real economies of scale exist, moreover, the market will "find them": firms will integrate vertically or horizontally by acquiring other firms or building up their internal capacity over time.

The evolutionary nature of a competitive market cannot be overemphasized. As the market develops, the structure of the firms making it up evolves along with it, in ways that cannot always be predicted. The nineteenth-century food retail industry in the U.S., for example, was similar to that in many developing countries, composed of small, independent butchers, green grocers, dairies, and dry grocers buying directly from wholesalers or even from farmers. From this evolved the nationwide system of highly integrated supermarkets. Now small independents are again becoming important, as specialty stores or franchise operations serving particular needs (e.g., convenience stores) increase their market share.

Government decision-makers (and donor personnel) may well be uncomfortable with the degree of uncertainty implied by reliance on a competitive market. The existence of parastatals is powerful if indirect testimony to their wish to leap immediately to full market development (or to some preconceived notion of it). As the experience with parastatals demonstrates, instant development is not always possible, much less desirable. It may be necessary for firms to gain extensive experience with marketing an imported processed food in the major cities, for example, before sales channels are sufficiently developed to justify expanding into in-country processing or extending the sales operation to reach rural consumers.

The existence of a large parastatal in an important market segment can impede rather than foster this critical market development function, especially if factors outside the control of parastatal management (such as politicization), prevent the parastatal itself from maturing into an effective institution. For example, expansion of private agricultural input suppliers is likely to be severely hampered, if not precluded altogether, by a state monopoly in the sale of a high-volume input such as fertilizer. If private dealers are cut off from the largest and most profitable market in their field of operation, they may be unable to reach an efficient scale of operation.

The corruption and inefficiency that are often hidden within a large parastatal also pose a serious barrier to healthy growth of private firms. These conditions encourage the firms to become overly reliant on dealings with the parastatal, or corrupt dealings with parastatal staff, rather than establishing independent competitive channels. Break-up of the parastatal then becomes a necessary precondition to efficient private sector development, but private firms that benefit from the existing situation are unlikely to support the reform. A history of corruption complicates privatization indirectly, as well, by lending credibility to government arguments that the private sector is a band of thieves.

One of the principal aims of the break-up approach to privatization is to create a market structure with sufficient diversity and opportunity to encourage innovation, allowing the market to evolve as it grows. The failure of some firms along the way is an inevitable part of this growth; it cannot and indeed should not be expected that all the firms created by the restructuring will survive. Indeed, the "weeding out" feature of market-based development is a strong argument in favor of break-up rather than sale intact. Breaking up the parastatal into separate functions may lead to cessation of uneconomic operations, a transition that is difficult to achieve when they are integrated into a single firm serving a major social and economic function.

Hard though it may be for government planners and donors to accept, a certain amount of duplication is desirable after the break-up, probably even necessary for competition. If every firm has its own guaranteed territory with a comfortable market share, on what basis will competition arise?

As the foregoing suggests, there are at least as many ways to break up a parastatal as to sell it intact. In addition to division along horizontal (geographical) or vertical (functional) lines, discussed above, important alternatives include the following:

i. Division: breaking up a single, large parastatal into several, essentially similar firms that must compete for survival, both with each other and with private entrants into the market (an approach similar to the creation of separate divisions within a American auto manufacturer);

ii. Franchising: allowing private entrepreneurs to buy the rights to deliver some of the services previously handled by the parastatal in a particular locale, possibly as an agent for the parastatal. For example, the government may retain the right to import grain, but franchise its internal distribution to private firms on a fixed fee, split fee, or auction basis. A similar method has long been used to collect local road tolls in Pakistan, wherein local firms bid for the rights on a given road, given a fixed rate schedule and a requirement to staff the booth at least partly with government employees.

iii. Contracting with local entrepreneurs to fill a function previously provided by the parastatal, often in support of other parastatal operations. This is currently being tried in Niger, where the main grain marketing parastatal has begun to buy grain on tender from local merchants rather than conducting its own buying campaign in the countryside. (Thus far, the experiment is not a total success, since the parastatal wishes to determine the price it will pay in advance of the bidding process.)

iv. Sale of goods and services, allowing private entrepreneurs at the retail level to purchase goods from the parastatal (or pay for services produced by it), rather than having the parastatal handle both retail and wholesale operations on a monopoly basis. This approach was central to the Bangladesh experiment in privatization of the fertilizer market, in which both private and cooperative retailers purchased fertilizer from the state-sponsored cooperative wholesale distribution depot.

Under all of these approaches, some functions may continue to be performed by the parastatal, at least in selected regions or market segments. Break-up therefore facilitates continuation of services that are politically or socially desirable, but not economic, a feature that may make it more attractive than outright sale of the parastatal as a single entity.

C. Options for Closing Down a Parastatal

A recent World Bank survey of privatization programs in thirty countries (forthcoming) found that by far the most common approach is simply to close down the parastatal, allowing private firms to enter the market and replace it (or, in some cases, allowing the function to disappear). When the activity in question is simply not profitable under competitive, unsubsidized conditions and there are no overriding social or political considerations, close-down may emerge as the best option. In effect, the parastatal has a negative value to the economy as an enterprise and the most profitable option is to liquidate its assets for whatever they will bring.

Liquidation of the parastatal's assets is not the only way to close it down, however. In some cases, it may be preferable to lease some or all its assets to a private firm that can put the plant and equipment to profitable use, whether for the same purpose or for another business altogether. As in nearly every approach to privatization, the key difficulty in leasing is presented by the parastatal's labor force. Political or legal considerations may make it necessary to complete a formal liquidation, dissolving the parastatal and transferring the assets to another entity that in turn leases them to private firms, minus the labor force.

In the industrial sector of developing countries (including food processing and manufacture of agricultural inputs), it is not uncommon to find that there is no possibility of operating the parastatal profitably, no matter how it is restructured. Thus closing it down, unattractive though this alternative appears to the government, is often the best among a bad set of options. Many LDCs are littered with factories that can hope to achieve profitability only behind high tariff walls or other costly barriers to competition.

Ill-advised investments have been no less common in the agricultural sector, but it is rarely the case that basic agricultural marketing activities are fundamentally unprofitable, once macro-economic or sectoral policy distortions are removed.

Price controls and other policy measures in the agricultural sector, however, can reduce the profitability of agricultural production. As a result, input use, demand for credit, and supply of a marketable surplus may be too low to permit profitable operation of agricultural marketing operations, and profit margins may be too slim to permit private sector marketing agents to function. In such situations, policy reform is an absolute precondition for any type of privatization, including liquidation of existing parastatals.

Even without these man-made barriers to delivery of agricultural services, high transportation costs and thin markets may make service delivery unprofitable in remote regions or may create a situation where only a monopoly can operate profitably. (It can be argued that these situations are less common than many government leaders believe, but the argument is notoriously hard to prove in the field.) Where technical factors (poor roads, lack of proven seed varieties) make service delivery on a competitive basis unprofitable, a case can be made for government intervention to overcome market failure. This case must rest on careful analysis of both costs and benefits, however, not on simple assertion of market failure.

If intervention is justified, an existing parastatal is not necessarily the best mechanism to implement it. On the contrary, it may be preferable to intervene instead by:

i. regulating private sector companies enjoying a monopoly to ensure that they do not make excess profits; and

ii. taking actions that lower costs or increase returns so that operation of several firms on a competitive basis is profitable.

When service provision by a parastatal is eliminated as an option (by closing down the parastatal), it becomes clear that the government must take responsibility for creating an environment that favors growth of agricultural services and, therefore, the expansion of production that depends on these services. Necessary and desirable interventions to accompany parastatal closedown may therefore include investments in roads, research, extension services and other measures designed to reduce the cost or increase the return to services, or policy interventions such as subsidies to transport in remote areas (if market failure or overriding social concerns can be shown).

The viability of closing down a parastatal depends to a large degree on the government's evaluation of the ability of private sector actors to rapidly replace it. In many cases, this question is easily resolved, because the parastatal can readily be shown to play a minor role at present. In other situations, however, the parastatal is a major actor in the market. It may enjoy an official or (more rarely) actual monopoly in the provision of particular goods or services, such as fertilizer supply. Where the private sector is weak or absent, careful attention must clearly be devoted to ensuring rapid entry by new firms or existing enterprises in related areas. Simple liquidation is unlikely to be acceptable to the government or, for that matter, the donors, without complementary measures to ensure that the parastatal's functions continue to be performed with a minimum of disruption during the transition.

A major complicating factor in the transition from parastatal market dominance to a competitive situation is the nature of private sector operations that tend to arise in a market formally controlled by a parastatal, a problem alluded to above. Parastatal inefficiency and corruption create opportunities for unfair marketing practices that unscrupulous entrepreneurs are quick to take up and loathe to let go.

Not all liquidations take the shape of a formal declaration of bankruptcy and sale of assets. On the contrary, "silent" liquidation was found in the IBRD study to be far more common, taking the form of a gradual sell-off of assets in an effort to generate cash for short-term operations or simply an unannounced or "temporary" cessation of operations altogether. Where the physical assets of the parastatal are badly deteriorated, there may be little to sell in any case, making silent liquidation effectively equivalent to formal sale of assets, but saving the government from an embarrassing situation.

As with formal liquidation, however, this option is not well-suited to dealing with the large, powerful parastatals that are of greatest policy concern in the agricultural sector. A firm with monopoly rights to trade in a country's major export crop is unlikely to fade away.

Silent liquidation may well be appropriate for moribund agricultural processing and marketing activities, and for small parastatal marketing organizations that do not have a monopoly. The agricultural marketing boards in some Caribbean countries, which may handle 5% or less of the nation's output of any single crop while more or less breaking even financially, are an example of the latter. Where the government has a strong commitment to such an organization, or its perceived political value is high, donors have little to gain by insisting that it be abolished, particularly if this battle is won at the expense of other, more important reforms affecting agricultural marketing.

D. Marginalization: A Promising Approach

For major parastatals with a large share of the market, neither sale nor closing them down may be acceptable alternatives to the government, especially in the short run. This section discusses an alternative that may be especially appropriate in such instances. Under this approach, which may be termed marginalization or liberalization, the parastatal continues in operation, but the scope of its operation and/or its importance in the agricultural sector is progressively reduced by measures to allow and encourage the entry of private firms into the market. This strategy may be pursued as a transition to sale or liquidation of the parastatal, or as a stand-alone strategy for privatization.

In the short term, the marginalization strategy does not necessarily require a reduction in the scale of activity of the parastatal, making it attractive to developing country governments that are unwilling to commit fully to a private sector strategy. Marginalization relies instead on freezing the parastatal's level of activity at the current level, or drastically curtailing its expansion, so that private firms are able to grow up around it as market activities expand.

For example, if the marketing parastatal currently imports 50,000 tons of fertilizer, its operation may be frozen at this level and a policy adopted whereby private firms will be permitted to meet any residual demand. Then, as fertilizer use rises over time, private firms can gradually assume control of the market, permitting the importance of the parastatal to diminish bit by bit. The parastatal may retain a small role, either real or symbolic.

This option has four main advantages:

i. Practicality. It is not necessary to find an immediate solution for such ticklish issues as what to do with the parastatal's large workforce.

ii. Reduction of uncertainty for the private sector. As long as the likelihood exists that the parastatal will continue to receive government support for expanding operations, private entrepreneurs will naturally be very hesitant to enter the market.

iii. Continuation of activities with noncommercial purposes. Parastatal activities that serve social or political aims regarded as critical can be continued at the current level, thus reducing the political cost of the privatization and easing adjustment costs for beneficiary groups. Ideally, the parastatal should be restructured to focus more closely on legitimate non-commercial activities (selling a greater proportion of subsidized imported rice in poor areas, for example).

iv. Limitation of losses. Although marginalization does not provide immediate relief for such problems as fiscal hemorrhage from a money-losing parastatal, it at least helps to prevent the situation from growing worse and sets in motion a process likely to lead to a solution within a reasonable time frame.

From an economist's viewpoint, marginalization sends the right price signals, if it creates a situation where users (and suppliers) of marketing services pay (and receive) the full economic price for the last or "marginal" unit of service provided. Any subsidies (or taxes) associated with so-called inframarginal transactions by the parastatal take on the form of lump sum transfers, which economic theory holds to have the least distorting effect on resource allocation decisions.

The main disadvantages of this option are three-fold:

i. Financial: If the parastatal is operating at a loss, it will continue to do so, so the drain on the treasury is not relieved. Nor does the government realize the one-time gain offered by an actual liquidation. Methods of avoiding these difficulties are offered below.

ii. Political: To be fully effective, marginalization requires that the commitment not to expand be made in a reasonably public and credible fashion, so that private firms are encouraged to enter the market, but such public policy pronouncements may not be popular where trust of the private sector is low. Moreover, experience indicates that governments find it difficult to hold to their commitment not to expand public activities or make new investments.

iii. Commercial: If the parastatal's current level of operation meets all or most of the effective demand, there may be too little room in the market for private operators to achieve an efficient scale of operations within a reasonable time frame.

There are several ways around the financial drawbacks of marginalization, depending on the nature of the parastatal and its financial viability after the reform. For example, rather than freezing the level of services, the government may freeze the real or nominal amount of subsidy provided to the parastatal, while implementing other reforms that permit its management to continue delivering at least a minimum service for the given subsidy. If the subsidy is frozen in nominal times, both the service level and the subsidy are likely to decline over time with inflation, particularly if the parastatal cannot evolve into a commercially-viable firm, but the decline may be sufficiently gradual to ease the transition and permit adjustments to be made.

The potential role for donor resources in easing the marginalization process is obvious. In Mali, where the government is attempting to marginalize the grain marketing parastatal, donor-supplied local currency has been used to subsidize consumer sales previously subsidized indirectly by forced procurement at low prices.

Another palliative measure consists of spinning the parastatal off as a "commercial entity." Since many parastatals cannot attract investment funds without government backing or guarantee, this is equivalent to a freeze on investments in the parastatal. Where the existing plant is aging or deteriorated, a freeze on investment is effectively the same as a gradual close-down, as few parastatals can maintain even a minimal level of activity for long under these conditions. This approach, although messy, may be much less costly in the long run than a theoretically cleaner but more impractical attempt to divest the parastatal.

In sum, marginalization offers a loss-limiting alternative that can be applied where more attractive options such as divestiture and liquidation are not politically or economically feasible. The variations discussed here are only some of those that permit the parastatal to persist in some form, while the government implements policy changes and other measures to gradually reduce the parastatal's role and transfer responsibility for agricultural marketing to private sector firms.

In privatization, as in other aspects of development, the route that appears most direct may in fact be the least promising. By focusing on sale of the parastatal, advocates of privatization do both themselves and the developing market economies a grave disservice.