EXECUTIVE SUMMARY

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Privatization & Development

Edited by
Steve H. Hanke

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About the Author

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Preface

In the past several years, interest in privatization—which means contracting with or selling to private parties the functions or firms previously controlled or owned by governments—has been growing in both developed and developing countries. There are many reasons for this, but the most important have to do with a combination of growing pressures on public budgets and mounting evidence that the competitive discipline of private markets increases efficiency, producing greater quality at a lower cost. Even the socialist countries have thus been affected by the movement, and pressures for privatization have surfaced in almost all of the Eastern Bloc countries.

Privatization has also become a policy "growth area" because of the *form* it has taken—in distinct contrast to past government efforts to "denationalize" public enterprises. A major impulse to nationalize private firms has come from the belief—whether mistaken or not—that the existence of large private firms concentrate power and wealth in the hands of the few and thus obstruct the commitments of many countries to equality. Where this perception has been strong, as in Britain for instance, denationalization was simply seen as a step backward, toward reconcentration of wealth. On the other hand, privatization, at least as it has occurred in many countries, has changed the perceptions of many people toward private ownership by consciously implementing the sale of firms to large numbers of individual shareholders.

The broadening of private ownership has important political implications, and also accords in a significant and interesting way with the International Center for Economic Growth's (ICEG) special interest in human development. In Britain, where the movement has been particularly strong, this aspect of privatization has stimulated a "people's capitalism," which has produced strong political constituencies for private ownership even among Labor Party voters.

While it is obviously impossible to know whether interest in privatization will continue, it is nevertheless a subject of great current interest in many places. This book, edited by Steve H. Hanke, is the result of a conference on privatization sponsored by the United States Agency for International Development held in Washington, D.C. in February 1986. The conference, as the papers in the book show, considered a broad series of issues related to privatization and explored practical approaches drawn from real-country experiences with it.

This book is meant to be a "how-to" manual on techniques of privatization. It is our first publication on this important subject, which will be an ongoing concern for the Center as it explores new development strategies.

This is an executive summary of the original book published by ICEG.

Nicolás Ardito-Barletta
General Director
International Center for
Economic Growth

Panama City, Panama
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- Encouraged largely by the growth and subsequent failures of government-dominated economies during the 1970s, many countries around the world have been adopting privatization strategies during the 1980s. While there are a wide variety, most involve the transfer of either control or ownership of public enterprises or services from the government to the private sector.
- Privatization has been most readily accepted, and most successful, in the industrial countries. There, capital markets are more developed, and there is a bigger private sector to which government can cede control. Great Britain has been most successful with its privatizations under the Thatcher government.
- In developing countries, there are many obstacles to successful privatization. Many groups—including the military, labor, government bureaucrats, and intellectuals—are suspicious of plans to allow ownership and economic pass to "powerful elites" or foreign vestors, and do not want to see their own stake in government jobs reduced. Nonetheless, many developing countries are beginning to privatize nationalized industries, with Chile representing the most significant success today.

- Privatization is much more than an economic policy. It is above all a *political* act that requires broad support to succeed. This support can be generated by offering the benefits of privatization to a broad constituency, including the potential opponents of privatization such as the managers and employees of currently nationalized firms and the users of the output of these firms.
- Many of the obstacles to privatization involve economic misconceptions that can be dispelled with public education. But a number of real barriers to privatization in developing countries exist, including regulatory problems, inadequate legal structures, and lack of financing. In many cases privatization will require establishing new institutions and practices in developing countries, particularly concerning property rights. Privatization can be the impetus for important structural changes in the political and economic systems of developing countries. Financing of privatization is now being undertaken by aid organizations, who see privatization as an important means of development.
- Successful privatization requires creation of an economic environment hospitable to private ownership, mounting a public education program to sell the concept, selecting targets for privatization that maximize chances for success, and preparing targets for privatization if necessary by investing in them.
- If successful, privatization offers a number of attractive possibilities to governments and private citizens. Those include an easing of foreign debt, increased productivity resulting from enterprises that are better managed in the private sector, a growth of the entrepreneurial climate necessary for economic growth, and a substantial broadening of ownership of private property in the society, thus broadening peoples' stake in and (therefore) encouraging political support for the system.

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Toward a People's Capitalism

Perhaps the most interesting thing about privatization is its popularity. Four or five years ago the word "privatization" could not be found in economic and political vocabularies. Now the word can be found in popular dictionaries, and talk is everywhere about it; even if one discounts what are often the excessive enthusiasms connected to fashions of the moment, the outpouring of news about privatization everywhere in the world must be considered astonishing.

It is probably true that the privatization enthusiasm varies from place to place. In Africa, for instance, James Brooke writes in a recent *New York Times* article that interest in privatization is motivated by the desire to correct past failures of development policy and cut the red ink of chronic, money-losing state enterprises. He writes:

> Twenty-five years ago, many newly independent Africans countries turned to the state to lead economic growth. Unfortunately, in most cases, growth did not come. Of Africa's 52 countries, 29 were poorer in 1986 than 1960, according to World Bank figures on per-capita gross national product.

Mr. Brook captures the spirit of the change in describing a Frenchman, working near Red Star Square in Contonou, Benin. "Everything was nationalized," he quotes the Frenchman as saying, "and everything was failing. . . . Now they are trying to privatize everything."

In considering the matter ideologically, one would expect the conservative governments of Margaret Thatcher in Great Britain and Jacques Chirac in France to favor privatization. But this economic revolution is not limited to conservative governments. Mr. Brooke is writing about the plans of *Marxist* governments—in Angola, Benin, and the Congo—to sell money-losing state companies.

That there has been a shift of thinking about "what works" is undeniable. Such an ideological shift would in fact be hard to believe if similar shifts were not also evident in the largest of the Marxist-Leninist countries—China and the Soviet Union.

Beyond the intellectual and practical attraction of private ownership and market mechanisms, there is a political factor that I think accounts for privatization's extraordinary popularity. While the traditional analysis of the political forces that generate increasing government spending contends that the *concentrated* interests of the few who receive the government's largess outweigh the *diffused* interests of the taxpayers, privatization, properly designed, has turned this on its head, at least in Western democracies: it has pitted a political constituency with a concentrated interest (the people who will own shares in the privatized company) against one (the general public) with only a weak, diffused interest in maintaining public ownership. In this case, the weakness of the diffused, general interest for maintaining public ownership will be particularly evident if the state-owned company is losing money. Managers and employees of public firms, as well as those who receive subsidized or unsubsidized output from public enterprises, do represent a concentrated, special interest; they might oppose privatization. Allow me simply to mention here that these two groups of public enterprise beneficiaries can be neutralized, if not won over, simply by insuring that they are allowed to participate in the benefits of privatization, through either higher wages, ownership rights, lower output prices, or higher quality services.

The British experience exemplifies how privatization can be used to generate political as well as economic benefits. Mrs. Thatcher has learned that the actual sale of assets and shares presents an enormous (and one would think obvious) opportunity to build a consistency of political support, especially for future privatization. Prior to Mrs. Thatcher's government, denationalizations were typically implemented by the "private placement" of shares to companies or small groups of individuals. In many cases, the new owners were merely the old owners who originally had their shares nationalized.

In consequence, privatizations did little to broaden capital ownership within the general public. In addition, privatizations failed to take note of Joseph Schumpeter's observation that all property rights are not equal in their ability to generate loyalties and political support. Ownership in "abstract forms," such as shares of stock held by the general public, generates far less loyalty than ownership of one's own home, business, or place of employment. Consequently, in England there were few who were devoted defenders of private ownership and who opposed labor government renationalization of private enterprises. Britain has experienced a cycle of nationalization-denationalization; Mrs. Thatcher's privatization strategy is designed to terminate this cycle by broadening ownership and by making it more than an "abstract form."

Britain's new privatization strategy is built on a very different political analysis. Under privatization, firms are now sold in public offerings to a broad constituency of *individual* shareholders. This broad constituency includes potential detractors of privatization, such as current managers and employees of nationalized firms and users of the output of the nationalized enterprises. Hence, these shareholders become personally interested and involved in the sale and thus become the basis of a powerful political constituency supporting future privatization and opposing renationalization.

To illustrate the power of his approach, in one sale 96 percent of the members of a particular labor union bought shares in a newly privatized firm, ignoring the union's campaign to persuade them to do otherwise. All of those who purchased shares have realized huge profits, and all have (not surprisingly) become great supporters of privatization.

The logical consequence of this is that today between 75 and 80 percent of the British public consistently support privatization regardless of their political attitudes on other issues or their feelings toward the Thatcher government. A similar thing has happened in France in response to the privatization program of Prime Minister Jacques Chirac. In the face of this support, the British Labor Party and the French Socialist Party have conspicuously de-emphasized their longstanding commitment to renationalization. A great deal of this change is the result of seeing privatization as more a political than economic action and structuring privatization strategies to build political constituencies.

Managing Successful Privatization

Initiating a successful privatization program requires developing a strategy with certain essential parts.

1. **Before one even thinks about developing a plan for privatization, one must create an economic environment hospitable to private ownership.** This issue must precede everything, for if it is not settled, no privatization plan can go anywhere. As Peter Thomas, Larry White, and I noted in respective chapters of the book, this task involves reviewing the tax system and law regarding property rights to be sure that the tax climate is sympathetic and that a basis exists in law for private property rights that ensure and protect value for new owners and stimulate the development of local capital markets. The issue—a great deal can obviously be said about it—goes to the entire legal structure in a country, whether it encourages or discourages private ownership. There is no space here to state the principle more than generally: the economic climate must be conducive to private ownership before one can even think about trying to develop a successful program for privatization.

2. **Begin with a serious program of public information.** Once one has reviewed the tax and legal systems and is satisfied they contain no serious problems, the first step in thinking about how to privatize is to build a political constituency for privatization, a sympathetic environment in which further privatization will be possible and encouraged. This is discussed by Lance Marston and others. Selling privatization to both the public and private sectors is more complicated than simply establishing a sympathetic environment, though that is certainly important. Public education must be an education based more on action than words, especially in the beginning. This means taking on the least controversial objects for it, doing it slowly, and doing it successfully—all of these things are important for "public education." It means, in short, developing priorities that allow the public to perceive the benefits of privatization, and show it can be accomplished without great difficulty.

3. **Organize a training program and develop specialists in the technical dimensions of the issue.** To ensure that initial privatization ventures are perceived as successful both by the policy audiences and by the general public, it is crucial that, before one begins selecting targets, one develops a stable of well-trained specialists to manage the

technical side of the plan. This means having people well versed in all of the enormously varied techniques for doing privatization—from contracting out public services to divesting ownership in publicly owned companies, either by sale of sock or even (at one extreme) simply giving the company away.

4. Especially at the outset, pick targets for privatization that minimize difficulties and guarantee success. This task involves establishing priorities and is extremely important. Everything cannot be privatized at once, and trying to do so only means that nothing will be privatized. Instead, selected targets that can be privatized with relative ease must be identified. This is especially important in Third World countries and in countries that have little experience with privatization.

Focusing on success—especially on the need for *perceptions* of success—tends to lead in an interesting and counter-intuitive direction. Focusing on success means *avoiding*, especially at the outset, companies that are sustaining the largest losses—causing the largest drains on the public purse. While privatization of such companies would bring the greatest efficiency gains, bringing greatest benefit to the public treasury, one must avoid the temptation to focus too much on economics, while forgetting politics. Such companies are difficult to privatize precisely because their losses make them difficult to market. For this reason, it is best—again, especially at the outset—to concentrate on privatizing firms that do not suffer terrible financial difficulties, firms that can be prepared with relative ease for public sale.

The central point in this task is to focus on *perceptions*. It is not enough for the first privatization to be (actually) successful if it is perceived to fail. The perception is crucial because it will determine the public response. If is is perceived to be difficult, not to be successful, that will probably kill all interest in it—perhaps for as long as a generation, until another generation can be interested again.

5. Select techniques and strategies that will maximize the supporting political constituency. Once targets are selected, this task is crucial, and there the Thatcher government has set the standard. The key is finding a constituency that will support privatization, and neutralizing or co-opting special interests who might oppose it. As Lance Marston notes, this suggests than an important part of preparing for privatization involves making sure that a lot of people will benefit, and that a portion of the beneficiaries be potential opponents who have been won over, or to put it bluntly, *bought off*. It is just as important that the beneficiaries *know* it well ahead of time.

6. Prepare the company for privatization, if necessary by investing in it. As Madsen Pirie and Peter Young note, sometimes effort and even perhaps money must be invested to make companies attractive to the private market. It is important because many companies will not attract private investors at what the public perceives as a fair price without special investments being made to upgrade the enterprises.

This is perhaps *the* central element in successful privatization. Preparing for privatization involves a series of things, including public education, but especially things that improve the prospects for profitability of the company or entity being privatized. Establishing the prospect for profits is the critical step in making the entity marketable—attractive in a market.

Establishing marketability involves both political and economic costs. They include overcoming concentrated opposition from interest groups who either stand to lose from privatization or who simply feel *uncertain* about its outcome. There is an old saying that people tend to prefer a known evil to an unknown good. It is not necessary that someone will actually lose from privatization for him to oppose it; it is enough that he is *uncertain* about the outcome to ensure his opposition.

Typically, the target for privatization is a public company that has existed over a long period on public subsidies. If privatized, the assumption will be that it must survive without such subsidies. Pirie reports that in England many nationalized enterprises are undercapitalized and have an excessive work force. Preparing them for privatization will mean, therefore (among other things), making investment, paring back the workforce, and building up the capital stock so that the company is appealing to private investors.

7. Avoid the temptation to suspend the special privileges often found in a public enterprises. In publicly owned firms, like government bureaucracies, the employees—both the managers and workforce—often enjoy enormous and unusual privileges. Pirie and Young strongly advise that no matter how outrageous these privileges may seem, it is essential that in preparing for privatization that a commitment be made not to suspend these privileges. For if the threat of suspension is heard, the immediate result will be enormous, concentrated opposition and probably an end to any serious possibility of privatizing that particular firm.

In dealing with special privileges, the best approach may be to *buy them out* with a cash settlement—for instance, to buy out a pension plan—because in the long run a buy-out will be an efficient way of dealing with an important element of the transaction costs.

Some Cautions

As noted above, the worldwide interest in privatization is extraordinary. It is particularly so when one considers that privatization involves a monopoly (the government) voluntarily yielding control to private parties (those who end up controlling the privatized entity). However, the concentration of the private interest in this case is turning out to be stronger than the concentration of interests in governments themselves—hence this extraordinary transfer.

I have discussed a number of reasons for the new privatization enthusiasm. It may be easiest to summarize its *political* appeal by noting that privatization can be a genuine "people's capitalism," and the very notion of that communicates why it has generated the momentum it has.

Despite the economic, social, and political values associated with privatization, it is important to note some cautions. The need for caution is especially important because one moment's exaggerated enthusiasm is often the next moment's defeated expectation. This would be a great pity in the case of privatization, which can achieve important and constructive things in developed and developing countries alike.

The major caution is directed at the hope that privatization will automatically improve economic efficiency and cut costs. Where privatization de-monopolizes public function—when it sells a business in a competitive industry, for instance—the movement from public monopoly to private competition will certainly change the incentive structure, and efficiencies and savings should result. James Brooke cites a number of examples of this from Africa in the article mentioned earlier. But where privatization transfers a government monopoly to a private one—especially where privatization takes the form of contracting out public services to a sole-source private company—then it does not change those incentives. In such instances, rather than reducing costs, privatization may end up actually *increasing* costs (especially when one adds costs of surveillance and monitoring that would go with contracting out).

In sounding this caution, I should note that Madsen Pirie, who has had a great deal of practical experience with privatization in Great Britain, is more optimistic. He believes—strongly, in fact— that privatization will produce efficiencies even if a private monopoly takes control. Although he opposes monopolies of any kind, he thinks public monopolies tend to be worse than private ones.

To avoid possible problems associated with private monopolies— and even to avoid the burdens of continuing government surveillance one should strive to create a competitive environment for newly privatized firms or services in which to operate. Consumers could then police quality and price, obviating the need for government bureaucratic surveillance.

This is a policy issue, as all discussions to this point has been limited to policy. If one wanted to try to institutionalize the benefits of these policies into a country's legal structure, then one would write *constitutional* rules requiring governments to do these things. For example, constitutions could be designed to simply outlaw the public provision of goods and services. At the same time, constitutional rules could be designed to allow the polity to express whether the private provision of goods and services should be financed solely through private means, or whether under certain conditions public finance or a mix of private-public finance could be used to finance the constitutionally mandated private provision of goods and services.

In the end, however, it may be that these economic issues have limited importance next to the much broader social and political implications of privatization. Manuel Tanoira, for example, underscores the need for dramatic reform of the attitudes that sustain mercantilism. In many parts of the world, especially in developing countries, governments must focus on development of stable, democratic political institutions. After all, without a stable political environment, no economic objectives for privatization or anything else mean very much. And here, for reasons given above, privatization may plan an important role in helping developing countries build stable political and social institutions. It may do this by increased responsiveness to citizen desires—whether in the form of allowing people to own their own homes, or of expanding the range of citizen-consumer choices, or of general decentralized decision-making. These are the greatest contributions privatization may make to the search for progress in many parts of the world.

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