TAB H

5. "Policy Environments and Privatization" by Charles Taylor

Policy Environments and Privatization

by Charles Taylor

prepared for the

A.I.D. INTERNATIONAL CONFERENCE ON PRIVATIZATION

February 17 - 19, 1986

Introduction

1. The importance of privatisation has become more apparent in the last five years, because of fundamental economic changes in developing countries. The debt crisis has renewed interest in direct foreign investment; the fiscal crises in several developing countries have increased the appeal of divestiture; and the failure of state owned enterprises to provide an adequate quality of services and goods has led several national governments to reconsider their reliance on the state sector for economic development.

2. Privatisation, either in the narrow sense of the sale of government assets or in the broader sense of the opening up of state monopolies to private competition, depends significantly on the overall policy environment for its success or failure. Moreover, broad policy objectives, be they the objectives of the aid agencies or the local or national governments concerned, determine the specific objectives of privatisation.

3. My aim in this brief paper is to review the most important aspects of this relationship between privatisation and the policy environment. The paper is not especially analytical -- it does not apply any particular macro- or micro-economic framework to the discussion -- because at this stage in the debate it is arguably too restrictive to confine ourselves to any particular set of assumptions or view point.

Essential Elements in The Policy Environment

4. Before considering what privatisation might achieve, it is only reasonable to ask, what are the prerequisites of privatisation? Or, in the context of this discussion, what are the essential elements in the policy environment for privatisation to be feasible?

5. Consider first privatisation in the narrow sense of the sale, partial or complete, of a state owned enterprise. To proceed, two elements of policy must be in place.

6. First, the level of political commitment to privatisation must be high. Without firm commitment from the national leadership, there is a small chance of privatisation actually taking place in the face of the competing pressures of may different interest groups. Although it may be possible to win over labour, management, suppliers and bureaucrats to the idea of privatisation, this alone takes a great deal of concentrated, high level effort.

7. Second, it is essential that enterprises up for sale should have a positive net worth. This is not a point about the book value of assets but rather about the value of the future stream of net earnings. After making suitable allowances for risk, their net worth must be greater than the cost of the capital to be invested, or there will be no buyers.

8. This has direct implications for the policy environment. For example, in Togo the government recently handed over a moribund steel mill to an American investor who has agreed to operate the complex on a ten-year lease. Besides being allowed to export and import spares and materials duty free, he has received a government guarantee of a 40% tariff on imported steel products. In other words, the policy environment has been adjusted to protect his profitability and therefore to contribute toward a positive net worth for which it was worth paying.

9. In this instance, the price structure was distorted, to facilitate the privatisation: an assumption was made, implicitly or explicitly, that the benefits of this particular privatisation agreement exceeded the costs. Generally, this type of policy change, aimed at accommodating a privatisation, lowers the economic value of privatisation significantly.

10. Privatisation in the broader sense of opening state monopolies up to competition may be much easier to do. In Somalia, for example, the Agricultural Marketing Corporation has, I believe, been effectively privatised by allowing private entrepreneurs to enter the business of buying and distributing farm output. Within 3 years, AMC's share of the agricultural product distribution business has dropped from 100% to less than 5%.

11. The necessary political commitment is less using this route to improving market efficiency. However, considerable determination may well be needed - possibly more, in fact - to subsequently reduce employment in the newly competing state-owned enterprise.

12. For privatisation to "succeed" by having a positive impact on the economy in the longer run, it is necessary that the policy environment should support private enterprise "in the right way". As experience and the theory of the firm both tell us, it is for example insufficient to sell a natural monopoly to private investors to achieve economic efficiency; some form of price regulation is needed too. Precisely what is "the right way" depends on the objectives of privatisation.

Objectives

13. Privatisation appeals to different groups for different reasons. Aid agencies, national governments and their political leaders are likely to have somewhat different objectives in mind when they consider the potential benefits of privatisation.

14. Indeed, some national policies may not be served by privatisation. Employment creation, for example, becomes much more indirect. Obviously, the basic goal of creating jobs can be promoted by incentives of various types that will attract and stimulate private investors. But the subsidiary goal - of ensuring the government gets credit in the eyes of its supporters - is far harder to achieve.

15. Equally, regional development may be more easily administered by direct investment in state enterprises in backward regions than through creating an incentive environment which will attract private enterprises to those same regions. (Whether it is more effective is another matter altogether.) And in general, policies of patronage are more difficult to exercise through private enterprises than the public sector.

16. While the national government, and the aid community may both favour more widely distributed ownership of capital, several national governments would limit this good to the citizenry of the country. Although we should note that attitudes towards overseas investors are changing now, foreign investment which the aid agencies might well like to encourage, is still unwelcome in many developing countries.

17. However, other goals and objectives are likely to be shared. Both governments and donors are likely to include increased efficiency and equity and stimulus to economic growth among their aims for privatisation. Increased effectiveness of the enterprises concerned is another key objective: several state owned enterprises, as we noted at the outset, have been notoriously ineffective.

Other Key Policy Issues

18. What other elements of the policy environment are important? The answer is most of those elements needed to make the private sector as a whole function well.

19. For example, policies that encourage foreign investors to participate directly or to take portfolio positions in local enterprises can have an important positive impact on privatisation. Whether it is the sale of a state enterprise or the creation of new competition in a sector previously monopolised by the state, opening up the market to foreigners is likely to increase many times the number of potential investors and thereby contribute to market efficiency. (Obviously, it can also ameliorate a difficult balance of payments position.) For this reason, it is important that the foreign exchange regime should be fairly liberal. Capital outflows must be possible without significant impairment, to allow repatriation of profits, royalty fees and the like.

20. As in other areas of development, getting the prices right is a prerequisite for efficient privatisation. So, for instance, much less is achieved than could be by privatising the agricultural distribution system, if farm gate prices and market prices are still regulated. The benefits of privatisation are likely to accrue to the distributors and, to a lesser extent, the consumer, with no improvement in incentives to the farmer. Equally, if the "price" of credit is kept artificially low, the privatised sector is likely to react by choosing techniques of production or service that are too capital-intensive. Controls in rents, wages and in trade, where tariffs, quotas and other non-tariff barriers result in severe price distortions in many countries, all mitigate against the efficiency of the private sector, and hence of privatisation.

21. Government procurement policy is an area sometimes overlooked in this debate. Some governments have been notoriously bad at paying their bills. If these become receivables for a state enterprise, addressing the problem can (although should not) be delayed since there is no threat of bankruptcy involved: not so, if a private firm is supplying the goods or services.

22. Assuming the government is paying its bills, however, another issue arises. Procurement contracts are likely to be in demand. In these circumstances, procurement policies should generally be non-discriminatory so that state enterprise or newly privatised concerns have to compete on an equal footing for government business. It has been argued that it may be necessary to guarantee a procurement arrangement with a newly privatised enterprise, to underwrite its income and thereby its net worth. However, if its net worth is that uncertain, it may be better to think in terms of liquidating the state enterprise rather than privatising it.

23. Perhaps the most supportive policy aspect for privatisation to succeed is a favourable policy orientation. Although policy may not be totally stable, private investors should be secure. They must feel policy changes will either be neutral or positive in their impact on private capital. To be credible in this respect is one of the most difficult aspects of policy reform for a developing country government changing from state socialism or state oriented development strategy to a more private sector oriented strategy. Investors, both domestic and foreign, will not forget any historical antipathy towards capitalism all that quickly.

The Importance of Law

24. Markets work well where contracts are observed, property rights are enforced, and there is freedom to determine where one works and for whom, and with whom one trades. In other words, to achieve the full potential of the private sector, and therefore, privatisation, it is important that the law should be respected by the great majority of people and institutions - including government in the country in question - and that the law should be impartial.

25. By contrast, in many developing countries, sources of authority more powerful than the law are kinship and fealty relationships.

26. It is difficult to see much advantage in privatising an organisation if its public accountability is not increased. If effective control is retained in the hands of someone closely associated through kinship to the government leadership, then privatisation may become a sham.

27. The social changes which can move a country form accepting kinship authority to the impersonal authority of the law, are many and complex. The process of privatisation, itself, can positively contribute to this change in a society. It should be coupled with the development of individual rights in impartially adjudicated property and contract law. Such institutional development can support the development of a middle class as well as entrepreneurial attitudes.

The Opportunity for the Aid Agencies

28. What can the aid agencies and external governments do to influence the policy environment in a way conducive to successful privatisation? Several possibilities arise. First is support for a strategy of experimentation. It is important that the developing countries concerned should be encouraged by the aid agencies to undertake privatisations to see how they work in local conditions. Some countries have begun programmes of privatisation already. Others are thinking of it. More privatisations are needed so that we can build from our very limited experience on how these can be made to work best in the medium term for economic development.

29. Second is the role of disseminating experience systematically, so one country may learn from the experience of others regarding the critical policies for privatisation.

30. Third, specialised agencies like the International Finance Corporation, the MIGA and OPIC can seek to develop new ways of encouraging foreign investment in developing countries. The frequent lack of credibility of local government policy may be offset to some degree if there are involvement and/or guarantees from an outside multilateral source in support of investment from abroad.