CEPAL

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Notes and explanation of symbols

The following symbols are used in tables in the *Review:*
Three dots (...) indicate that data are not available or are not separately reported.
A dash (—) indicates that the amount is nil or negligible.
A blank space in a table means that the item in question is not applicable.
A minus sign (-) indicates a deficit or decrease, unless otherwise specified.
A point (.) is used to indicate decimals.
A slash (/) indicates a crop year or fiscal year, e.g., 1970/1971.
Use of a hyphen (-) between years, e.g., 1971-1973, indicates reference to the complete number of calendar years involved, including the beginning and end years.
Reference to "tons" mean metric tons, and to "dollars", United States dollars, unless otherwise stated.
Unless otherwise stated, references to annual rates of growth or variation signify compound annual rates.
Individual figures and percentages in tables do not necessarily add up to corresponding totals, because of rounding.

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Conceptual aspects of privatization

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The process of privatization has an impact on various macroeconomic variables. This article presents an analytical framework for studying that impact: it is a conceptual study which can be applied to different actual situations.

Among the possible effects of a privatization process, the first to be analysed are those concerning the national product, a distinction being drawn between the effect on transfers of funds and the static and dynamic effects on efficiency. The impact of privatization on income distribution is then considered. Finally, an analysis is made of the question of the proper price of the goods to be privatized, the issue of whether the leading agent should be public or private, national or foreign, and the problem of the operations of monopolic or monopsonic enterprises.

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This memo explores a series of concepts that, in the author's opinion, are likely to be central in any appraisal of a proposed programme of privatization. The principal issues, as we shall see, sometimes involve questions of theory; but more often they are empirical in nature, turning on questions of fact and forecast.

I

Possible effects of privatization

1. *Output effects*

Perhaps the most comprehensive question that can be asked with respect to a proposed programme of privatization is its likely effect on national output.[1]

Privatization can be thought of as having two principal consequences that directly affect national output:

a) It transfers financial assets from the private sector to the public sector;

b) It transfers the ownership (and presumably control) of enterprises from the public sector to the private sector.

Factor a): the transfer-of-funds effect. What has driven most governments to consider programmes of privatization has been the hoped-for transfer of funds from the private sector to the public sector. The fact that so many governments have responded urgently to that stimulus, however, tells us very little about the consequences of the shift upon output. It we attempt to estimate the output effects of factor a), the transfer-of-funds effect, it becomes evident that effects upon output depend on a number of critical assumptions about the *size*, the *origins*, and the *disposition* of the transferred funds.

[1] L.P. Jones, Pankaj Tanden and Ingo Vogelsang, *The Economics of Divestiture*, published in 1988, presents an approach to that question. The approach is deeply flawed in some critical respects, partly because it cannot be implemented in practical terms. But it is useful in exposing and articulating some of the underlying judgements that are implicit in privatization exercises.

The *size* of the shift in funds is determined, of course, by the amounts paid by the private sector for the equity it receives. Economists have sometimes argued that if the private sector is charged appropriately for the equity it receives, the shift of funds to the government should be no more than the government could acquire in an efficient market through government borrowing. That position begs some questions, such as whether an efficient market exists, capable of fixing an appropriate price for the government's assets. And it bypasses others, such as whether the firms' assets in private hands would subsequently be more profitable than if they had remained in the government's hands. As we shall presently see, these are not trivial questions. In any event, we shall be returning to the question of the size of the payments by the private sector in a number of different contexts below.

The *origin* of the transferred funds also determines their output effects. If the funds paid to the government are diverted from domestic private capital investment or from domestic private consumption, the depressing effects on private output associated with the transfer of the funds needs to be taken into account. On the other hand, if the funds are brought in from abroad or if they are diverted from capital flight that might otherwise occur, their effects could be expansionary in the short run through an increase in the supply of money and a decline in interest rates. (Secondary effects are more complex, because the tendency of such funds to stiffen the exchange rate would have to be taken into account.) This element of the analysis, therefore, depends critically on questions of fact which are difficult to ascertain.

As to the *disposition* of the funds received by the government, the output effects would be very different if the funds were used, say, for the reduction of government debt than if used for the improvement of roads and very different again if used to expand the consumption of the poor. A reduction in debt could offset the deflationary impact induced by "crowding out" private investment, while investment in roads could conceivably break bottlenecks that had previously reduced output. Once again, questions of fact dominate the analyses.

Factor b): the efficiency effect. Turning to factor b), the problem is to estimate the static and dynamic effects on efficiency of a transfer from public to private ownership.

It is common practice in developing countries to ask a rather different question regarding State-owned enterprises, almost as if it were a surrogate for the efficiency factor: namely, the question of the size of the cash drain on the public sector generated by such enterprises. It may seem unnecessary to point out that in the circumstances of developing countries, the two questions are imperfectly related. Efficiency is measured not only in money terms but in "real" terms —the "real" output achieved by given "real" inputs, with the inputs being combined at their "real" opportunity costs. Moreover, efficiency is a concept that is independent of the identity of the party receiving its benefits: an increase in efficiency depends on aggregate output, whether in the end that output benefits government, labour, rentiers, consumers, or thieves. The cash drain, on the other hand, depends on the prices paid to capital, labour, and material inputs and the prices charged for final output, all of which are highly manipulated figures in the circumstances of most developing countries. Labour income in State-owned monopoly enterprises, for instance, commonly captures some of the rent generated by the monopolies, not only through high wages but also through a swollen labour force. And consumers are commonly subsidized through price structure that are not expected to recover the real costs.

The problem of measuring the efficiency effects associated with a transfer of ownership is complicated by the fact that such a transfer could have dynamic consequences not readily captured in data on current outputs. The shift from public to private ownership is presumably a long-term decision, affecting the firm for the rest of its existence. That shift could affect all relevant parties in ways that could have a considerable long-term impact on efficiency. Managerial decisions could change with respect to choices of process and product, rates of reinvestment, and physical conditions in the work place. Labour could be affected through changes in the work ethic or in contractual relations to management.

The government itself could be affected in terms of its preferred forms of regulation and supervision. Indeed, political arguments in favour of privatization commonly rest on the assumption —untested as a rule, and difficult to test in any case— that the dynamic efficiency effects will be positive and substantial, offsetting any short-run adverse effects. In so far as any single issue dominates the decision whether to privatize, this issue is probably it.

The argument for privatization, however, is not always based on such sweeping generalizations. In some cases, the expectation of an efficiency increase is based on assumptions that privatization will overcome the adverse effects of some specific inefficiencies in factor markets. In some developing countries, for instance, it is believed that there is managerial and technical talent in the private sector that cannot easily be recruited for State-owned enterprises. The barrier to such recruitment may be based on regulation, such as the level of salaries available in the public sector; it may be racial, as in the case of many African countries that refuse to hire expatriate labour for State-owned enterprises; or it may even be cultural, as in the case of some Latin American countries, where managers in some classes of society are reluctant to work for the State. Distortions in the wage levels and in the costs of capital are also thought to hamper efficiency. Managers of State-owned enterprises, for instance, usually find capital relatively cheap (or even costless) and labour relatively dear, pushing them toward technologies that are less efficient than those the private sector would select.

However, to make any serious exploration of the efficiency effects, static or dynamic, it will be necessary to draw careful distinctions between various kinds of industry. At a minimum, it will be necessary to distinguish between industries with different types of market structure: natural monopolies; oligopolies; and competitive structures.

In the case of *natural monopolies*, if a shift to private ownership takes place, some form of public regulation will presumably be maintained. Estimates of the efficiency effects must therefore make assumptions as to the character of that regulation. If a pattern of regulation existed prior to the ownership, it conceivably might remain unchanged. Nevertheless, even if no change occurs, the managers of the monopoly might respond differently, reflecting the interests of their new owners. They might push more assiduously for rate increases, bargain harder with labour, or resist more energetically proposals for cross-subsidization. If any of these changed managerial responses do occur, what will be their implications for efficiency?

The possibility that patterns of regulation might be altered with a shift to private ownership would also need exploring. In what respects will such patterns change, and with what implications for efficiency?

The *oligopoly* case, common in developing countries, is even more complex than that of the natural monopoly. One possibility, already encountered in some privatization projects, is that the proposed buyers of the State-owned enterprise are private-sector competitors eager to reduce the competition in national markets. In an industry whose firms could reduce their unit costs through higher volumes, a merger could increase the industry's efficiency in the short run by allowing for the greater exploitation of scale economies, while at the same time reducing efficiency in the long term through a loss of positive dynamic effects. Another case, also drawn from actual experience in developing countries, is one in which the private-sector oligopolist tries to capture an upstream facility hitherto in State hands, in order to acquire a competitive advantage over private competitors downstream who have been drawing their supplies from the upstream facility. In such cases, tracing the efficiency effects can prove extraordinarily complex; while the new vertical links can improve the efficiency of the dominant enterprise, the increased capacity of that enterprise for controlling its competitors could have the opposite effect. Once again, the critical questions are empirical.

In most developing countries, oligopolistically structured industries are the object of some regulation by governments, often through price and wage controls. Estimates of dynamic efficiency effects, therefore, often require some guesses about the future shape of government regulation, similar in character to the questions asked with regard to the regulation of natural monopolies. It is commonly assumed that government regulation would be less pervasive

in those industries if private ownership were more dominant; but that is only a guess. It is also often assumed that oligopolies unhampered by government regulation would be more efficient in both the static and dynamic dimensions than those exposed to such regulation. All such issues deserve much closer analysis, applying measures of efficiency that are technically defensible.

The *prima facie* case for expecting an increase in efficiency as a result of privatization is strongest where *workable competition* exists in a market and is likely to continue to exist after the sale of the State-owned enterprise. In such circumstances, it is a reasonable starting assumption that the private firms in the market are under stronger compulsions for efficient operation than the State-owned enterprises. Indeed, there is already some empirical support for that conclusion.[2] But even this category of cases has not been adequately explored and would require much more investigation before one could be reasonably sure that the *prima facie* assumption was well supported by the evidence.

2. *Effects on income distribution*

As usual, there is a conflict between questions of economic growth and issues of income distribution in any effort to define optimal policy; this is as true of privatization policy as of any other issue relating to economic development. Whether it is possible or desirable to combine both sets of considerations in a single social criterion poses some interesting theoretical problems. But they are not problems unique to the issue of privatization.

In any event, any substantial programme of privatization is likely to have significant effects on income distribution. In such cases, various price changes can be expected, usually reflecting a shrinkage in subsidies on some staple consumer items, including transportation, power and foodstuffs. Payrolls are likely to be pared and wages held down. For reasons we shall presently develop, private buyers of the enterprises can be expected to acquire their new investments at windfall prices. At the same time, however, funds will be transferred to the government with unspecified effects on government spending patterns, possibly including effects on the volume of health services, education, and housing delivered to the public.

Generalizing about the income distribution effects of privatization programmes is rendered particularly difficult by the fact that a considerable portion of the subsidies in developing countries is said to go to an urban middle-income group rather than to the poor, and that the labour force of the affected State-owned enterprises is also said to fall primarily in the middle-income group. One cannot assume, therefore, that the changes in subsidies and in payrolls that are expected to accompany privatization primarily affect the income of poor. More empirical work is needed before defensible generalizations can be made. Such generalizations are rendered even more difficult if one tries to go beyond the immediate impact of privatization and tries to trace out long-term distributional effects. Yet such considerations are always implicit or explicit in the decisions of developing countries to support privatization programmes.

II

The right price for privatized property

There is one issue, however, to which governments have given far more attention than it may deserve. This is the question of determining the "right price" for specific offerings.

In the most research on the price issue, the "right price" has usually been implicitly defined as the lowest possible price that the government could charge without exposing itself to the accusation of giving away public assets. Behind that implicit definition lies an ineluctable fact. Whatever the initial motivations of governments may be in launching a privatization programme, once a specific sale is announced the overwhelming

[2] Gabriel Roth, *The Private Provision of Public Services in Developing Countries* (New York: Oxford University Press, 1987); George Yarrow, "Privatization in Theory and Practice", *Economic Policy*, No. 2, April 1986, pp. 323-378.

objective of the government is to ensure that the sale is "successfully" completed. At that late stage, governments are invariably prepared to give up some income from the sale in order to reduce the risk of a "failure" of the offering.

If the objective of governments in privatization projects were simply to maximize social output, they might well be justified in giving away many State-owned enterprises and even subsidizing their transfer. Indeed, if that objective alone were the controlling factor and if one assumed that the efficiency of enterprises usually increased as a result of transfer to the private sector, only one reason would exist for not giving the enterprise away, namely, the possibility that funds shifted from the private to the public sector would add even more to social output. But as we saw earlier, that is no more than a possibility, dependant for its realization on various surrounding conditions. Indeed, one cannot exclude the possibility that the transfer of funds to the public sector would actually reduce social output rather than increase it.

But the objective function of governments includes more than a simple desire to increase output. Governments characteristically place some value on avoiding the appearance of blatant discrimination and on protecting themselves from charges of giving away the national patrimony. With those objectives in mind, governments almost universally reject such possibilities as giving the assets away, or distributing them by lottery, or even selling them to the highest bidder. Instead, they call on advisors to determine a "right price", based upon criteria that will be acceptable to the public, to be used as a basis for sale to the private sector.

In such offerings, one obvious criterion is the value of the State-owned assets to the prospective private buyer. Unless the assets for the sale are priced at levels that are attractive when compared with alternative opportunities, prospective buyers presumably will not buy, but on the other hand, selling far below the prospective buyer's value will open the government to charges of giving away the national patrimony.

Yet, developing criteria for determining the private value of any State-owned enterprise is not easy, for reasons already adumbrated. An enterprise will have different values to different buyers depending on the other interests of the buyer in the national economy. A buyer who hopes to gain control of a competitor through the purchase, for instance, will probably pay more than a buyer who is making a portfolio investment. And when the desired estimates of value are calculated on the basis of different assumptions about the future policies of government, the estimates can also vary enormously, especially in the conditions typically encountered in developing countries. Yet the compelling need to determine a defensible sale price suggests that governments will devote considerable analytical effort to this issue.

III

Old problems in new settings

The principal-agent issue. If there is any issue associated with privatization that invites some hard abstract thinking, it is the question of the relationship of the State-owned enterprise to the government, and particularly whether the State-owned enterprise can fruitfully be thought of as an agent of the State in a sense that distinguishes it from private enterprises.

There are two distinctly different facets of this question.

One of these facets, transcending the privatization issue in importance, is whether it is useful to think of the State as having the attributes of a unitary rational actor, including a definable objective function, or whether instead the State must be thought of as a coalition of interests, each with a distinctly different objective function that cannot be aggregated with the others, so that the idea of maximizing welfare on a national level is meaningless. Economists and

political scientists have occasionally made passes at this difficult issue.[3] But so far, despite its central importance to the State-owned enterprises issue, it remains largely unexplored.

If it is not useful to think of the State as a unitary rational actor, then to what values are State-owned enterprises in theory expected to respond, and how do these differ from the values to which private enterprises are expected to respond?

The issue takes on even greater complexity in the privatization context because so many privatization exercises lead to partial divestiture, producing joint ventures between the public and the private sector. Trying to define the objective function of the principals to which managers should respond in such cases is an overwhelming challenge. Yet it is a challenge that is not easily avoided if one is trying to appraise the consequences of partial privatization.

The same set of issues can also be approached empirically: In what respects do managers of State-owned enterprises actually differ from those of private enterprises in their responses? The question is implicit, of course, in some of the issues already raised in this article including the effects of privatization on efficiency and on income distribution. But raised in this way, the question is likely to lead to a different type of research, much more micro in focus, aimed at generalizing from what will probably in the end be fairly small samples.

One reason why the issue is important is that research on this topic to date suggests the existence of some considerable variations from one national culture to another. In Israel and Italy, for instance, managers of State-owned enterprises appear to respond quite differently from managers in the private sector of their respective economies, yet at the same time, State-owned enterprise managers in those two countries do not appear to have much in common with managers of State-owned enterprises in, say, India or Nigeria.[4] (Indeed, the research so far suggests that the simple dichotomy between managers of State-owned enterprises and managers of private enterprises may prove inadequate for serious research and that breakdowns may be required along various other dimensions, including type of industry and type of manager.)

The foreign investor issue. The process of privatization makes germane once more the question of the effects of foreign investment on developing countries. The issue arises in a number of different variants: in the context of debt-equity swaps; in the context of proposals for joint ventures between State-owned enterprises and foreign enterprises; and in the context of proposals for portfolio investment by foreigners.

There is no lack of literature on the economic and political implications of the consequences of foreign direct and indirect investment in developing countries. Much of the literature on the economic consequences is technically flawed, being more in the nature of polemic than of scholarly research, but in the main, the principal causal chains to be considered in an economic evaluation are reasonably well understood.

The economic advantages of accepting foreign direct or indirect investment are too obvious to require comment. The economic drawbacks that are associated with foreign direct investment in developing countries usually turn around some familiar problems. One of these problems, especially applicable to import-substituting industries, is the fact that domestic markets are often so highly protected as to offer the foreigner the opportunity for monopoly profits. Another is that profits may be siphoned off through transfer prices. And a third is that when profits are repatriated, they may constitute a drain on the economy that exceeds the value of the technology and capital provided by the foreigner. The transfer pricing problems is also applicable to export industries; inputs to the subsidiary and exports by the subsidiary may be priced at levels that generate a net drain on the economy. Apart from these two specific ques-

[3] See for instance Howard Raiffa, "Decision-Making in the State-Owned Enterprise", in Raymond Vernon and Yair Aharoni, (eds.), *State-Owned Enterprise in the Western Economies* (London: Croom-Helm, 1983, pp. 54-62).

[4] The most systematic study of this issue of which I am aware appears in Yair Aharoni, *Managers in the State, Histadrut and Private Sectors in Israel: A Comparative Study*, Research report 53/84 (Tel Aviv: Israel Institute of Business Research, September 1984).

tions, larger researchable issues may be raised, such as the effects of foreign direct investment on choices of product and process, on investment in human resources, and on the propensity to innovate, but the answers are usually inconclusive. Developing countries may be expected to raise these questions in the future, as they have in the past, and despite the voluminousness of past studies on these issues, research that helps to redefine the concepts and methodology by which the required judgements could be made would be well worth undertaking.

Some issues relating to foreign direct investment in the privatization context, however, are quite novel. One of these arises from the fact that some foreign investment is generated through debt-equity swaps. In effect, the government is paid for its equity interest in a State-owned company through the buyer's surrender of some of the external debt of the country in question, such debt being converted at a concessionary rate for the buyer. Organizing the elements in the swap so as to facilitate the government's rational consideration of any proposed deal would be a challenging task well worth addressing.

Another novel issue associated with foreign direct investment in the privatization context arises from the propensity of some State-owned exporters of raw materials to integrate downstream into their principal foreign markets, setting up such downstream facilities in joint ventures with foreigners CODELCO, PDVSA and CVRD are among the growing number of State-owned enterprises that have taken such steps.

The economic consequences of such investments are not simple. The State exporter typically makes a financial investment in the foreign market, entailing some opportunity cost to the government. With that investment, the exporter typically reduces the risk of variability in the foreign demand for its raw material, while reducing at the same time its freedom to charge foreigners what the traffic will bear for that material. Once again, what is needed is a careful mapping of the economic terrain which might serve to guide State-owned enterprises in the making of such investments.

Exploiting monopoly and monopsony. Most privatization programmes in developing countries include proposals to liquidate some State-owned enterprises that were created in the first instance as monopolists in selling or monopsonists in buying some specified commodity for the national economy. The ostensible original reasons for such régimes are of various types. Sometimes their purpose has been to capture some scale economy in export or import, as in transportation of financing; sometimes, to exercise added market power in negotiations with foreigners; and sometimes to perform an excise function, such as collecting an export tax or levying an excise tax on imported sumptuaries such as liquor and tobacco.

The reasons for reconsidering such monopolies are as varied as the reasons for creating them in the first instance. In some cases, governments may have discovered that their original hopes were not realized and that the results being achieved appeared no better than those likely to be achieved without the monopoly. In other cases, the circumstances that originally justified the creation of the monopoly may have changed: increases in volumes of trade may have reduced the need to maintain a monopoly in order to achieve economies of scale; changes in the international market structure (as in the case of oil and copper) may have reduced the gains to be made from exercising monopoly or monopsony power; and improvements in the administrative capabilities of the government may have created alternatives to the monopoly enterprise as a way of levying export or excise taxes. Accordingly, the merits of continuing the monopolies could well have changed.

On the other hand, there is not much indication that governments are rationally attempting to weigh the pros and cons of continuing or terminating their existing monopolies. Systematic explorations of some of these cases could therefore prove useful in guiding government policies.