

Surrey Energy Economics Centre

PRIVATIZATION IN THE MIDDLE EAST

by

Paul Stevens

SEEDS 45

MAY 1989

Discussion Paper Series

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ISBN 1852370440

PREFACE

At first sight, the inclusion of this paper in a series on energy economics may seem unusual. However, there are at least two ways in which the topic is of direct relevance to energy. First, because energy and energy related activities dominate many of the economies to be discussed, it will be these industries which may well become targets for privatization. Equally, for strategic reasons they may be excluded. Either way the link exists. Second, the process of privatization (for reasons to be discussed) could be of crucial importance in shaping the region's economies in the 1990s. Such developments will influence in a variety of ways the revenue needs of the oil producing countries. This in turn will clearly influence the ability of those producers who are members of OPEC to hold to quota agreements, their need to develop (or not) further export capacity etc. Inevitably, anything which effects the Middle East eventually impinges on energy.

PRIVATIZATION IN THE MIDDLE EAST ¹

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Introduction²

The paper³ seeks to do three things. First it tries to define what privatization might mean in the region. Second, it attempts to explain why privatization is becoming a very important issue in the region. Finally, it seeks to debate whether privatization in the region is either desirable or feasible. The paper is therefore a framework approach which seeks to draw on examples from the region.⁴

Defining Privatization

The word privatization is a relative newcomer to the English language. To my knowledge it first appeared in a dictionary in 1983.⁵ It means many things to many

¹I have been somewhat cavalier with my regional definitions since the 'region' to be considered is the Arab World (Middle East and North Africa) plus Turkey and Iran.

²There are two limitations on the coverage of this paper. First, I wish to look at the issues through the eyes of an economist. Subsequent papers I hope will consider various aspects of the subject in a very technical way. This initial version is aimed at a multi-disciplined audience and therefore I have tried to avoid the use of technical jargon. Where this was not possible, I have digressed to explain as simply as possible the nature of the economic concepts. This approach therefore requires a certain forbearance from professional economists. The second limitation on coverage concerns the political implications of privatization. In reality these are probably the most important implications. They imply far reaching consequences and explain why, in my opinion, the issue of privatization will be of central importance in the region in the 1990s. However, as an economist, apart from the occasional sally, I shall steer clear of considering directly the political implications.

³An earlier version of this paper was presented as a seminar to the Centre for Middle Eastern and Islamic Studies, University of Durham and the Centre of Near and Middle Eastern Studies, School of Oriental and African Studies. I would like to thank both audiences for comments and suggestions.

⁴This gives the author an immediate methodological problem. The three countries which have explicitly said and done the most about privatization in the region are Morocco, Tunisia and Turkey. These are the three countries in the region about which this author knows the least. Therefore the factual descriptions relevant to privatization are dependent (at this stage of the research) on secondary sources. This is unsatisfactory since I lack the knowledge to corroborate such sources. Hopefully, as the research continues, I will be able to make increasing use of more reliable primary sources.

⁵Webster's Ninth New Collegiate Dictionary, 1983. I prefer the American spelling with a 'z' but where the English spelling with an 's' has been used in titles or quotations I have retained this.

people.⁶ Where it has been mentioned in the literature on the Middle East, it is usually linked to the notion of reduced state involvement in the economy in general⁷ and reduced levels of subsidies in particular.⁸ In the growing economic literature on the subject⁹, it is generally taken to encompass three aspects. These are the deregulation of statutory monopolies to allow competition, the contracting out of services and finally the sale of publicly owned assets. At this stage of the research and in this paper I want to concentrate on the latter aspect. This is because it is the aspect which has attracted most attention outside of the specialist literature and because, to anticipate some of my conclusions, it is the aspect which may do most damage in the region.

The Relevance of Privatization in the Region

There are three reasons why privatization is of growing importance in the region. First, there is lots to privatize. Second, there is lots of pressure to privatize. Finally, there is lots of discussion about privatization and some action. Consider each in turn.

⁶One source - M. Pirie, Dismantling the State: The Theory and Practice of Privatization. National Center for Policy Analysis, Dallas, 1985.- identifies more than 20 methods of privatization.

⁷For example see M. Cooper, Egyptian State Capitalism in Crisis: Economic Policies and Political Interests. In T. Asad and R. Owen (Eds.), Sociology of "Developing Societies" The Middle East. Macmillan, London, 1983.

⁸For example see M. Chatelus, Policies for Development: Attitudes Toward Industry and Services. In H. Beblawi and G. Luciani (Eds.), The Rentier State. Croom Helm, London, 1987.

⁹P. Cook & C. Kirkpatrick, Privatisation in Less Developed Countries. Wheatsheaf, Brighton, 1988; S.H.Hanke, Prospects for Privatization. Academy of Political Science, Washington, 1987; C. Johnson, Privatization and Ownership. Pinter, London, 1988; J.A.Kay & D.J. Thompson, Privatization: A Policy in Search of a Rationale. Economic Journal 96: p.18-32. 1986; D. Swann, The Retreat of the State. Harvester-Wheatsheaf, New York, 1988; J.Vickers & G. Yarrow, Privatization -An Economic Analysis. MIT Press, Cambridge Mass., 1988.

Lots to privatize

The statement that there is a lot to privatize is clearly a loaded argument. It assumes that there exists some correct, accepted norm for the level of state involvement in an economy. No such norm exists, nor could it. However, that said, the region is characterized by very heavy state involvement in the economy relative to much of the rest of the Third World. For example, in 1983, a World Bank Study¹⁰ listed for 24 developing countries the percentage involvement of state owned enterprises in manufacturing. In the list of 24 countries four -Egypt, Syria, Tunisia and Turkey- were in the region. The top two on the list were Rumania and Hungary with figures in excess of 90 percent. Given the ideological imperative, this is not surprising. The next three in the list were Egypt (65 percent), Tunisia (60 percent) and Syria (58 percent). Turkey was 10th with 30 percent. Many other examples could be cited to provide support for the assertion of a high level of state involvement which arose for a variety of historical reasons associated with oil, ideology and habit¹¹

In general, it is reasonable to assume that state involvement in the region's economies is large relative to many other Third World countries. The significance of this for privatization is expressed by the IMF¹² as follows

'The economic case for privatization is made by reference to public ownership that is more extensive than can be justified in terms of the appropriate role of public enterprises in mixed economies'.

The statement of course begs the interesting question as to what constitutes an appropriate role. The source of the quote (ie. the IMF) makes it an important guideline in the privatization debate for reasons which will become apparent below.

Pressures to Privatize

The pressure in the region for privatization stems from both external and internal sources. The external pressure comes from two sources. The first is the various

¹⁰Cited in World Bank, World Development Report 1983. Oxford University Press, Oxford, 1983. Figure 5.5.

¹¹For example see Beblawi and Luciani, op.cit..

¹²R. Hemming and A.M. Mansoor, Privatization and Public Enterprise. Occasional Paper 56. International Monetary Fund. Washington, D.C., January 1988. Page 3.

governmental aid agencies led with almost missionary-like fervour by USAID.¹³ The second source of pressure comes from the World Bank and the IMF. Pressure from these sources is of crucial importance since both institutions have the power to make their views effectively felt with debtor nations. Rescheduling of debt requires acceptance of the medicine. Between 1980-84 some 67 countries were involved in 94 adjustment programmes 'negotiated' by the IMF. In 23 of the countries, the programme involved the selling of public assets to the private sector¹⁴. Currently, the region's debt situation is very ominous. A large number of IMF 'negotiations' are likely to occupy the next few years in addition to those already underway. In 1986, based on World Bank data¹⁵, the weighted average debt service ratio¹⁶ on exports was 19.7 percent for the upper middle income Idcs, 20.8 percent for the middle income Idcs and 24.1 percent for the lower middle income Idcs. In the region, Egypt has been having horrendous problems negotiating with the IMF. Yet Egypt's debt ratio is only close to the average at 21.3 percent. The same debt tables¹⁷ give data on 9 other countries in the region (excluding Iraq with its huge debt). Of these, only two are below average (Syria at 15.6 and Oman at 11.3). The remainder were above average of which four -the Yemens, Algeria and Morocco were above 40 percent. Clearly there will be significant pressure for rescheduling and the conditionality requirements which will go with that. As this article is being written Jordan is in the process of commencing such a 'negotiation'.

Internal pressures for privatization are from two sources. The first concerns the fiscal situation. Almost without exception the countries face fiscal deficits of varying sizes¹⁸.

¹³For example in a paper (The Promise of Privatization) to a conference on privatization (Proceedings are the book by Hanke, op.cit), P. McPherson, a senior USAID official in the first 15 lines talks of 'ideas...changing the world' and the conference as a 'dramatic celebration of change ... sweeping ... the developing world'. The article continues in similar enthusiastic vein.

¹⁴Fiscal Affairs Department, Fund-Supported Programs, Fiscal Policy and Income Distribution. Occasional Paper 46. international Monetary Fund, Washington D.C., 1986. Table 3.

¹⁵World Bank, World Development Report 1988. Oxford University Press, Oxford, 1988. Statistical Appendix, table 19.

¹⁶This is defined as the debt service as a percentage of exports of goods and services.

¹⁷Ibid.

¹⁸Even Kuwait, based upon the official figures which exclude significant parts of income from overseas assets, has shown deficits.

This occurred largely because of the collapse in oil prices which had both direct and indirect effects on the revenue side of the budget both in the oil exporting and non-oil exporting countries in the region. As a result, the perception has developed that a privatization programme may go some way to removing the problems. The reality of this will be considered later.

The second source of internal pressure to privatize concerns what might loosely be called ideology with respect to the role of the state. As previously explained, one explanation of the increasing role of the state in Third World economies generally in the 1960s and 1970s came from the predilections of economic advisors, both indigenous and foreign. Their ideas were developed in an era when planning and notions of the 'big push' dominated. In the 1980s the pendulum has swung. The emphasis is much more on issues such as government failure and the power of the market. In such an ideological environment, the predilection of advisors is to roll back the power of the state. Privatization is seen by some as the tool to achieve that objective. This view could also gain some support from elements in the current theological debate about what an Islamic economic system should look like.

Discussion and Action on Privatization

The final reason why privatization is an issue concern what is already going on.¹⁹

Egypt - There is stated commitment to increase private sector involvement in the economy. So far only the Egyptian Hotel Corporation has been privatized by a management buy-out.

Iraq - The programme began in 1985 when 42 entities with a turnover of \$394 million were sold followed in 1987 by a further 47 companies. All agricultural output has been privatized. Currently on offer are 51 percent of shares in the Baghdad Sheraton. 50 million shares of 1 ID (\$3) are to be sold. Also to be sold-off are a carpet factory and three tile factories. The programme has been linked to extensive deregulation of prices and removal of subsidies. This has made the programme extremely unpopular although

¹⁹The following is drawn from a wide variety of sources, mainly trade press such as Middle East Economic Survey and the Economist Intelligence Unit's Quarterly Economic Reports.

in January 1989 the Minister of Information announced that the programme would continue.

Iran - Various statements have emerged that as yet unspecified enterprises will be returned to the private sector under the auspices of the Financial Organisation for the Expansion of Proprietorship of Productive Units. To date most share offers have been to employees.

Jordan - five targets have been identified as candidates for sale the largest being Royal Jordanian Airlines (valued at \$500 million).

Libya - The General People's Congress has announced that it will distribute loss making farming projects to private owners, transfer some medium sized industrial concerns to the private sector and re-open privately owned maintenance workshops. In addition it was announced that the Arab Banking Corporation, Bahrain's largest offshore banking unit jointly owned by Libya, Kuwait and Abu Dhabi would secure the unpaid-up part of its capital \$250 million from the private sector.

Morocco - The Moroccan programme was launched in April 1985. Subsequently there has been much talk but little action. In July 1985 the Casablanca bus service was privatized with licenses being granted to five operators. Since then three sugar refineries and some long distance bus routes have been privatized. It was also announced that 250,000 ha (about 3 percent of cultivable land) expropriated from foreigners in 1973 was to be returned to the private sector. In January 1988 further legislation was put before the Chamber of Representatives to enable further privatization based upon advice from Lavalin International (Canada). There has however been considerable amount of contracting out of services by local authorities as part of efforts to decentralize. This was to move the central government deficit into the regions. However, the IMF is clearly pleased with Morocco (witness in August 1988 a stand-by arrangement for \$287 million).

Saudi Arabia - Shares in some existing public enterprises notably SABIC have already been offered successfully to the public. The recently announced objectives of the next Five Year Plan (to begin in 1990) have explicitly stated privatization as an objective. The restructuring of the oil sector has been designed specifically with the objective of privatizing Petromin's holding companies.

Syria - A number of targets for privatization have been cited ranging from the Damascus bus service to a tomato paste plant to the government pension fund.

Tunisia -The programme was launched in August 1987 as part of an IMF agreed structural adjustment programme. Of the 400 state owned enterprises, 30 in textiles, tourism, building materials and trade have been targeted. To date only two textile companies have had some of their shares sold to the public (Sitex and Somotex) while 25 percent of another textile company Siter has been sold to the World Bank's International Financial Corporation.

Turkey -The 1980s saw significant liberalization of Turkey's 40 odd state owned enterprises with exemptions and advantages abolished and greater managerial control allowed. However, progress was too slow and in February 1984, the legal framework for privatization was created. Initially, fixed income bonds associated with a variety of public projects were sold to the public. Meanwhile the Mass Housing and Public Participation Administration was created to act as the privatization agent for the government. In April 1987, 8 enterprises were transferred to the MHPPA and in February 1988 the first company Teletas (a manufacturer of communications equipment worth 15.6 billion TL) was floated extremely successfully. Unfortunately, within months the share price had collapsed by over 40 percent due to internal problems in the Turkish economy. The result was that the momentum of the programme was severely damaged and the next stage to privatize five cement companies was postponed.

These discussions and actions have received a mixed response in the countries concerned. At a popular level the moves have evoked little response except where they have been linked to the removal of subsidies and price controls. Here opposition has been growing. Not to privatization per se but to the subsequent prices increases. This is important since the post hoc ergo propter hoc argument has validity. Further privatization in heavily subsidized economies can only lead to further decontrol, higher prices and hence growing opposition. There is opposition already from within the system. The programmes in one sense are an admission of the failure of the existing system. It is hardly surprising that those responsible for creating that system should be uneasy at a visible and explicit condemnation of what was done. Immediate vested interests are also opposed. Bureaucrats see a diminution of their power and influence. Management face (possibly) a tougher, less secure existence but also possibly greater rewards for some. The workforce face threats to the current state of overmanning. There are also some intellectual reservations stemming from an ideological base and a fear that national assets

are being sold to foreigners (or indeed to those already too powerful). Those actively in favour of the programmes tend to be those responsible for fielding immediate pressures (internal and external) just outlined. Also there is some support from the young technocrats imbued with the spirit of market forces. It is the former who are most important since they can direct or buy-off significant opposition²⁰

Is privatization desirable or feasible

Clearly to make the question manageable requires it to be broken down into analytically compact parts. I intend to take three generally cited motives for privatization - efficiency, ideology, fiscal - and convert them into specific objectives. This taxonomy is of my own making. However, public pronouncements by governments in the region on their objectives all fall within the scope of these objectives. In Morocco, the King (March 1988) emphasised the need to reduce the absorption of state investment and expenditure and to improve management and efficiency. In Iraq, Saddam Hussein (June 1987) talked in terms of trimming bureaucracy, liberalizing imports and currency controls and deregulating the labour market. In Turkey, the head of the MHPPA emphasised efficiency, productivity and the promotion of the capital market.

The next stage is to consider whether these objectives are either desirable or feasible in the context of the Middle East. The approach has its limitations since it is possible that the list of motives is not exhaustive and that there are other objectives. It is worth citing the response of a senior British civil servant when asked what the motives for privatization were.²¹ 'The mistake in that question is to suppose that privatization is actually about anything. It is a political imperative pursued for itself. If any argument for it can be found, or any benefits from it can be perceived, a grateful government will seize on them as rationalisation; these are not objectives. The policy is the policy because it is the policy. There is fundamentally no more to it than that'.

²⁰This requires some qualification since it depends upon how far the economies can survive absent subsidization and how far removal of subsidization is an associated condition of privatization. In some economies the economic consequences of privatization associated with liberalization could lead to large scale and irrepressible opposition.

²¹Quoted by John Kay, Who Benefits from Privatisation? The City Association Lecture, November 1985.

Efficiency Objectives

To consider efficiency it is necessary to introduce some economic jargon. This is to make a distinction between two types of efficiency - productive and allocative. The first is straightforward and refers to the type of efficiency which most lay persons would recognize when they use the term 'efficiency'. This relates to the specific company or plant and means producing an output in the least cost possible way. Economists call this productive efficiency. It is secured when the firm is producing the output at minimum average cost. The second type of efficiency is a little more difficult to grasp. It looks at the output of a company or plant in relation to the output from all the other companies or plants in the economy and asks if the output is too much or too little given society's preferences. Put another way, the question is whether the plant is getting too many or too few of the scarce resources in the economy given what society wants. Economists call this allocative efficiency. At the risk of gross oversimplification, allocative efficiency is secured by everyone charging competitive prices. Increased competition will (other things being equal) lead to improved allocative efficiency.

The distinction between allocative and productive efficiency is important since they can often pull in opposite directions. For example, it was often said in the UK that the nationalized industries provided allocative efficiency because the government could impose competitive prices but that this was at the expense of productive efficiency since there were no obvious mechanisms in the public sector to force lower costs. Consider each objective in turn.

Allocative Efficiency

We start from the assumption that allocative efficiency is a desirable objective. This may be contentious since there is a familiar (to economists) conflict between allocative efficiency and equity. It is perfectly feasible to consider sacrificing equity (as represented by income distribution) for allocative efficiency and vice versa. However, assuming we find the present income distribution acceptable (an heroic assumption in the region) more allocative efficiency is preferable to less. For many of the public enterprises under consideration this would tend to imply the use of significantly less resources after privatization.

If the objective of allocative efficiency is assumed to be desirable, is it feasible in the region? In reality there may be serious problems. Allocative efficiency is achieved by competition. In the context of privatization competition usually means either taking a public monopoly and breaking it up into competing firms or allowing firms equal access to government controlled resources. For competition to exist, two conditions are required. These are the existence of more than one supplier and rivalry between those suppliers. In the region both may be inhibited. In many cases (but by no means all) the national markets are often either too small or too fragmented to justify the existence of more than one plant supplying particular goods. In a recent study, the Gulf Organisation for Industrial Consulting (GOIC)²² looking at 26 projects found only 9 had a minimum efficient plant size in relation to the Gulf markets to justify at least one plant. Thus it might be argued that in many of the countries, many of the industries would be natural monopolies²³ due to small market size. One obvious way round the problem of the number of suppliers would be to allow completely free imports. This for traded goods would guarantee more than one supplier. Such a move would raise a great many contentious questions not least those connected with dumping.

The second problem in creating competition concerns ensuring rivalry.²⁴ A key element behind the creation of rivalry is who buys the shares? If they are bought up by the same family or grouping²⁵ then it is plausible to expect that rivalry will be limited.

²²M.H. Badr, Joint Projects and Gulf Cooperation: Performance and Prospects. GOIC. Qatar. Undated but based upon a paper presented at the International Seminar on 'Economic Outlook for the Middle East', Athens, Greece April 1983.

²³This is a classification of monopoly used by economists to distinguish from a contrived monopoly. In simple terms, if a monopoly is a natural monopoly, competition would not emerge nor (in terms of efficiency criteria) should it emerge. A contrived monopoly on the other hand precludes competition by some sort of barriers to entry. In such a case competition cannot occur if the barriers are effective but competition would be desirable.

²⁴Also important is to ensure that rivalry is within bounds and does not result in predatory pricing ie. using 'unfair' means to drive out competition to secure a monopoly position.

²⁵This could be regional or it could be by existing industry. For example in Turkey there has been talk of privatizing by block sales to existing shareholders where the company is a joint venture, or by sale of the share blocks to one company. For example it appears that a letter of intent has been signed by Turkey with Societe Ciment Francais for the sales of the 5 cement plants. however, the subsequent fuss has led to an unofficial hiatus.

Even absent such a blatant eventuality, oligopolies²⁶ are expected normally to collude to overcome the disadvantages associated with oligopolistic uncertainty. This is precisely why countries have, in one form or another, anti-trust legislation to prevent such collusion. The ability and willingness of Middle East governments to introduce such legislation, let alone ensure its implementation must remain extremely doubtful. In the absence of competition, moves towards allocative efficiency may well prove to be illusory. This it must be said has been equally a problem in privatization programmes in industrialized countries. In the UK for example the sacrifice of allocative efficiency stemming from the lack of competition left many enthusiastic supporters of privatization extremely unhappy.²⁷

It is possible to leave the monopoly as a monopoly provided some sort of regulation is applied which forces the equivalent effects of a competitive market. Indeed if the industry is a natural monopoly then regulation would be preferable since not only would competition not appear with a natural monopoly, for reason of productive efficiency nor should it. However, there are problems with regulation.²⁸ In the case of a contrived monopoly, the purpose of regulation is to hold the fort until competition rides to the rescue. It is not obvious for the region why the 'contrivance' behind the monopolies would necessarily go away. Ultimately, there is no substitute for an effective competition policy which in the region faces severe political constraints.

Productive efficiency

As with allocative efficiency, the desirability of productive efficiency as an objective may be linked to issues of equity. There may be considerable social benefits associated with using the enterprise for the provision of employment opportunities, training or encouragement to local suppliers. In less developed countries where the fiscal system is extremely weak such enterprises may represent the only realistic mechanisms available to the government to redistribute income. Use of the enterprise for such purposes would be

²⁶These are industries where a few sellers dominate the market.

²⁷For example see some of the discussion in S. Littlechild, C. Price, C. Robinson and A. Sykes. Energy Privatisation. Surrey Energy Economics Discussion Paper, No. 39, June 1988. Surrey Energy Economics Centre, Guildford.

²⁸For example, see Kay and Thompson, *op.cit.*

inimical to productive efficiency. There is also the problem of defining what is meant by lowest cost in an economic context which is characterized by large pervasive subsidies.

For the moment, let us assume productive efficiency is a desirable target. Is it feasible? Some would argue that simply the act of moving the enterprise from the public to the private sector would improve productive efficiency. This view is based upon the assumption that public enterprises are congenitally inefficient. There are some theoretical grounds supporting this view associated with economic theories of agencies²⁹ and the economics of public choice.³⁰ However, at an empirical level the issue is apparently undecided. There has been a significant amount of empirical work to evaluate comparative efficiencies of public and private enterprises. There are significant problems of comparability.³¹ The results are mixed.³² One may be tempted from this to conclude, as many do, that the evidence is inconclusive. However, I would suggest that there has now been a sufficient number of serious studies to assert that there are no empirical grounds to assume either is automatically superior to the other. Superior performance is essentially determined by the environment in which the enterprise operates. The act of privatization alone cannot be assumed to lead to productive efficiency.

Let us consider the positive arguments in favour of the private sector being more efficient. These arguments have two strands. First that the private sector is faced with significantly less government interference. Second that the different property rights in the private as opposed to the public sector create incentives to perform better.

Political interference in the running of public enterprise in the Middle East has without doubt been a major disadvantage to productively efficient operation. Many examples exist. In September 1968, Aziz Sidqi, the Egyptian Minister of Economy admitted that

²⁹For a comprehensive discussion see J.Vickers and G. Yarrow, Privatization- an Economic Analysis. MIT Press, Cambridge Mass. 1988.

³⁰For example see Institute of Economic Affairs, The Economics of Politics, IEA, London, 1978 and A.Peacock, The Economic Analysis of Government and Related Themes. Martin Robertson, Oxford, 1979.

³¹For example, public sector enterprises are often assigned multiple objectives especially those associated with income distribution.

³²M. Aylem, Privatization in Developing Countries. In Johnson op. cit.; Y. Haile-Mariam & B. Mengistu, Public Enterprises and the Privatisation Thesis in the Third World. Third World Quarterly. October 1988, vol. 10 no.4; Kay, op.cit..

'My opinion as the minister responsible for some of the units of the public sector, or a large part of them, is that we practised an excessive control and an excessive intervention, for the results which we expected did not occur as a result of increased intervention, which led to an increase in difficulties... Also ... it led to an increase in avoiding responsibility.'³³

More recently, Algeria has actually created state sponsored trust companies in 8 sectors (Fonds de Participation) whose function is to hold shares in state owned companies specifically to protect them from government interference.³⁴ However, given the nature of the political systems in the region, it is far from obvious why an enterprise in the private sector should necessarily be insulated from government interference.³⁵ Privatization cannot be assumed per se as an automatic cure.

The property rights argument stems from the notion that in the private sector there are incentives (pay rises etc) and punishments (sacking) which force management into better performances. Equally, in the public sector it is argued there is a lack of incentives because managerial objectives are ill-defined and often unmeasurable. Also in the public sector job security tends to be stronger and rigid pay scales more common. In reality, it is not at all clear from the extensive literature on the subject that managers in a large private firm have a strong interest in profitability for the shareholders. Rather they are more concerned with issues such as salary, survival, growth and prestige.³⁶ What is crucial to force an improved performance is pressure from competition and the capital markets. Thus as one observer has commented it is

'not ownership as much as market environment, firm's organisation and managerial incentives that determine the performance of companies'.³⁷

Hence it is assumed that the management work harder to avoid bankruptcy and take-over. Neither outcome it is argued would be feasible in a public sector company. For

³³Quoted in Asad and Owen, *op.cit.* page 88.

³⁴Economist Intelligence Unit. *Quarterly Economic Review*. Algeria. No 3 1988.

³⁵A good example was the case of Libya when there were 'spontaneous' takeovers in the private sector and subsequent interference from the Popular Committees. See D. Vandewalle, *Political Aspects of State Building in Rentier Economies: Algeria and Libya Compared*. In Beblawi and Luciani, *op.cit.*

³⁶In support of this view see Aylem, *op.cit.* and Kay and Thompson, *op.cit.*

³⁷Aylem, *op.cit.* page 128.

such pressure to work to enhance productive efficiency requires competition and active financial markets. Simply switching ownership is not enough.³⁸ Problems with the existence of competition in the region have already been discussed. Problems with the capital markets will be considered shortly.³⁹ Prospects for both are highly uncertain. Suffice it to say at this stage that huge improvements in productive efficiency in the region may be illusory absent other fundamental economic reforms. It is however a very complex issue which requires consideration of many factors - importance of company size, influence of family firms, impact of employment laws etc. All of these require specific research before generalization can be asserted with more confidence

Ideological Objectives⁴⁰

Two specific objectives can be discussed under this heading. The first concerns who should control the economy, the second is the objective of wider share ownership.

Rolling Back the Power of the State

The argument starts from a premise that government intervention in the economy at the levels experienced in the 1960s and 1970s is a 'bad thing'. Roughly, the view has three dimensions.⁴¹ There is the political dimension along the lines of Hayek that political freedom is a function of private property.⁴² There is the administrative dimension which argues that the large scale bureaucracy associated with the involvement drains skilled manpower, causes undesirably high levels of centralization and creates a bureaucratic constituency.⁴³ Finally there is the economic dimension which would argue that

³⁸For example, Vickers and Yarrow, op.cit. claim that it is broadly agreed in the literature that gains from competition are greater than gains from any change in ownership.

³⁹See the section under the heading of Wider Share Ownership.

⁴⁰Although this is apparently a 'political' issue, the emphasis of the paper will continue to seek to concentrate mainly on the economic aspects.

⁴¹A good example of this view can be found in D. Lal, The Poverty of 'Development Economics', Hobart Paperback 16. Institute of Economic Affairs, London, 1983. For an effective counter view, see J. Toye, Dilemmas of Development, Basil Blackwell, Oxford, 1987.

⁴²F.A.Hayek, The Road to Serfdom, Routledge and Kegan Paul, London, 1944.

⁴³See Institute of Economic Affairs, op.cit. and A. Peacock, op. cit..

government intervention blunts and distorts the market signals. Wrong signals lead to wrong decisions. Under this general objective, privatization is seen as part of a package to roll back the power of the state. In the 1980s, this has been ideologically very popular in the industrialized countries and has been vigorously peddled in the Third world.

On balance, for reasons already outlined it is probable that in many of the countries of the region, the intervention by the state in the economic system is excessive.

⁴⁴ This is, in the nature of the beast, a vague and subjective judgement. The only empirical basis for the assertion is a view that in general the economies have failed to deliver the goods. Thus purely subjectively I would argue that a partial⁴⁵ roll-back of the power of the state in the economies of the region, is a desirable objective associated with privatization. However, given the current political system in many of the countries the probability of the state willingly relinquishing its pre-eminent position seems unlikely. Experience suggests that power once attained is rarely surrendered without a fight.⁴⁶ This begins to raise serious issues of an essentially political nature which this paper does not wish to consider.

Wider share ownership

One might legitimately put this objective under a heading other than ideological given the economic basis of the paper. However, the issue does have an ideological content since it might be argued that share owning democracies are a 'good thing'. In terms of the desirability of wider share ownership, I will argue that in so far as it redistributes wealth and expands the domestic capital market the objective is assumed to be desirable.⁴⁷

⁴⁴For further justification of this view see. P. Stevens, *The Impact of Oil on the Role of the State in Economic Development: A Case Study of the Arab World*. Arab Affairs, Vol 1, No. 1, Summer 1986.

⁴⁵Defining this of course begs the question.

⁴⁶There is a strong argument that Turkey is an exception to this in the region. Turkey however could be viewed as atypical.

⁴⁷The former is subjectively based due in large part to the absence of data. Of the 17 regional countries listed in the Statistical Appendix of the World Bank Development Reports *op.cit.* only two (Egypt and Turkey) have data on income distribution. Based upon casual empiricism my experience of the region argues that the income distribution record is poor. The World Development Report 1988 *op.cit.* shows for Industrialized Countries reported that the richest 10 percent of households have 24.5 percent of income. This compares to 33.2 percent in Egypt and 40.7 percent in Turkey. The latter point on expanding capital markets has a more objective basis since the need to mobilize domestic savings for development has long been a central pillar of much development thinking.

Feasibility is another matter and raises some of the most serious practical problems with privatization in the region in terms of its ability to redistribute wealth or expand capital markets.

Unlike the situation in many Third World countries, the availability of funds in the region is likely to be less of a problem. There have been a number of instances when privatization programmes have been postponed because they are simply too large for the domestic capital market to swallow.⁴⁸ Taking the region as a whole however, there is surplus liquidity in the system. For example, in the Saudi banking system alone it has been estimated that there is 70-80 billion rials of surplus liquidity.⁴⁹ This is roughly equivalent to the privatization proceeds of the British government up to the end of 1987. In Turkey, it has been estimated that some \$400 million are saved in the form of gold annually. Of course there is variability between countries and some may find themselves short of domestic investors. This raises questions about the willingness of governments to allow non-nationals to participate. Foreign investment is a sensitive issue in the region but a number of countries have already created the legal framework necessary to allow it. In particular, the type of debt-equity swaps popular in Latin America might be of interest. If the 'foreigners' are other Arabs this may reduce local hostility. Many of the supporters of privatization in the region see the potential repatriation of Arab capital as a major gain from such programmes. The experience of the 1970s suggests such enthusiasm may well be premature since the record of Arabs investing in Arab countries has not been good.⁵⁰

However, the availability of funds need not necessarily be associated in a privatization programme with redistribution of wealth or expanded capital markets. The first point is that the income distribution in the region is such that it is unlikely that a privatization programme would bring forth the small investor. The implication is that far from redistributing wealth, the programme would simply reinforce the existing concentration of economic (and hence political) power. A possible mechanism to avoid this result would

⁴⁸Hemming and Mansoor, *op.cit.*.

⁴⁹This number is based upon private discussion.

⁵⁰For example see M. Rumaihi, Beyond Oil. Al Sagi Books. London, 1986.

be to privatize by giving preference to the workers -the cooperative route.⁵¹ In the region this raises a number of problems. Many of the likely privatization candidates are capital intensive projects which means that the workers could not afford to purchase unless the selling price was significantly below market value. There is also the problem over the identity of the workers. Clearly, if expatriates predominate as in the Gulf, selling to them would be unacceptable especially at 'give-away' prices. Equally, the predominance of minorities in the workforce could inhibit such a route. In many Third World countries, this latter point has been a serious stumbling block to such programmes.⁵²

The development of capital markets also faces many problems. In virtually all the countries, the capital markets are new⁵³ and very small⁵⁴. For example, in Turkey, the Istanbul Exchange only opened in 1986 specifically for the privatization programme. Forty companies are quoted and trading is negligible. Smallness gives rise to two problems. The first is volatility. Small markets on which little is traded can be subject to enormous fluctuations in share price, either as a natural consequence of trading or as the result of deliberate manipulation. The result is that shareholders, especially small ones are likely to get hurt. In such a case this would add significantly to the existing inhibitions against the holding of paper which is a necessary condition for an expansion in the capital market. As outlined, the Turkish experience with the Teletas launch illustrates this well.⁵⁵

The second problem is that of short-termism.⁵⁶ Firms may be forced to take decisions to keep the financial markets happy which may well be against their (and the economy's) long term interest. After all, in many of the countries, the state owned enterprises were

⁵¹Hemming and Mansoor, *op.cit.* suggests this as an offset to the problem of small capital markets.

⁵²Kenya and Malaysia are frequently cited in the literature.

⁵³Those that are old such as the Cairo Stock Exchange are effectively defunct.

⁵⁴Traditionally in the Third World, companies tend to rely more on debt than equity. For example Aylem, *op.cit.* cites the Seoul Stock Exchange where at the end of 1985 the 340 companies listed had an equity capitalization equal to only \$6 billion with an average gearing ratio of 350 percent.

⁵⁵Currently in Turkey to overcome this problem the possibility of block sales of share to one company is under discussion.

⁵⁶This is where exigencies of the capital market force companies to make decisions or not to undertake activities / investments which on any long term basis would be beneficial.

created precisely because the private sector would not set up such enterprises. Research in the industrialized countries suggest that short-termism is much less of a problem than many believed.⁵⁷ Research is needed to assess if such a conclusion can be legitimately carried to the Third World. In general however, it is likely that any boost to local capital markets may be overstated. This is particularly true if the block sale approach is adopted. Equally it is fair to argue that the process of developing capital markets must begin somewhere and privatization could be a useful starting point.⁵⁸

Fiscal Objectives

In many cases in the Third World and in the region this is a key motive for the proposed programmes.⁵⁹ The underlying argument is deceptively simple. Budgetary problems stem from two possible causes which are not mutually exclusive. First is low revenues, therefore privatization is seen as a means to boost revenue through the sale of assets.⁶⁰ Second is high expenditure in which case privatizing losers will remove their drain on the public purse. As an objective of privatization I would argue quite strongly that revenue considerations are undesirable. This is because maximizing revenue requires making the asset as financially attractive to potential buyers as possible. Monopolies are worth more than competing firms because of the ability to earn monopoly profits. Thus it is probable that a fiscal objective will inhibit the implementation of other broadly desirable objectives such as enhanced competition.

In reality, the objective is in any case not feasible.⁶¹ On the revenue side, objectively it is impossible to gain from privatization. The market value of an asset is equal to the

⁵⁷For example see McConnell & Muscarella, *Corporate Capital Expenditure Decisions and the Market Value of the Firm*. Journal of Financial Economics, September 1985.

⁵⁸For example, Hemming and Mansoor, *op.cit.* claims that in Turkey, sales of bonds secured by revenues from the Bosphorus bridge and the Keban dam have been a major influence on the growth of the domestic capital market.

⁵⁹Hanke, *op. cit.* page 204 claims that many attempts at privatization in the Third World have failed because of overpricing ie. the governments were too greedy.

⁶⁰The IMF practise with respect to the proceeds of sales to the private sector is that they are included either as capital revenue if it was a fixed asset held for the state's own use or as a loan repayment if the sale was an interest in a public enterprise ie sale of equity.

⁶¹There is one qualification to this which will be explored shortly.

present value of its expected stream of future income.⁶² Therefore, if the asset is sold at 'market value' the government is simply exchanging a future stream of revenue for a lump sum today. The effect on revenue over time is neutral. If of course the sale is made below market price for whatever reason (to encourage small savers etc) then the revenue is actually reduced. In the real world, politicians can and do have very high discount rates.⁶³ Thus it is not necessarily a choice between jam today (present value of the future income stream) versus jam tomorrow (the future income stream). It may well be if there is no 'jam today' there is no tomorrow for the politician. Thus the government requires money now to survive. However, this cannot be equated objectively with the assertion that this is a 'good thing' for the country. That can only be argued if it is argued that the government's retention of power is good for the country. Any government would probably argue so but it is not an objective stance.

There is a qualification to this view of the negative or neutral effect on revenue. If the enterprise performs significantly better in the private sector, then it may be able to make a larger contribution to tax revenues. In such a case, revenue could be enhanced compared to retaining public sector status. However, such a change would only occur over time and for reasons already outlined may be a slow process absent major reforms to the economic operating environment.

Gains on the expenditure side are also debatable. It is true that many state owned enterprises have been (and are) a drain on the public purse. The World Bank has estimated⁶⁴ that between 1978-82, annual net transfers from government to non-financial state owned enterprises accounted for more than 5 percent of GDP in Egypt and 4 percent in Turkey. Thus removing them from the public sector would provide fiscal relief. However, to achieve this would mean either closing them or passing them over to the private sector. The former option is not relevant to privatization. The latter option, while within the purview of privatization, raises the question of who would take on the loss makers? To 'sell' a loss maker would involve more than giving the enterprise away. It

⁶²This is an oversimplification since there may be asymmetry of information between buyers and sellers. Equally the expectations of buyers and sellers may well differ. There is no such thing as the present value. There are only estimates.

⁶³This is simply another way of saying that they discount the future very heavily reflecting very short time horizons.

⁶⁴World Bank Report 1983, op. cit..

would also involve giving it away with a lump sum equal to the anticipated negative future cash flow.⁶⁵ This would therefore increase government expenditure not decrease it.

Objectives-Final Comments

So far the paper has argued that the prospects are not encouraging. Objectives which are desirable are not feasible and those which are feasible are not desirable.⁶⁶ It is legitimate to ask if this actually matters? If much of the programmes are being put into place as cosmetic to satisfy outside pressures it may well be sufficient to go through the motions. There are however serious potential costs which arise from a privatization programme. The first is what I shall call pre-privatization paralysis. This has two dimensions. First, if privatization is on the horizon, it is very likely to freeze decision making in the enterprise until the new owners are in place. Thus management would adopt a wait- and-see approach. If the privatization programme is long winded, or drawn out because of unexpected problems and delays this could have a very negative effect on enterprises in desperate need of reform. Second, the programme may well generate a perverse incentive structure for existing management in the limbo between conversion from the public to the private sector. The management anticipating privatization would also expect the better pay and conditions generally associated with the private sector. However, such rewards would be greater if post-privatization performance improves. Improved performance stems from a starting base. There is a danger that management would actually seek to reduce the starting base during the run-up to privatization. Of course such a strategy could be double edged since too sharp a decline in performance could lead to dismissal from the new owners.⁶⁷ However, there is cause for concern.

⁶⁵This would be so unless the recipient believed he could turn the enterprise's negative cash flow into a positive one fairly quickly.

⁶⁶An obvious point which has not so far been made is that many of these objectives (desirable or otherwise) in fact conflict.

⁶⁷This point may be in danger of being too Machiavellian. However, my ideas on pre-privatization paralysis have received some confirmation from executives in the UK industries which have been or are about to be privatized.

There is a second possible cost to privatization. Once the state owned enterprise is sold, the chance may be lost to reform an institution ie. promote liberalization⁶⁸. In general, it should be easier to reform a state owned enterprise since the loss of profit or prestige falls upon the state. Other things being equal, the state is normally better able to cope with this than the private sector. Once privatized, there is a danger that opportunities for much needed reform may be lost forever.

Conclusion

Despite the rather gloomy prognosis argued in this paper, there may exist a major benefit from privatization which has not yet been mentioned. In other countries, privatization programmes have generated significant debate. This in turn has led to very fundamental changes in the economic system. In other words, privatization has created a more favourable climate for liberalization of the economic system. Thus

'privatization is a slogan. The true watchwords are reform and liberalization'.⁶⁹

For many, this is seen as the main value of privatization.⁷⁰ If a similar pattern of economic reform and liberalization were to develop in the region, then this alone might be sufficient to more than offset all the earlier negative arguments against privatization. My own view is that this is unlikely in the region given the nature of the power systems and the extent of subsidization already in place. However, if I am wrong then history could record a favourable verdict on privatization in the region.

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12 April 1989

⁶⁸In this context this means the removal of monopoly and the creation of competition.

⁶⁹Aylem, *op. cit.* page 136.

⁷⁰See for example the argument by S. Brittan, *Privatisation: A Comment on Kay and Thompson*. *Economic Journal*, Vol. 96 no 381, March 1986.

