Privatization Essay, Research Paper

PrivatizationWhat is Privatization? Privatization is the process of transferring productive operations and assets from the public sector to the private sector. Broadly defined in this fashion, privatization is much more than selling an enterprise to the highest bidder, as it includes contracting out, leasing, private sector financing of infrastructure projects, liquidation, mass privatization, etc. My testimony will argue that there is no single “best” approach to privatization; the appropriate privatization path depends on the goals that the government is seeking to attain, the individual circumstances facing the enterprise and the economic and political context of the country. It should be noted that privatization is fundamentally a political process as well as a commercial and economic process. Privatization changes the distribution of power within a society, as it diminishes control of the economy by the state and government- appointed managers. Workers often feel threatened by the potential changes inherent in privatization, although employees frequently benefit from the process. As a result, public support is a major consideration in any privatization program and many of the choices made in designing and implementing transactions reflect the need for such support. Two consequences flow from this factor. 1) choices of approaches are sometimes altered due to “political” considerations, meaning that equity must be promoted in the privatization strategy, and 2) program implementation must be objective and fair to avoid adverse publicity. What are the goals of privatization?Many goals are often pursued through privatization programs. These goals often fall along two principal dimensions: 1) broad social or macro economic goals, and 2) enterprise specific or macro economic goals. Macro economic goals are numerous. Fundamentally, privatization is advocated as a means to reduce the governments role in the economy, partly as a philosophical matter (as in the UK) but principally because governments have performed badly in that role. Many countries can attribute substantial portions of their external debt to liabilities of state-owned enterprises and significant portions of government budgets are devoted to paying subsidies or otherwise assisting loss-making State-owned enterprises. Government’s objectives in these situations are often simply to extricate themselves from these financial commitments, and focus scarce resources instead on education, infrastructure, and social welfare. A second macro economic goal of privatization is to promote the development of the private sector by “leveling the playing field” and ending subsidized competition from state-owned enterprises. There is a danger in some countries that emerging private businesses face unfair competition from state enterprises that have access to credit and other inputs at below market rates and better access to government distribution channels. In order to give the private sector a fair opportunity to compete and thrive, state-owned enterprises are privatized. A third goal of privatization’s to obtain the sales proceeds and use them to finance shortfalls in the government’s budget or retire some of the public sector debt. While it is widely recognized that focusing on sales proceeds may be shortsighted and ignore other important outcomes of privatization, it is a fact that many governments are strongly influenced by the availability of funds from privatization. A fourth goal is to broaden share ownership so that the public has mechanisms for saving money and participating in the economies of their countries. The macro economic goals of privatization focus mostly on the potential improvements that private sector operators will bring to an enterprise to improve this performance and increase chances of survival. These goals recognize the need to improve enterprise efficiency by introducing new technology and financing sources, improving the quality of the product, enhancing marketing-especially in the international market, providing information systems, and generally improving the management of the enterprise. Obviously successful changes of this nature, when applied to a number of individual enterprises, will have significant macro economic implications as well. The final goals of privatization is to note that in most countries privatization is but one part of a broad program of structural reform. This is most evident former Communist country, where privatization is an element of the process of developing a market economy and its associated financial institutions. In such cases, the privatization program designed should take into account the broader economic goals that are being pursued, as well as the goals specific to the enterprise. What types of privatization techniques can be used?There are a variety of techniques that can be selected to use in privatizing state-owned enterprises of activities. These techniques include the following: Small business auctions–A normal procedure for privatizing small businesses is to auction them to the highest bidder. Especially when dealing with truly small businesses, such as sole proprietorships and small partnerships, it is advantageous to sell to a single bidder. Given the size of the enterprises, elaborate bid evaluations and valuations are not appropriate and will only serve to delay the process. Auctions also create a dramatic setting to promote the visibility of privatization and allow for broad participation, and they are truly transparent, in the sense that all participants can see for themselves how the process was conducted and identify the high bidder. Auctions are generally not appropriate for larger enterprises because the bids will not be as readily comparable. The quality of the new ownership group becomes important–what technology will it bring, is it well financed, what investments will it commit to making, where will it market the product, will it close the business to limit competition? Strategic investors–Larger enterprises are often sold on a case- by-case basis, by soliciting technically and financially capable investors to acquire the enterprise. In soliciting the investors, the seller normally conducts a thorough review of the business and prepares material describing the business and it’s equipment, workforce, financial condition, markets, and prospects. This information is circulated to a group of candidate investors that express initial interest in the business. These investors then submit bids outlining the terms under which they would purchase shares of the enterprise. Trade sales have significant disadvantages in that they can take a long period of time and substantial expense to conduct. Because of the substantial amount of negotiation often involved, they also have the aura of “back room deals” being conducted and are susceptible to complaints from bidders that the decision process was unfair– particularly when the bids are structured very differently. Initial Public Offerings (IPOs)–Initial Public Offerings are the sale of shares directly to the public. Most of the privatization conducted in the United Kingdom during the 1980’s was done through IPOs. Because the potential buying public includes a large number of unsophisticated investors, relatively more information and higher quality information needs to be prepared to conduct an IPO. A valuation of the enterprise is prepared and a pricing strategy is developed that reflects the valuation, but seeks to ensure that the offer is sufficiently attractive that the shares available can be sold. IPOs have the virtue of stimulating interest among the general public in financial markets and increasing share ownership in society. The disadvantages of IPOs are that they do not bring new capital to the enterprise and do not bring in new managerial talent or resources. As a result, IPOs should only be used if the performance of existing management is satisfactory. In addition, IPOs are very time consuming and expensive to conduct, and they generally require the existence of a formal stock exchange and broker network or other distribution mechanism to be implemented effectively. Joint Ventures–A common form of privatization in some parts of the world–especially China–is the joint venture. Under a typical joint venture, an investor approaches the government and offers to contribute something of value to an enterprise, such as capital, management, or technology, and in return receives a share of the ownership of the newly constituted business. Joint ventures are often attractive to governments that are not fully supportive of privatization because the government does not give up all control of the enterprise. Over time, and with new investments, it may be possible to minimize government control by diluting its ownership interest. There are several significant disadvantages to joint ventures as a form of privatization. Because of the government’s continued involvement, many of the goals of privatization stated above are not met. The government remains involved in management and it’s liability for poor performance is retained. Mass Privatization Programs–One of the significant innovations in privatization techniques during the last few years is the development of mass privatization programs. In concept, mass privatization programs avoid the time and expense of case-by-case transactions and involve the general public by distributing shares for free or in exchange for specially created privatization vouchers. The mechanics of mass privatization programs are similar to IPOs, except that vouchers are used to purchase shares, rather than cash. As a result, significantly less analytical time is required and disclosure requirements are greatly reduced. The disadvantages of the mass privatization programs lie principally in the diffusion of owner-ship across broad groups and in the critical role that management is able to play in the privatization process. It is argued that subsequent restructuring of enterprises will be more difficult due to these factors. Offsetting this argument to some degree is the fact that potential investors in these enterprises can negotiate with the new owners–rather than the government–and can make investments into the enterprise in return for shares, rather than have their funds go into the state treasury.Build-Own-Operate/Build-Own-Transfer Programs–Governments facing severe needs for infrastructure investments increasingly turn to the private sector to finance, build, and operate the needed facilities. In return, the government gives certain assurances to the investor and pays fees for the services provided. This technique has proved useful in attracting additional capital into infrastructure investments and alleviating critical shortages of power and transportation, especially in Asia. The disadvantages of these programs are that they are often very difficult and time consuming to negotiate and structure. Because these programs are relatively new and involve financing of new projects not assets that are already existing–many difficult issues emerge that have not previously been confronted. Liquidation–State-owned enterprises with very limited prospects for survival are sometimes liquidated and there assets auctioned to the private sector. Sometimes these “liquidated” enterprises continue as going concerns; in other cases their assets are sold separately. Liquidation ends the government’s commitment to support an enterprise and lays the groundwork for private sector investment, if the product has a market and it can be manufactured efficiently. Liquidation is normally a last resort, used when the government has no realistic alternatives. In practice, many transactions do not fit neatly into these defined categories. In most of these transactions the government initially sells a minority of shares to a qualified international operator through negotiated trades sales. The evaluation criteria for this bid depend on the purchase price and on the commitment of the operator to expand service coverage and quality significantly. Following one or more years of performance and improvements by the operator, the balance of the government’s shares are sold through several rounds of public offerings, involving both domestic and international shareholders.What is the process of privatization?Regardless of the privatization technique that is selected, the process of privatization is relatively standardized. Governments generally follow several steps in privatizing enterprises. First, the target companies are reviewed to understand, in a very general way, their characteristics, markets, and prospects. Second, a privatization plan is prepared to guide the implementation. This plan should match the goals of the government and the characteristics of the enterprise to determine the approach that will be taken. Third, the company is marketed, whether to core investors or the public, depending on the path chosen. Fourth, if necessary, the terms of the transaction are negotiated and the legal documentation prepared. Finally, the transaction is closed. Throughout this process, several factors are critically important to the success of the privatization program. First, speed is absolutely essential. During the period that governments are deciding to privatize, until the point that new owners are recognized, the enterprise is essentially under control of its management. Few true ownership interests are represented and the interests of capital– whether of maintaining existing capital or investing new capital are ignored. Great potential exists for asset-stripping or other misappropriation of assets. Second, the transparency of the privatization process must be preserved and publicized. Any questionable ethical conduct has the potential to destroy the integrity of the process and erode political support. Finally, the privatization program must be implemented professionally. If it is not, the enterprises, investors, and the public could be discouraged from participating–with disastrous consequences.Privatization Developments around the WorldPrivatization is moving forward very quickly in many countries throughout the world. In contrast to several years ago, when privatization was much discussed and the U.S. government was actively promoting the concept of privatization, the rationale for privatization is now widely accepted. Issues now concern the implementation of privatization and the appropriate techniques to use, whether in the wealthier countries of Latin America or the poorest countries of Africa. In this section our group briefly reviews recent privatization developments in each major region of the developing world, Africa, Eastern Europe, Middle East and Latin America. International and International Privatization Group estimates. Latin America has led the developing world in terms of the pace of its privatization, although central and Eastern Europe and the former Soviet Union have recently begun to implement massive programs. In 1992, transactions in Latin America accounted for about one-third of the developing world’s total, up from less than 10% in 1988. Latin American governments see privatization as a quick means of economic reform, specifically, as a means of attracting foreign investment and fostering economic liberalization. Progress in this region has been mixed, as some countries have several years of success behind them while others are only beginning.

The predominant method of privatization in the region is trade sales of enterprises, conducted on a case-by-case basis. In addition, there have been several significant public offerings. Chile is nearing the end of its privatization cycle. By 1991, it had privatized the financial sector, nearly all the manufacturing sector, and much of its transport and communications. While the state sector in 1973 accounted for 40 per cent of Chile’s gross domestic product (with over 375 enterprises), Chile’s military rulers distributed to general investors shares in state run companies, mostly in insurance firms and utilities. Other state firms were auctioned off or sold to individual shareholders. As a result of this massive privatization effort, the Chilean government sold 24 state enterprises, between 1985 and 1989, raising $1.7 billion. Mexico has been one of the leaders in the area of privatization in the Latin America. As of mid-1990, the government claimed to have sold, merged or liquidated 750 public enterprises out of a total 1,155. The Argentine government took in revenues of $7.6 billion from the sale of more than 200 companies by 1992. Investments in privatized companies are expected to total $36 billion by the year 2000. Excluding the petroleum sector, the new owners invested nearly $8 billion in the last three years. Once the railroad proper-ties are fully disposed of, outflow to state enterprises will amount to only about $200 million.Nicaragua successfully divested itself of 237 companies from its targeted 350 through the end of 1992. Bolivia and Ecuador have just recently begun their privatization programs, though neither had established specific timetables for privatization and privatized only on a case-by-case basis. Bolivia has announced aninnovative program, combining features of trade sales and mass privatization. The expansion of investment for modernization and the development of local capital markets were significant during 1992. Within the realm of emerging stock markets, Latin America captured 33% of global market capitalization. Governments in Latin America permit employee participation when conducting the sale of a state owned company, allowing employees to be the first to make bids on shares to be sold. Venezuela and Panama stipulated in their privatization laws that initial offers of shares were to be extended to the company’s employees prior to accepting bids from outside investors. In some cases, preference for share purchase was also extended to the company’s suppliers and customers before allowing other investors to make bids. In general, employees were permitted to purchase a minimum of 5% of the company and a maximum of 20%. The role of foreign investor participation varied within the region, though there existed a desire for increased foreign investment in order to enhance capital market development. The future of privatization in Latin America has a positive outlook, particularly with growing support for the program. Privatization in Brazil will be back in full swing once the government has made final revisions. Argentina and Mexico will carry on as leaders of privatization in the region, even though both countries plan to complete their programs in the near future. The nations in Asia have made significant progress toward achieving their privatization goals and are now beginning to privatize larger state-owned enterprises (SOES) and public utilities. According to International Privatization Update (Jan/Feb 1993), annual privatization activity, measured in dollar volume, has increased 70% from its 1991 level. Privatization through public offering is the most common method of privatization in Asia. There is an increased emphasis on infrastructure privatization as power generation facilities, rail lines, roads, airports, and seaports are now candidates for private sector involvement. These SOES, usually government monopolies in sectors such as petrochemicals, air transport, or steel, enjoy a domestic market with few competitors, but the rigors of international competition necessitates their privatization. Malaysia has already raised $3 billion, and is planning transactions for another 50 firms by 1996. The stock exchange in Kuala Lumpur increased its capitalization and its listings. A large number of state-owned enterprises were sold in industries such as automobile manufacturing and pharmaceuticals for a total of 5 major transactions. Malaysia has also authorized an ambitious privatization program to be implemented over the next six years. Sri Lanka’s privatization initiative yielded positive results as well. Nearly 50 SOEs have been transferred from the government to the private sector. Sri Lanka also had success in its efforts to attract foreign capital as foreign investment increased by 75% in 1992. Privatization efforts have commenced in China with several high publicity initial public offerings (IPOS) on regional stock exchanges. Additionally, state governments in China were directed to list local agencies suitable for privatization. These are China’s first serious steps toward large-scale privatization. To date, most private sector involvement has been in the form of joint ventures with foreign partners. Bangladesh has been putting far greater reliance on the private sector since the late 1970s and has sold state equity in numerous companies in chemical, textile and jute industries. Within two years of privatization, the textile mills in question have been turned around and are making substantial profits compared with heavy losses previously. Taiwan authorized an enormous $303 billion six-year plan designed to develop the country’s infrastructure. The program includes an initiative that will involve the private sector in infrastructure development. The government also conducted studies on the feasibility of privatization in certain sectors, but has not yet initiated the privatization process. The Philippines has made impressive progress by privatizing several large enterprises and is now completion of the portfolio of state assets held by the Asset Privatization Trust. Privatization is new to Thailand and Vietnam and their governments have not developed long-standing commitment to the process. In Thailand, SOEs account for a large portion of government revenues. Vietnam has recently initiated a privatization program, but until recently officials in that country have been most concerned with attracting capital, in the form of aid and investment, from foreign sources. In the years to come, Asian privatization will be funded by regional leaders such as Japan, Hong Kong, Taiwan, and Singapore. These countries will be the leading investors in China, Vietnam, Indonesia, and the Philippines. The political will to continue privatization remains strong, but Asian governments have entered a more difficult stage as they attempt to privatize larger enterprises and infrastructure. Privatization and private sector development were relatively insignificant in Africa just a few years ago. They are now a prominent part of the economic reform programs of most African countries, very often the mainstays of broader economic reform programs. Adjustment programs, becoming more common in the region, usually stipulate some adherence to private sector development and public sector reform. Few countries seem able to move beyond the planning stages or even sustain successful programs once implemented. Countries in this region have so far approached privatization hesitantly, mostly as a revenue-enhancing measure or to relieve the budget of the strains of debts incurred by state-owned enterprises. Of all the countries in the region, several have established and maintained successful privatization programs capable of carrying out transactions on a sustained basis. These countries-Chate d’lvoire, Egypt, Ghana, Zambia, and Nigeria–are continuing programs of moderate success from previous years. Morocco and Egypt have probably been most successful in making the recent transition from the planning stage to implementation. Political stability is a precursor for the initiation and implementation of a privatization program. Governance issues are particularly prominent in the preparation stage, while meeting training and technical objectives become more important as the process nears the transaction stage. In Africa, a shortage of capital has been the primary problem, slowing the progress to economy-wide transaction implementation, a fact reflected in part by the distribution of countries on either end of the privatization process. Privatization is often adopted because it is seen as a method to quickly convert to a market economy. Nowhere has this been demonstrated better than in the former socialist countries of Central and Eastern Europe and the former Soviet Union. These newly independent countries have undertaken the most extensive privatization programs in the world, adopting almost every method of privatization available. Both the scope of transaction activity and public participation have been impressive. Hungary, the Czech Republic, and Poland lead this region in terms of implementing and carrying out successful privatization transactions. In each of these countries, the private sector now controls the majority of the economy. Russia has developed an innovative mass privatization program that has divested thousands of enterprises and served as a model for other countries in the region. In many parts of the region, successful programs to auction small businesses have been conducted.Privatization in Eastern and Central Europe and the Newly Independent States(NIS) of the former Soviet Union led the rest of the developing world, both in innovative approach and overall volume of transactions. Regional privatization activity generated approximately $18.0 billion in transactions during 1992, includingnearly $12.0 billion handled by Germany alone. Programs in Czechoslovakia, Hungary, and Poland progressed the furthest in 1992, having privatized between one-quarter and one-half of their economics by the end of the year. Other countries, including Russia and some of the Newly Independent States, are rapidly implementing mass privatization programs. The United States economy is substantially in the private sector, with state-owned enterprises comprising a small share of national income, relative to other countries. In the United States, privatization debates focus on the more exotic forms of privatization, such as schools and prisons, or on private provision of infrastructure. With the exception of a few very large enterprises– such as the Tennessee Valley Authority, Bonneville Power Administration, and the US Postal Service-there are no candidates for privatization that are widely discussed. Experts say the sale of federal assets could raise large sums. The sale of federal energy projects including the Tennessee Valley Authority could bring $30 billion. Congress has already approved the sale of the federal government’s oil and gas reserves at Elk Hills, California, which could bring $1.6 billion. Sale of the nation’s Strategic Petroleum Reserve could generate $13 billion. Auctioning off drilling rights to federal lands and offshore fields controlled by the government might bring in as much as $420 billion. Hydroelectric and petroleum properties are not the only assets belonging to the federal government. It owns one-third of he land area of the U.S. Sale of timber lands owned by the Forest Service and grazing lands under the auspices of the Bureau of Land Management, a total of 351 million commercial area, could fetch $160 billion, according to Reason Foundation estimates. Many urban buildings and properties owned by the federal government across the country are not needed and could be sold. The U.S. also owns $12 billion in foreign real estate — some of which could be sold off.US role in promoting and assisting privatization in other countries has been significant. The US Agency for International Development has played a critical role in providing needed technical assistance to governments around the world in developing privatization programs. This technical assistance has helped to develop the infrastructure needed for privatization programs, promoted better policies and broader marketing of companies, and provided the expertise needed to facilitate informed, confident decision-making by governments in developing countries. This assistance in many countries has made a positive contribution toward speeding and sustaining the privatization process. Trends In Developing Countries According to World Bank data, privatization has become increasingly popular in developing countries over the past 10 years. In 1992, completed privatization in developing countries numbered in the thousands — raising $23.1 billion. The number of privatizing countries rose from 12 in 1988 to 43 in 1995. The value of the sales as a proportion of the gross domestic product (GDP) of the privatizing countries has remained fairly stable at about 0.5 percent from 1988 to 1995. The World Bank data cover 88 countries that sold $135 billion worth of assets in 3,801 transactions of more than $50,000 over the 1988-1995 period. Privatization have a particularly strong influence over decisions to invest, and each dollar of privatization revenue generates an extra 38 cents in new investment — with financial and infrastructure privatization having the most positive effect on other foreign direct investment.