# Review Study of Privatization in developing countries

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**Introduction:**

Privatisation is defined in more general terms as the transfer of ownership and control from the public to the private sector. Privatization has turned into a major phenomenon for the developed countries as well as the developing countries. Over the last decade, state-owned enterprises (SOEs) have been privatized at an increasing rate, particularly in developing countries. In this regard, Sader (1993) reports that total privatization proceeds in developing countries raised from $2.6 billion in 1988 to $23.2 billion in 1992 (not counting privatizations in former East Germany). Furthermore, the importance of privatizations in developing countries relative to that observed in developed countries increased dramatically. In 1992, the total sales volume in developing countries ($23.2 billion) was, for the first time, larger than the revenues generated by privatizations in industrialized countries ($17.3 billion). Spectacular numbers of privatisations also took place during the transition process in Central and Eastern Europe, with proceeds totalling US$240bns over the period 1988-2008 in addition to widespread free or subsidised share allocation to the general population (Estrin et al, 2009). The proceeds of privatisation have been more limited in Africa, the Middle East and South Asia, with total proceeds below US$50bns for each of these regions.

The objectives of privatization are numerous. Country studies show that these objectives include:

- Improving government cash flows by reducing subsidies and capital infusions to SOEs,
- Promoting popular concept of market economy through a wider ownership

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of shares,

- Satisfying foreign donors by reducing the government's role in the economy and especially enhancing the efficiency and the performance of the SOE sector based on the rationale that the private sector outperforms the public sector (Ramamurti, 1991).
- improving the efficiency of enterprises by increasing management autonomy and improving corporate governance;
- Allowing investment decisions to be subject to commercial factors and be financed by the private sector;
- Reducing the budgetary cost of public enterprises in order to create fiscal space for social sector investments.

In countries where capital markets are developed, privatisation is effected through the sale of the enterprise's equity to the public. In developing countries where capital markets are underdeveloped, divesture is likely to involve the sale of the enterprise as a complete entity or through some form of a joint venture. In cases where the government fails to sell the state owned enterprise or enter into a joint venture agreement with private interests, liquidation measures can then be instituted (Hemming, Richard and Mansoor M. Ali.1988).. In the discourse on public enterprises and privatisation, various issues surrounding the efficiency, economy and effectiveness of public enterprises are major tenets of the privatisation debate. Given the fact that public enterprise have become a drain on the budgets of governments due to various operational challenges, issues of their nature and form of operations have become central in the privatisation debate. The following are methods of privatizations.

**1. Direct Selling**

Internationally, direct selling is the most popular form of privatization method. This method represented 80% of the total transactions between 1988 and 1993, generating an equivalent of 58% of the total earnings (Sader, 1995), and also represented 86% of total transactions in 1986 (World Bank, 1996). Direct selling may take various forms, such as tenders, public auctions or selling to strategic investors. The common element in all these forms is the absence of middlemen as brokers between the two parties.

The tender method enables the state to compare different offers and choose the highest bidder. This method is notable for its clarity, as it uses a straightforward mechanism and the tender is open to all interested investors to take part in the competition for buying a company, on condition that they meet the required specifications set by the state.

However, critics of this method point out that it is slow, procedures may take a long time, and high administrative costs are involved. Nonetheless, this method has been used by a number of East European states in the privatization of shops and restaurants. Also it has been used by Arab countries such as Morocco in the privatization of a number of hotels (Dahel and Elhag, 1998).

On the other hand, the public auction method also involves a high level of clarity. This method is fast and simple, and enables the state to generate massive earnings from privatization. Its main drawback is that it will not allow the state to set its own terms and conditions for selling. Therefore, to secure a successful auction, the state would have to make every effort to persuade a sufficient number of competitors to take part, besides making sure that those competitors will not conspire to disrupt the bidding process. In ex-Czechoslovakia, for instance, the privatization of small businesses through public auctions was acknowledged for its efficient and fast procedures. The whole programme was completed within two years, generating total earnings of around $1.6 billion. The selling process will then take place through negotiations which will allow the state to impose its terms and conditions on the potential investors. However, direct selling to a strategic investor through negotiations is not an easy task, and it might be associated with various difficulties for developing countries, including the following:

a. The size of some of the companies to be privatised, local investors might not be able to secure the required capital. In this case, the state is likely to go for one of two options: either to sell the company to eligible foreign investors or, in case of strong opposition to selling to foreign investors, to sell the company by instalments based on estimates of future profits. Different forms of the latter option have been used in Estonia, Hungary and Poland (Grey, 1996, was quoted in Dahel and Elhag, 1998).

b. Distribution of ownership might appear to be an unfair process in direct selling privatization due to its lack of clarity, and because it will not allow the wider public to take part. Direct selling might be a slow and costly process, as it involves tedious negations every time a company is put on sale. This method also requires investors to be closely monitored so as to make sure that they deliver on their promises and commit themselves to the terms and conditions of the contract.

However, among the Arab countries, Morocco had used three methods for the privatization of hotels by the end of 1996. Around 44% of the hotels were sold through tenders which generated 26% of total earnings, whereas the relative shares of the total earnings for negotiated tenders and direct negotiations were estimated at 44% and 30% of total earnings respectively (El-Ftouh, 1997). The state of Kuwait, on the other hand, put on sale 40 million shares of the SOEs for shipbuilding and maintenance. This represented about 30% of the total shares sold through public auctioneering in the stock exchange at an initial price of 206 fils per share (El-Ftouh, 1997). The sale was broken up into four divisions; every division involving the selling of 10 million shares. This gave as many as possible local investors the chance to take part and consequently maximise share prices, which in turn maximised state earnings. Jordan is an example of one of the first states to try an experiment in strategic partnership (Sader, 1995). In the second half of 1996, Jordan put on sale around 20% of state shares in the cement manufacturing company, which is 49.5% state owned.

In the selling process Jordan targeted certain international companies which specialised in the cement industry in order to win a strategic partner for the purposes of developing the company technically, improving quality, boosting production, and exploring new markets.

**2. Management and Employees Buy-Out (MEBO)**

This method represents a sort of internal privatization; the ownership of the company may be wholly or partially transferred to its workforce and management. One of its advantages is popular support, in that the government will not need to negotiate the future of the workforce as this issue will be resolved by them together with management. Secondly this method is ideal for the privatization of companies that are difficult to sell by other methods. A third point is that selling by this method will be a great incentive to boost production at the minimum cost, because it will allow ends to be met for both workforce and management. A fourth point is that this method will constitute an effective tool for the creation of a broader base for ownership. This method has been used in a number of East European countries, and in Chile, and even in Britain.

Despite the above advantages, selling to the workforce and management has inherent defects. One of its drawbacks is that it will not seem fair in cases where it is applied indiscriminately to companies; that is, without distinctions made between successful and unsuccessful companies. In this case the managements and workforces of successful companies will have an advantage over others, whose suffering may increase. Moreover, giving the priority to the workforce and management will play down the role of competition as a major driving force in the process of privatization, due to its exclusion of other investors from outside the company. This will eventually result in the devaluation of the company, which will multiply the state's losses. Other drawbacks of the method include the fact that the new owners will be financially incapable of introducing new technologies and management skills in order to improve or boost production. Hence, for this reason most privatization processes by this method have so far concentrated on small companies, which mainly depend on manpower for their production processes.

The first major privatization of this type was in the United Kingdom with the sale of the National Freight Corporation in 1982 to a consortium of existing and retired employees and four banks (Berg, A. and Berg, E. 1997). This method was also used in Chile during the 1980s for the purpose of creating a broader base for private ownership, where 35% of the workforce in the public sector took part in buying shares, whereby the government gave priority to the workforce in buying these shares (Nankani, 1990).

However, to restrict monopoly the government had to introduce legislation that would not allow an individual or an organised group of individuals to buy more than 20% of the shares of the company in question. Also, to encourage them to buy shares, members of the workforce were given shares in exchange for their pension schemes, whereby these schemes were used as a guarantee for borrowing money from the government authority overseeing privatization at lower interest rates then the current market rates.

Moreover, the authority had committed itself to buy back the shares from members of the workforce if they were not satisfied with the return on these shares.

In Britain the state privatised national buses and the shipbuilding companies, after having created and developed a system that would link the fixed prices to the auction prices, whereby prices were carefully chosen to be attractive for the purpose of encouraging what they called "peoples' capitalism" (Vuylsteke, 1988). However, the main problem was that young investors would tend to sell their shares for profit once the markets were open for them. To overcome this problem, and in order to persuade them to keep their shares, the government decided that after a certain period of time (normally five years), the original shareholder would be rewarded with a number of free shares (one for every ten shares) provided that he was still the original shareholder. The rest of the shares were then put on sale to big investors.

**3. Privatization of Management**

This will boost the efficiency of SOEs by improving their management through the introduction of management techniques used by the private sector. The different form of management privatization, such as management contracts, leases and concessions, might be either an end goal or a transitional stage in the termination of state ownership. These methods are discussed briefly as following:

1- Management contracts are an agreement between a public sector organisation and a private sector company in which the latter will undertake management responsibilities in the former. Here the private company will run the public sector company without having the right of ownership to that company. However, the private company will impose charges for its services, with the possibility that these charges are likely to be linked to profits and performance. On the other hand, the public organisation will still be responsible for operational and investment costs. This method is normally used when the government intends to revive unsuccessful companies by introducing management techniques used by the private sector so as to render the company more valuable when put on sale. Experiments in many countries have proved management contracts to be successful for many economic sectors. In Lebanon, for example, management contract method has been used for three interrelated projects: garbage collection, incineration and recycling (Sadq, 1995).

Similarly, in Guinea Bissau this method was used for the electrical power sector in 1986, when the state asked for technical assistance from France for the development of this sector. A contract was made with the Department of Electric Power in France to assume the management of this sector, and this contact was renewed in 1991. The outcome was an increase in productivity and better administrative and financial performance (Kessides, 1993).

The main advantage of management contracts from the state's point of view is that they give the state the right to retain ownership of the company. Moreover, they enable the state to sort out problems of mismanagement through the employment of highly skilled managers, and at the same time keep control over those managers by the enforcement of the terms of the contract. The main disadvantage of management contracts lies with the duplication of the private and public ownership of the company, where the state and not the contractor has to take all the risk (Kikeri et al, 1994).

2. Leasing is a contract agreement between the utility owner (the public sector) and a private company. The contract gives the latter the right of using the utility for profit in a certain period of time in return for a lease charge. As opposed to management contracts, the private company has to take all

of the risks. This will be the main incentive for cutting down costs and for maintaining the utility value. However, the state still bears the responsibility for investment as well as the payment of debts. The period of lease may vary from 6 to 10 years, and this method has been widely used by a number of African and Asian countries in sectors such as water supply, transport and mining, which have struggled to attract investment (Hegstad and Newport, 1987).

Thailand in 1985, for example, made some of its passenger railway services available for lease. By the year 1990 the experiment was already a success, and the new railway services became very popular, generating huge profits (Kessides, 1993). The Ivory Coast is another example, where the electrical power sector had suffered severe deterioration in the 1980s. Hen in 1990, following the introduction of major reforms, this sector was taken over by two French companies and local investors via lease contracts. Earnings dramatically improved in the first eighteen months of the contract. Maintenance standards likewise improved following the introduction of modern technologies, which led to increases in electrical power and the development of better services (Kessides, 1993).

The main advantage of leasing is that it cuts down the costs of running the utility while it is still in state ownership. Also the state gains annual earnings without taking any risks, while also saving on sponsorship funds or any other financial commitments. Leasing also provides opportunities for the introduction of technical and managerial skills that will allow the use of the utility in a more efficient manner.

3. Concession contract which implies that the state gives the private company the right to run and develop the utility. In this sense, concession contracts contain all the elements of leasing in addition to the capital and investment costs which lie within the concessionaire’s duties. The utility is usually returned to public sector ownership after the expiry of the concession contract, which may extend from 15 to 30 years depending on the life expectancy of the investment. The running and investment costs as well as the debts will be likely to determine the earnings of the concessionaire. This method has been successful in countries such as Argentina, where it has been used in the railway sector (Kessides, 1993). Internationally, concession contracts in the area of infrastructure represented 80% of the total concession contracts for the period 1988-1993 (Sader, 1995).

The main advantage of the concession method lies in the fact that the concessionaire remains responsible for all capital and investment costs, which will tend to relieve the state of part of its financial burden. Nevertheless, for the same reason, it would be very difficult for many countries to find suitable investors, given, the huge costs of this kind of contract. A special kind of concession contract known as Build-Operate-Transfer (BOT) is used by the private sector to develop new infrastructure schemes. The main idea behind this kind of concession is that a private company undertakes the task of funding, establishing and operating a new infrastructure project, such as electrical power, water and irrigation or transport, for a certain period of time (concession period) at the end of which the utility will be handed over to the state.

However, during the concession period the state will undertake the duties of organisation and supervision. Different forms of this type of concession exist such as Build-Own-Operate (BOO), Build-Own-Operate-Transfer (BOOT), Build-Transfer-Operate (BTO) etc (Banerjee and Munger, 2004). Hence, the selection of a suitable form of concession depends on the circumstances of the project in question, such as the duration and type of potential investors (local, foreign, financial institutions, etc), as well as the risks involved.

Generally speaking, to ensure the success of management privatization in its all forms, contracts should clearly specify the nature of services to be provided by the contractor as well as giving a clear description of the duties and the responsibilities of each of the parties involved during the duration of the contract. Consequently this implies that the state should not interfere with company management, and instead should limit its duties to calling the company to account according to the terms and conditions of the contract.

**4. Public Share Offerings in the Stock Exchange**

This method is appropriate for big companies with good financial status. It implies putting the shares of the company on sale to the public, usually for a fixed price. A small sample of shares may be put on sale as an experiment first, as was the case with Egypt, Tunisia and Morocco. In the Egyptian example, 10% of the shares of 314 companies were put on sale in 1992, as an experiment to be implemented on a wider scale if it was successful. In fact that was exactly what happened. The experiment proved to be effective and people were persuaded to buy shares (Dahel and Elhag, 1998). This encouraged the government to put more companies on sale, giving close consideration to their status.

The Egyptian government also encouraged small investors to buy, in order to create a broader base for private ownership to include as many citizens as possible. The government also concluded that the transfer of ownership should be completed gradually; giving many guarantees to new owners and most importantly banning monopoly. The government also took certain measures to protect the workforces of the privatised companies, including the allocation of 10% of the company's shares to the workforce, rendering it a partner (Dahel and Elhag, 1998).

In the aftermath of the success of this experiment the Egyptian government put the shares of 15 companies in the manufacturing, food and engineering industries up for sale in 1996, whereby the ownership of these companies was fully transferred to Egyptian, Arab and foreign investors. The terms and conditions of the ownership of these companies involved an increase in their market activities and the sustenance of the nature and quality of the activities, the allocation of part of their products for export and safeguards to the rights of the workforce without government intervention.

The choice of those companies was based on the fact that they were engaged in activities similar to those in the private sector and their production would not affect national strategic security. The privatization of the companies was expected to generate around 15 thousand job opportunities. Sometimes the state might sell its shares in some companies in circulation, as is the case with the privatization programme executed by Kuwait since 1994.

Kuwait is one of the most significant Arab countries in the privatization of the public sector shares through the stock exchange, whereby the selling process is restricted only by market conditions and the interests of investors. However, the main aim of the privatization process was to create a broader base for ownership that would assist the development of the stock exchange. The local investment created by this programme was estimated at $1.65 billion in the form of state shares sold by the end of 1996 (Dahel and Elhag, 1998). Around $198 million of this was generated by the direct selling of state shares in the stock exchange, and the rest through other processes such as public offerings and underwriting. This method is highly regarded for its clear procedures, as the selling process is advertised and the all-financial bills of the company will be revealed according to the terms and conditions of the selling procedures in the stock exchange. To reduce risks, the state can sell its shares by general underwriting or otherwise through an entrepreneur, even though this might be costly. Also, the state can put shares on sale in both local and international markets.

The main advantage of the method of selling shares in the stock exchange, however, is that it will tend to create a broader base for private ownership, providing that the state imposes restrictions to limit the shares to be bought by any one investor. Moreover, this method will most likely contribute to the development of local markets, as was the case with some Arab and Latin American countries (Dasoki, 1995). On the other hand, selling shares in local and international markets is deemed to be the most important privatization method, representing 12% of all privatization methods used, and generating around 39% of total earnings between 1998 and 1993 (Sader, 1995).

The size of the market compared to the volume of shares on offer is likely to determine the success of this method of selling shares in the stock exchange. Consequently, smaller markets are likely to have negative effects on share prices. However, in case of small markets the shares could be sold in small portions one at a time (Sadq, 1995). This is what many developing countries do where big markets do not exist, such as in Arab countries like Egypt.

**5. Mass Privatization through Voucher Distribution**

Privatization through the voucher system is based on the quick transfer of a large group of public sector utilities to the ownership of a wider group of citizens. Hence this process implies the mass privatization of companies instead of dealing with them separately. The vouchers are usually issued in the form of certificates transferable to shares in public sector companies through public offerings. This method has been widely used mainly in transition economies, namely in Russia, the Czech and Slovak Republics, Lithuania and Poland, with slight variations in each case (Lieberman et al, 1995). In the former Czechoslovakia, for example, the first stage of privatization through the voucher method resulted in the selling of 1491 small utilities in 1992 (Hyclak and King, 1994). However, at the end of the second stage at the beginning of 1995, 80% of the utilities of the big companies were also privatised (Borish and Noel, 1996).

The mechanism of this method starts with the publication of a list of the group of companies to be privatised, including some information with regard to their financial performance, their book value, the size of workforce, debts, etc. Every eligible citizen has the right to obtain vouchers to allow him to take part in the public offering and bid for the companies to be privatised. In most cases the vouchers are free of charge, but are sometimes obtained for a minimum charge to cover administrative costs (Lopeze-Calva, 1998). The vouchers can be transferred directly to shares in the company through the auction, or otherwise can be invested in one of the privatization investment funds which have emerged as independent entities during the privatization process, especially in Central and Eastern European countries.

In some countries, however, such as Russia and the Czech and Slovak Republics, voucher holders can use them to buy shares in privatised companies, whereas in other countries such as Poland the vouchers are used for buying certificates issued by investment funds instead of buying shares directly (Dahel and Elhag, 1998). The main purpose of the voucher method has been to establish a market economy through the privatization of public sector companies as quickly as possible.

According to Lieberman et al (1995) other objectives include: (i) political, to give as many citizens as possible the opportunity to take part in the process of transformation to the market economy; (ii) social, the distribution of the ownership of utilities among as many citizens as is possible; and (iii) economic, to enhance market powers as well as the environment for economic competition.

The main advantage of mass privatization is that it tends to address the potential problems that might face the state when selling public sector companies. These problems are, in essence, the shortage in local capital to buy shares, and the vouchers are used for this purpose. This is one of the main barriers facing privatization via the auctioneering system in economies passing through a transitional state. Furthermore this method is unique for its fairness, as it gives every citizen the opportunity to buy vouchers, and therefore the selling process will not be limited to just a few investors. However, another important disadvantage of this method is that it imposes obstacles to the attraction of foreign investment and the transmission of financial, technical, and managerial expertise (Lopeze-Calva, 1998).

The main problem with the voucher method is that it will not per se lead to improvement in economic performance. This is for the simple reason that the distribution of ownership among a great number of investors will hamper efforts to improve performance, especially when the company is struggling in terms of the necessary capital and the right skills, which are essential elements in the market economy.

**Conclusion:**

- It is acknowledged that all countries need both a private and a public sector. The decision to provide any good or service in one or the other sector should be a pragmatic choice based on the appropriate criteria.
- It is generally agreed that public provision will mainly be appropriate where there would be severe market failures with provision by the private sector. Such market failures could create natural monopoly which prevents competitive pricing.

- It also recognised that problems and failures can occur in both the private sector and the public sector.
- The success of privatisation should be considered against the specific objectives of any particular programme. Since these objectives vary, there is a danger of declaring the policy a failure against one objective, when the key aims of the policy were something different.
- Where privatisation is pursued with multiple objectives in mind, it should be recognised that failure or partial success against one objective may not in itself constitute a judgement of policy error.
- Overall, the studies on developing economies show that private ownership alone rarely generates economic gains. The success of privatisation also depends on the regulatory framework which in turns depends on the institutional and political environment. Effective competition is also the key to bringing about performance improvements, as it is associated with lower costs, lower prices and higher operating efficiency
- Besides the impact of privatisation, there is a range of considerations relating to the process of privatisation. These concern how the government implements the privatisation process and whether effective corporate governance is created for privatised entities. Some privatisation programmes in developing countries have been associated with high levels of corruption and poor value to the public, as well as increasing levels of inequality.

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