Development (2018) 61:84–88
https://doi.org/10.1057/s41301-018-0187-0

DIALOGUE

Privatization Rarely in Public or National Interest

Kwame Sundaram Jomo[1] · **Anis Chowdhury**[2]

Published online: 13 November 2018
© Society for International Development 2018

Abstract Privatization of state owned enterprises (SOEs) has been a key plank of the neo-liberal counter-revolution against economic development since the 1980s. Privatization's promoters promised improved efficiency and improved fiscal balances, both supposedly contributing to higher economic growth. Privatization was also supposed to ensure improved consumer welfare through increased competition and lower prices. Empirical support for these claims is scant and often contradictory. Thus, in many cases, privatization has been worse as a solution to the ills it purported to overcome. The problems of SOEs are not necessarily due to public ownership per se. In any case, there are alternative governance, management and organization means to improve SOE performance without privatization.

Keywords Neoliberal · State-owned enterprise · Profit · World Bank · IMF

Privatization has been central to the neo-liberal counter-revolution against development economics and government activism from the 1980s. Many developing countries were forced to accept privatization as a condition for support from the World Bank while many others voluntarily embraced privatization, often due to real or exaggerated fiscal and debt constraints.

✉ Kwame Sundaram Jomo
jomoks@yahoo.com

Anis Chowdhury
anis.z.chowdhury@gmail.com

1 Khazanah Research Institute, Kuala Lumpur, Malaysia

2 School of Social Sciences and Psychology, Western Sydney University, Sydney, Australia

Privatization generally refers to changing the ownership of a business, service or industry from state, government or public to private hands. It sometimes also refers to using private contractors to provide services previously provided by the public sector.

Privatization can be strictly defined to only include cases of eventual 100%, or at least majority ownership of a public or state-owned enterprise (SOE), or its assets, to private shareholders. The definition of privatization is so broad in some contexts to include cases where private enterprises can participate in activities previously the exclusive preserve of the public sector.

Historical Origins

Privatization is not a new phenomenon, arguably dating back millennia.[1] Britain privatized its steel industry in the 1950s, while West Germany conducted large-scale privatization, including sale of a majority stake in Volkswagen to small investors in public share offerings in 1961. The most common reasons cited for privatization were cost savings and efficiency improvements.

The current wave of privatization worldwide began with the divestiture of SOEs in the United Kingdom by the Thatcher Government during the 1980s. This policy shift can be traced to the unexpected coincidence of high unemployment and inflation, referred to as 'stagflation', from the mid-1970s, which undermined confidence in Keynesian macro-economic policy prescriptions.

This 'neoliberal' counter-revolution against Keynesian and development economics marked the rise of the *laissez-*

[1] Parker and Saal (2003); see also Jomo (2008); for an earlier assessment Jomo (1995).

faire or market fundamentalism, dominated by and serving corporate interests. But there was little privatization in the United States which never had many SOEs to begin with.[2] Nevertheless, US President Ronald Reagan embraced privatization advocacy in his prosecution of the Cold War. Government intervention abroad was deemed 'socialist', to be terminated and dismantled.

Balance of payments problems following the oil shocks in the 1970s and the US Fed's interest rate hike in the early 1980s precipitated sovereign debt crises in Latin America and elsewhere. This forced many countries with already heavy foreign debt obligations to seek emergency credit from the International Monetary Fund (IMF) and the World Bank.

The Fund and the Bank attributed developing countries' inability to adjust to these external shocks, *inter alia*, to their import-substituting industrial policy initiatives and SOE inefficiency. So, emergency credit support from them typically came with conditions to undertake measures for 'stabilization' and 'structural adjustment' which included privatization.

Privatization was portrayed and advocated as an easy means to accelerate growth, improve efficiency and productivity, shrink the public sector and associated debt, as well as reduce governments' financial and administrative responsibilities and activities.

The Bank and the Fund's 'neoliberal' policy conditionalities and prescriptions—involving economic liberalization, deregulation and privatization—became the new 'conventional wisdom' shared by the emerging Western Anglophone establishment. This came to be known as the Washington Consensus, referring to the common views of major financial institutions—the US Treasury, the IMF and the World Bank—based in the US capital city.

From the 1970s, various studies portrayed the public sector as a cesspool of abuse, inefficiency, incompetence and corruption. Books and articles with titles including terms such as 'vampire state' and 'bureaucrats in business' (World Bank 1995; Frimpong-Ansah 1992; Ayittey 2002). provided the rationale and justification for privatization policies. Notwithstanding the caricature and exaggeration, there undoubtedly were horror stories which could be easily cited as supposedly representative.

But to avoid marginalization by the new narrative, it became convenient to obscure and ignore evidence that SOEs could be well run, even on commercial bases, contradicting the dire predictions of the prophets of inevitable public-sector doom. For example, China's Bao Steel and South Korea's Pohang Iron and Steel Company (POSCO), both SOEs, have long been acknowledged as the world's most efficient steel producers, boasting the lowest costs in the world (Kim 1997).

Rationale

Privatization was recommended and advocated as the best, if not the only means to:

- 'promote competition, improve efficiency and increase productivity' in the delivery of public services;
- 'better consumer welfare';
- reduce 'the presence and size of the public sector, with its monopolistic tendencies and bureaucratic support';
- diminish the 'financial and administrative burden of the government', particularly in providing and maintaining services and infrastructure;
- 'stimulate private entrepreneurship and investment'; and thus,
- accelerate economic growth.

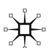
To be sure, unclear and contradictory objectives—e.g., to simultaneously maximize sales revenue, address ethnic or spatial disparities, generate decent employment, etc.—often led to ambiguous performance criteria, many open to abuse. SOE failure on one criterion (e.g., cost efficiency) was often justified in terms of fulfilling other objectives (e.g., employment generation). However, such ambiguity and conflation of objectives were rarely due to public or state ownership per se.

Problems of co-ordination among various government agencies and inter-departmental rivalries have been important. Some consequences have included ineffective monitoring, insufficient accountability, and over-regulation.

'Moral hazard' has also been a problem as SOE managements expected sustained financial support from the government, come what may, causing weak fiscal discipline or 'soft budget constraints' (SBCs).[3] However, government bail-outs of 'too big to fail' privately owned financial institutions in the wake of the 2008–2009 global financial crisis demonstrate that moral hazard and SBCs do not depend on ownership. As the long and widespread history of public 'bailouts' and 'bail-ins' of failed private

[2] Complete privatization of public assets to private investors in the US was limited prior to 1992 due to federal regulations that required state and local governments to fully reimburse the federal government for grant monies received for infrastructure assets upon the sale of those assets. See Commission on Government Forecasting and Accountability, State of Illinois (2006).

[3] A term associated with Hungarian economist, Janos Kornai. The 'softening' of the budget constraint appears when the strict relationship between the expenditure and earnings of an economic unit (firm, household, etc.) has been relaxed, because excess expenditure will be paid by some other institution, typically by a paternalistic state (Kornai 1986).



enterprises demonstrates, the prevalence of SBCs can be better explained by their 'political desirability'.

SOE budgets can be and have been 'hardened' by changing incentives. Changing institutional mechanisms and credible policies have served as 'internal incentives', effectively ending SOEs' expectations of SBCs without privatization. At the same time, market forces have provided 'external incentives' and disincentives to discipline managers' and owners' corporate performance.

Often, SOE managements lacked adequate or relevant skills, but were constrained from addressing them expeditiously. But privatization does not automatically solve such problems of inadequate technical or managerial skills.

Many SOEs enjoyed monopoly or monopsony powers *de jure* or de facto, which often served to obscure inefficiencies and abuses. Hence, competition and enterprise reorganization and incentives—rather than mere changes in ownership through privatization—are more likely to induce greater enterprise efficiency. Similarly, privatization of state-owned public utilities (e.g., water supply), which are natural monopolies, will not overcome problems of inefficiency due to the monopolistic or monopsonistic nature of an industry or market segment.

Misleading Claims

Arguments for privatization can be refuted on the following grounds:

- The public sector can be more efficiently run, as demonstrated in Singapore and South Korea, for example. Greater public accountability and a more transparent SOE sector can ensure greater efficiency in achieving the public and national interest while limiting public sector waste and borrowing.
- Principal-agent problems between owners and managers, such as information asymmetries and monitoring difficulties leading to inadequate accountability and enterprise failures, are not only confined to SOEs. Inadequate corporate governance was identified as a major contributory factor in the collapse of the Lehman Brothers that triggered the global financial meltdown in 2008.
- Pressure to ensure more equitable distribution of share ownership (e.g., via 'voucher privatization') may inadvertently undermine shareholder pressures to improve corporate performance since each shareholder would then only have small equity stakes, and would therefore be much less likely to incur the high costs of effectively monitoring corporate management and performance.
- Therefore, even though it is an article of faith for some that SOEs must be less efficient or, at least, less profitable than privately owned firms, to date, the empirical evidence is mixed. Whether SOEs are more or less efficient than private firms largely depends on specific circumstances, including enterprise organization and incentives, rather than being determined by an enterprise's ownership status (Dewenter and Malatesta 2001).
- Privatization may postpone a fiscal crisis by temporarily reducing fiscal deficits, but the public sector would lose income from profitable activities, and be stuck with financing and subsidizing unprofitable ones. Fiscal crises may even become more likely if the new owners of profitable SOEs avoid or minimize paying taxes, sometimes due to the typically generous terms of privatization.[4] Fiscal gains are typically short of the claims made by privatization proponents as public asset under-pricing is common to ensure privatization's popularity.[5]

Privatization gives priority to private profit maximization, at the expense of social welfare, equity and the public interest. It tends to adversely affect public sector employees and the public, especially poorer consumers who face heightened access barriers as the new profit-maximizing private owners raise prices or user charges following the privatization of public utilities such as water supply (Wood 2004; Beder 2005; Cortina de Cardenas 2011; Corporate Accountability 2012). By diverting private capital, from productive new 'greenfield' investments to 'brownfield investments', to buy over public-sector assets, economic growth would be retarded, rather than enhanced.

Cure Worse than Malady

However, the privatization experiences of the last four decades have generally been anything but salutary, especially for developing countries. Privatization has not provided the miracle cure for the problems (especially the inefficiencies) associated with the public sector.

The public interest has rarely been effectively served by private interests taking over public-sector activities. Privatization was supposed to free market forces and

[4] For example, the Sydney Airport Corporation did not pay any tax for at least 10 years after its privatization despite earning nearly AUD8 billion while enjoying tax benefits worth almost AUD400 million. See http://www.smh.com.au/business/airports-pot-of-gold-20130822-2segw.html.

[5] See, for example, Dewenter and Malatesta (1997); they report on under-pricing in privatization programmes of eight countries; Jones et al. (1999) presents similar findings from their coverage of 630 share issue privatizations.

encourage competition, but the new owners have an interest in retaining the SOE's 'competitive advantages', including monopoly positions.

Hence, there has been widespread concern about: (1) formal and informal collusion, e.g., cartel-like agreements; (2) collusion in bidding for procurement contracts and other such opportunities; and (3) interested parties enjoying special influence and privileged information.[6]

As a matter of fact, both the IMF and World Bank were aware of such likely adverse impacts of privatization.[7] However, Fund and Bank safety-net or compensation proposals were either too costly for the public exchequer or too administratively burdensome for most developing countries due to targeting requirements.

Since a significant share of state-run activities are public monopolies, privatization will hand over monopoly powers to private interests likely to use them to maximize profits at public expense. Privatization of public services tends to burden the public, especially if charges are raised for privatized services which may not even improve with privatization. 'Value for money' may go down, despite modest improvements used to justify higher user charges.

Private interests are mainly interested in lucrative or potentially profitable activities and enterprises. Thus, the government will be saddled with unprofitable and less profitable activities, reinforcing the impression of SOE inefficiency. Consequently, privatization may worsen overall public-sector performance.

Privatization in many developing and transition economies has primarily enriched a few with strong political connections who 'captured' the most lucrative opportunities associated with privatization, while the public interest has been sacrificed to such powerful private business interests. This has, in turn, exacerbated problems of corruption, patronage, clientelism, 'rent-seeking' and other related problems.

Privatization created two types of services, i.e., one for those who can afford more costly, private—including privatized—services, and another for those who cannot, and hence, have to continue to rely on subsidized public services, e.g., medical services and education. Such social differentiation has important social and political implications, especially in democratic societies with egalitarian ethos or promises.

Minimal long-term investments by private owners, narrowly focused on maximizing short-term profits, will undoubtedly have adverse effects, eventually undermining public service delivery. 'Economic costing' of utilities, e.g., water supply and electricity, has generally increased living costs and compromised service delivery, especially in remote and rural areas. All too often, employees of privatized concerns have experienced reduced employment, promotion prospects, overtime work opportunities and real wages following privatization.

Thus, privatization has not proved to be the universal panacea for the myriad problems of the public sector it was touted to be. In many instances, the problems of an SOE have little to do with its ownership per se. While some improved services may have followed, and often been misleadingly attributed to privatization, it has often also reduced consumer and employee welfare, compromised national and public interests, concentrated wealth, and worsened corruption and other abuses, rather than achieved most of the benefits promised by its advocates.

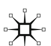
Therefore, instead of presuming that privatization is the only solution, the variety of modes of enterprise reform, marketization and other measures, including privatization, should be considered as alternative options for improving the public sector. With such an approach, privatization becomes one among several options available to the government for dealing with the undoubted malaise of many public sectors and SOEs. There may well be instances when privatization offers the superior option (e.g., the UK privatization of National Freight to its staff or the Hungarian privatization of retail shops), but this should be the policy conclusion after careful consideration of options available rather than the default option it became in recent decades.

Alternatives Need Consideration

Many SOEs have undoubtedly proven problematic, often inefficient. As mentioned earlier, all too often, they may be due to the absence of explicit, feasible or achievable objectives, or the co-existence of too many, often contradictory goals. In other cases, the absence of appropriate good managerial and organizational systems (e.g., with suitable elements of flexibility and autonomy) and cultures

[6] Admitting that privatization has damaged the economy, such concerns led a leading advocate of privatization, Rod Sims, Chairman of the Australian Competition and Consumer Commission, to the verge of becoming an anti-privatization critic. Referring to the outcomes of the sale of ports and electricity infrastructure as well as the opening of vocational education to private companies, he noted, 'I've been a very strong advocate of privatization for probably 30 years; …I'm now almost at the point of opposing privatization because it's been done to boost proceeds, it's been done to boost asset sales and I think it's severely damaging our economy.' http://www.smh.com.au/business/privatisation-has-damaged-the-economy-says-accc-chief-20160726-gqe2c2.html.

[7] For example, 1999 IMF research found that privatization 'can lead to job losses, wage cuts and higher prices for consumers' (Gupta et al. 1999). 1997 World Bank research on the experiences of Argentina, Bangladesh, Chile, Ghana, Malaysia, Mexico, Sri Lanka and Turkey in 1997 found large-scale employment losses when big SOEs were privatized (Kikeri 1997).



supportive of such goals and objectives may be the key problem.

Improvements in SOE management must be required by the national political leadership and enabled by increased administrative autonomy, new incentive systems and greater accountability. Such changes are achieved with greater decentralization or devolution of managerial authority and other innovations.

It is also relevant to consider the circumstances of the establishment of SOEs. Some SOEs were set up because the private sector was found to be unable or unwilling to provide certain services or goods. Such arguments may still be relevant in some cases, no longer relevant in other cases, and perhaps, never even true or relevant in yet other cases.

Privatization may facilitate achievement of organizational goals or objectives with the changes it may inadvertently bring about, but even this does not make privatization per se responsible for such improvements. In such cases, SOE managerial and organizational reforms without privatization may well have achieved the same objectives and goals, or even do better, at lower cost, and thus prove to be a superior alternative. Clearly, the best option cannot be presumed a priori, but should instead follow from careful consideration of the origins and causes of an organization's malaise.

The widely acknowledged failure of most privatizations, in terms of advancing the public interest, and often by the rationale and criteria for privatization announced by the government, and not infrequently, even judged by the performance of the privatized enterprises themselves, has forced governments and their advisers to retreat from further privatizations. Thus, the new favoured policy approach even before the end of the century has been to promote public–private partnerships (PPPs) in place of the old Washington Consensus' straight-forward promotion of privatization, which appears to have become discredited in the process, and thus run its course.

However, PPPs can hardly be regarded as more desirable alternatives to privatization. PPPs have often promoted private interests at the expense of the public and national interest. Many PPPs have also worsened fiscal balances and vulnerabilities due to biased risk-sharing forcing governments to bear the main burdens of failure due to cost escalation or revenue shortfalls. In sum, PPPs do not necessarily ensure better value for money or more equitable outcomes compared to straightforward public investments.

References

Ayittey, George. 2002. Analysis: Why Africa is poor. *The Daily Telegraph*, 27 Aug. http://www.telegraph.co.uk/news/worldnews/africaandindianocean/1405540/Analysis-Why-Africa-is-poor.html.

Beder, Sharon. 2005. Critique of the Global Project to Privatize and Marketize Energy. https://www.uow.edu.au/~sharonb/critique.html. Accessed 8 Nov 2018.

Commission on Government Forecasting and Accountability, State of Illinois. 2006. *Government Privatization: History, Examples, and Issues*. http://cgfa.ilga.gov/Upload/2006Gov_Privatization_Rprt.pdf. Accessed 8 Nov 2018.

Corporate Accountability. 2012. Shutting the spigot on private water: The case for the World Bank to divest. https://www.corporateaccountability.org/resources/shutting-spigot-private-water-case-world-bank-divest/. Accessed 8 Nov 2018.

Cortina de Cardenas, Susana Maria. 2011. Does private management lead to improvement of water services? Lessons learned from the experiences of Bolivia and Puerto Rico. Ph.D. thesis, University of Iowa. http://ir.uiowa.edu/etd/941. Accessed 8 Nov 2018.

Dewenter, Kathryn and Paul Malatesta. 1997. Public Offerings of State-Owned and Privately-Owned Enterprises: An International Comparison. *Journal of Finance* 52: 1659–1679.

Dewenter, Kathryn and Paul Malatesta. 2001. State-Owned and Privately Owned Firms: An Empirical Analysis of Profitability, Leverage, and Labor Intensity. *American Economic Review* 91(1): 320–334.

Frimpong-Ansah, Jonathan. 1992. *The Vampire State in Africa: The Political Economy of Decline in Ghana*. Trenton, NJ: Africa World Press.

Gupta, Sanjeev, Henry Ma and Christian Schiller. 1999. Privatization, Social Impact, and Social Safety Nets. IMF Working Paper No. 99/68.

IMF Working Paper No. 99/68, May. https://www.imf.org/en/Publications/WP/Issues/2016/12/30/Privatization-Social-Impact-and-Social-Safety-Nets-3030.

Jomo, K.S. (ed.). 1995. *Privatizing Malaysia: Rents, Rhetoric, Realities*. Boulder, CO: Westview Press.

Jomo, K.S. 2008. A Critical Review of the Evolving Privatization Debate. In *Privatization: Successes and Failures*, ed. Gerard Roland, 199–212. New York: Columbia University Press.

Jones, Steven L., William L. Megginson, Robert C. Nash and Jeffry M. Netter. 1999. Share Issue Privatizations as Financial Means to Political and Economic Ends. *Journal of Financial Economics* 53: 217–253.

Kikeri, Sunita. 1997. Privatization and Labor: What Happens to Workers when Governments Divest? World Bank Technical Paper 396, Washington, DC.

Kim, Jung. 1997. The Success of Pohang Iron and Steel Vo. Ltd. (POSCO): Perfecting Internal and External Incentive. *The Korean Journal of Policy Studies*, 12: 23–44. http://s-space.snu.ac.kr/bitstream/10371/70280/1/kjps_12_23-44.pdf.

Kornai, Janos. 1986. The Soft Budget Constraint. *Kyklos* 39(1): 3–30.

Parker, David and David Saal (eds.). 2003. *International Handbook on Privatization*. Cheltenham: Edward Elgar.

Wood, Randall S. 2004. The Privatization of Public Utilities: What are the Gains? Why the Popular Opposition? https://indypendent.org/wp-content/uploads/2012/08/privatization.pdf. Accessed 8 Nov 2018.

World Bank. 1995. *Bureaucrats in Business: The Economics and Politics of Government Ownership*. New York: Oxford University Press for World Bank, Washington, DC.