Public Enterprise at the Crossroads

What is the future for public enterprise? In many parts of the world it is going through a crisis. Privatization is being advocated as the solution to the many problems associated with its organization and management. This book focuses on the underlying causes of those problems and looks critically at some of the solutions adopted.

The contributors analyse the experiences of countries in four continents, using a rich blend of survey material, individual country reports, and chapters on specialist topics such as the role of the World Bank. They find a recurrent pattern, with political problems as well as economic ones, and bureaucracy and administrative confusion at the heart of poor financial performance. In the solutions they propose, the contributors emphasize the wide variation of circumstances which can affect performance in public enterprises: political aims, economic environment, administrative and managerial capabilities, and culture.

The wide experiences represented in this book will be of immense practical value to policy makers world-wide concerned about the future of public enterprises in their countries. It will also be of interest to advanced students of economics, politics, and development studies.

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Frontispiece: V.V.Ramanadham (photograph by Ravi Photo Studio, Bank Street, Hyderabad)
Public Enterprise at the Crossroads

Essays in Honour of V.V.Ramanadham

Edited by John Heath
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Preface

This book is written in honour of Professor V.V.Ramanadham, and to mark his seventieth birthday. He has written about many of the ideas in it at some time or other himself. Most of the authors are his personal friends. As someone privileged to be in that position, I hope this book is a fitting tribute to his inspiration.

Rama is a man of peace. Gentle, kind, unassuming, yet with the great gift of inspiring others; and of getting things done. To meet him he might not strike you as a dynamic person, until you ask what he has been doing. Then your head will spin. He goes everywhere. And his plans for the future seem to take no account of age or time. He will carry on, surely, for ever.

He lives in many worlds. To English speakers he is a distinguished academic whose main focus for the past forty years has been research in the field of public enterprise. He has several books and many articles to his credit, and his latest book, The Economics of Public Enterprise, is a comprehensive work based on his long experience in the field.

He has also developed a talent for gathering together people from all parts of the world to make intellectual progress in some aspect of the field, inevitably adding his own striking contributions to the debate.

To those who speak Telugu, his native tongue, he is a different man. His poetical works, plays, operas, novels, stories, and essays of literary criticism mark him as a man of culture, an intellectual of distinction, a thinker on a grand scale. Universities have prescribed his work as textbooks. His plays and operas in the classical Indian style have been widely performed.

His academic career began in 1938 as an undergraduate at the Andhra University, Waltair, a coastal town 300 miles east of Hyderabad. Here he also took his first doctoral degree, a study of railway finance, and for sixteen years from 1941 he served on the Faculty.

Between 1949 and 1951 he attended the London School of Economics, where he undertook doctoral research into the just-nationalized electricity supply industry. As a Nuffield Fellow in the UK, he wrote a study in 1958
on ‘Public Enterprise in Britain’, in which he argued for ‘clear rules’ in the government’s control of public enterprise, and he discussed issues of cross-subsidization and self-finance.

As Dean of the Faculty of Commerce and Business Administration at the Osmania University, Hyderabad during 1959–70, he created a research focus for its activities, especially in relation to public enterprise, and edited the semi-annual journal *Applied Economic Papers*, which published research papers from around the world.

At that University in 1964 he was also Founder-Director of the Institute of Public Enterprise, which was devoted to research, consultancy, and training. There he developed his skills in organizing seminars directed towards serious substantive issues. As I discovered on a visit to the Institute in May 1989, under its present Director, T.L.Sankar, it remains a lively place, humming with activities, and with good contacts —through consultancy and in other ways— with public enterprise in India and abroad.

Rama’s other contributions have also been substantial. In India he has been a member of the boards of directors of Bokaro Steel Ltd and of the Andhra Bank Ltd, a member of the Major Ports Commission, a member of the Wage Boards on Cement, Chemicals and Fertilisers, a member of the Research Programmes Committee and of the Panel of Economists of the Planning Commission, and a member of the Indian Council of Social Science Research. But it is on the world scene that his contributions have been greatest.

In 1970 he became an advisor of the United Nations in New York on public enterprise and technical assistance projects. He travelled to many developing countries on technical advisory assignments. As he himself admits, the learning process moved in both directions, and the experience he gained greatly increased his own effectiveness.

In the early 1970s he helped to form the programmes of both the Economic Commission for Latin America and the Asian Pacific Development Centre, and from its inception he made crucial contributions to the development of the International Centre for Public Enterprises in Developing Countries in Ljubljana, Yugoslavia. He helped to design seminars for the Commonwealth Secretariat in Kingston, New Delhi, Mauritius, Colombo, and Ghana.

On retirement from the UN in 1982 he spent over a year at the London Business School. The seminars which he held resulted in a book entitled *Public Enterprise and the Developing World*.

Following three years (1984–7) as a UN Advisor on Parastatals with the Kenyan Government, he returned to the UK to become a Visiting Academic at Templeton College, Oxford. There in 1987 he conducted a series of seminars, and in 1988 he organized the Interregional Workshop on Privatization in Developing Countries, sponsored by the United Nations Development Programme (UNDP). As a result, he edited two books:
Preface

Privatization in the UK and Privatization in Developing Countries, the latter dedicated to the United Nations.

He is currently the Coordinator of the UNDP-sponsored Interregional Network on Privatization.

He has a deep devotion to the cause of developing countries and an abiding faith in the United Nations. He has described the UN as ‘the one living hope of mankind’.

JOHN HEATH
London
Part one

Introduction
Chapter one

Survey of contributions

John Heath

In many developing countries public enterprise has reached the crossroads. Its future is uncertain. In some places, it is no exaggeration to say it is in crisis.

The aim of this book is to examine the public enterprise experience in many parts of the world, especially, but not exclusively, in developing countries. What are the real problems, what solutions are being sought and tried, and what are the results?

Its purpose is to provide guidance from this broad international experience, so that as countries reach a turning point they can more easily decide which path to follow.

The structure of the book is as follows. Part two consists of two survey chapters. In chapter two Dr Ramesh Adhikari and Professor Colin Kirkpatrick examine the scale and performance of public enterprise in a wide range of developing countries, largely through careful summaries of the methodology and results of research by other specialist authors. It sets the scene for the whole book. The powerful message of this chapter is the importance of meticulous care if valid conclusions are to be derived from the analysis of national statistics. Even so, the difficulties of study are immense.

The other survey, in chapter three, is quite different. Dr Esther Brimmer and David Thompson illustrate many of the general principles involved in considering the future of public enterprise through the detailed analysis of the privatization of what is now British Telecommunications plc. It is an important story of public policy formation and execution, and stands in its own right as an example of the complexities of privatizing what many would regard as a natural monopoly.

Part three comprises eight country reports on public enterprise, from the People’s Republic of China, Hungary, India, Malaysia, francophone Africa, Argentina, Chile, and Greece, respectively.

There are seven chapters on specialist topics in part four. These include the role of public enterprise in economic and social development,
‘performance contracts’, the role of holding companies, divestiture in a developing country, the political economy of public enterprise, and cultural change, especially in the context of privatization. These chapters also contain country material relating to Sri Lanka, Sudan, India, Pakistan, and Italy.

In addition, the World Bank’s role and experience in aid to African countries is reported in an important specialist contribution by Myrna Alexander (chapter twelve), which is itself a survey of thirty-four countries, though different in orientation from that by Adhikari and Kirkpatrick.

Symptoms

The major cause for concern both within developing countries themselves and internationally has been the large scale of financial losses, in some countries rising and in others falling, incurred by public enterprises. As Adhikari and Kirkpatrick cautiously conclude:

> The weight of evidence surveyed on financial performance seems to support the conclusion that public enterprise performance has been unsatisfactory. In most cases these enterprises failed to generate sufficient revenue to cover their recurrent costs...and they have contributed significantly to the macro-economic problems, particularly external debt, experienced in many developing countries.

Alexander also reports from a World Bank survey which concludes that:

> public enterprises have contributed little to national savings and are a major source of savings-investment gaps, which in turn are closely correlated with current account imbalances...and in sub-Saharan Africa poor enterprise performance has contributed to overall macro-economic imbalance.

Moreover, careful studies of like-with-like reported by Adhikari and Kirkpatrick show that, with a number of important exceptions, productivity levels have been lower in the public sector than in the private sector —although productivity growth has often been higher. ‘X-efficiency’ (cost reducing efforts, modernization and structural adjustments to meet market needs) is also found to be lower in public enterprises.
These general findings have been confirmed by many of the more detailed studies from authors in this book. For example, Dr Venugopal Reddy, writing about India in chapter six, says that from the mid-1960s the 700 or so public enterprises ‘came to be identified with unplanned and unwarranted expansion, inefficient operations, poor service, and large financial losses’. This led to several studies in the early 1980s to try to find a solution. Since 1985, under the New Economic Policy, many changes have been introduced, although there is still disappointment with public enterprise performance.

In 1988 the Malaysian government had equity in 1,133 companies. In chapter seven Dr Mavis Puthucheary reports that nearly one half of the 770 public enterprises which were under scrutiny by the government in that year were making losses, which in total value significantly exceeded the profits of the remainder.

In the People’s Republic of China the financial losses of state enterprises are expected to be Rmb 52 billion (=US$14 billion) according to the 1989 budget. Adding other subventions to state enterprises, the total amounts to 28 per cent of national revenue—which, if the figures are to be believed, is more than double the cost of defence. (On top of these subsidies to state enterprises is Rmb 41 billion expenditure for price subsidies.)

It appears also that, according to Alexander, public enterprise performance in Asia has been consistently better than in Latin America, and that in Africa it has been the worst of all. Moreover, in chapter eight, Professor Alfred Saulniers finds that public enterprise performance in francophone African countries has exceeded that of anglophone countries in Africa. It is an interesting and important question as to why there should be such systematic differences.

Causes

Governments

The most powerful message which comes through reading this book is that often the ultimate responsibility can be laid at the door of governments. Some are inept, others inefficient, a few ideologically blinkered. There can be abrupt and drastic changes in policy. In many countries there are simply too many public enterprises for the administrative capabilities available in government. Corruption is not unknown. Public enterprises, being close to government, do not thrive under these conditions.

There are exceptions. The situation is far from uniformly gloomy. There are also some marked improvements in recent years, but the learning process is long.
For example, Professor William Glade, writing about Chile in chapter ten, notes that:

The Allende episode (1970–3) brought with it a wildly aberrant expansion of the state that enlarged the scope of public management far beyond the capability of the administrative machinery to handle its new responsibilities.

In the muddle and confusion which followed, many of these newly formed public enterprises took advantage of the situation and ‘the payrolls of almost all agencies of government came to be bloated, as did the employee rolls of the firms brought into the public sector’.

Fortunately this experience was short-lived, the lessons were learnt, and the efficiency of the post-1985 privatization programme provided a sharp contrast.

In Argentina, as described by Dr Horacio Boneo and Enrique Waterhouse in chapter nine, government policy towards public enterprise has stumbled from expedient to expedient, new control agencies have been piled one on top of another while the earlier ones struggle to retain their power. Financial management in the public sector has been a constant problem— ‘in most cases central government administrative capability is of such low quality that projects only undergo superficial analysis’ — and arbitrary financial restrictions have had many different kinds of dysfunctional and costly consequences.

The major programme of divestiture in Pakistan from 1977, as described by Riyaz Bokhai in chapter sixteen, was brought about from a realization that ‘the public sector just did not possess the necessary administrative machinery and managerial skills to operate and control successfully such a large number of small units spread all over the country’.

In chapter eleven, Professors Spyros Lioukas and Demetrios Papoulas describe the numerous detailed matters on which public enterprises in Greece need authorization and the many supervising bodies from which they have to obtain consent. The exact functions of these agencies are so unclear, inconsistent and uncoordinated that a single decision may be taken to make different decision-makers in search of approval.

The focus of their chapter is a carefully executed and richly woven econometric study of 110 Greek public enterprises. This identifies which factors are most closely associated with good performance. Intensity of state control, competition, internal decentralization and internal management systems all come under
statistical scrutiny. State controls, which in general are very tight, are negatively associated with enterprise effectiveness—however measured.

In chapter four Professor Hua Sheng and Dr Du Haiyan describe how, since the reform of public enterprise in the People’s Republic of China commenced at the end of 1978, there has been a series of experiments with the decentralization of state control—no single system was all pervasive. Most ran into great difficulties, and by the end of 1984 they had come to a halt. Efficiency had not been raised and internal inconsistencies had become apparent. New methods were then tried: leasing small enterprises, an ‘assets management responsibility’ system for top management appointments and control (described below), a ‘share capital system’, and, becoming widespread after 1986, ‘contracts’ between each enterprise and the administration. Most of these have run into difficulties, generally from heavy-handed administrators who lacked the commitment necessary to ensure success.

The 69 Articles of the April 1988 ‘Law of the People’s Republic of China on Industrial Enterprises Owned by the Whole People’ entrench what would appear to a Western observer to be some of the problems. For example, the parallel hierarchy of political and managerial control is retained. Article 8 states that:

The grassroots organization of the Chinese Communist Party in the enterprise shall guarantee and supervise the implementation of the guiding principles and policies of the Party and the State.

And Article 35 states that:

The enterprise must fulfil the mandatory plans. The enterprise must perform economic contracts concluded according to law.

There are, incidentally, nearly 400,000 public enterprises in China, including 87,000 state-owned and 300,000 ‘collectively-owned’ industrial enterprises, which are state enterprises attached to lower administrative levels.

But Hua and Du do not mention this new law in their chapter because ‘in China the law is not very important and has little effect. What matters is the political trend, and a directive or request today is much more important than what happened yesterday. For example, since the events in Tian An Men Square a new document has been issued which emphasizes the central role that the
Communist Party should play. Who makes the directive is also important.'

In chapter five Dr Zoltán Román describes how in Hungary, with 1,043 public enterprises in 1988 (and a US$17 billion external debt in convertible currencies), rigid adherence to the central plans are no longer required but there is still ‘bargaining, manipulation and manoeuvring’ in the administrative controls over prices, subsidies, tax-exemptions, preferences and special rules of regulation. ‘Intense bargaining’ between individual enterprises and the government administration is also common in China, as Hua and Du mention.

In Hungary, weak market competition has been accompanied by increasing non-market competition. Román distinguishes between formal and informal non-market competition. In the former, enterprises submitting plans for R & D, investment, subsidies, grants, etc. ‘compete for a favourable decision’. In the latter there may be attempts to influence decisions ‘through personal connections and other clandestine means including return services bearing marks suspiciously like corruption’.

Behind-the-scenes government interference and ‘intense informal interventions’, to quote Lioukas and Papoulias, in the affairs of public enterprises are almost a universal problem in developing countries, mentioned by many authors.

However, in chapter seven Dr Mavis Puthucheary writes that in Malaysia there is significantly less government interference because the primary motive for having a large public enterprise sector was not ‘control’ but ethnic ownership. The notion of the ‘commanding heights of the economy’, which was influential elsewhere, played no part in that government’s thinking.

In India holding companies of groups of state enterprises were formed in order to protect individual enterprises from government interference, but that failed to work because each enterprise was still regarded as separate, and so holding companies were bypassed by the government (which had of course set them up in the first place).

**Developmental and other social policies**

It is not only the administration of government which is often at fault, but also the requirements placed on public enterprises which are sometimes unrealistic, unfeasible, or badly organized.

In most developing countries, public enterprises have a social as well as a commercial role, and their performance in this dimension should also be assessed. Although empirical evidence is extremely limited, Kirkpatrick and Adhikari argue that:
what is available indicates that the use of public enterprise as an instrument to achieve social and redistributional objectives may not only adversely affect their financial and economic performance, but may have perverse distributional consequences.

In chapter fourteen, for example, Dr E.A. Musa, writing about Sudan, explains that public enterprises in that country, which account for some 70 per cent of employment, have very wide developmental as well as social roles. The developmental role set by the government has five headings which include:

- the creation of jobs on a large scale to stop emigration from rural to urban areas;
- balanced (even) development within and between regions;
- achievement of self-sufficiency in major consumer goods.

There are, however, no separate measures of performance in relation to these objectives; and generally management accounting information is seriously deficient.

Moreover Musa writes that ‘the government fixes the prices of finished goods, which are in most cases below the actual costs of production’. It is hardly surprising that public enterprises have made huge losses’ (though since 1982 this has now improved).

In their social role, public enterprises in Sudan provide social services to their employees and to citizens in rural areas. These include building schools and clinics, providing furniture maintenance and transport facilities, building houses and roads, and providing electrification. For these activities they have a separate budget and are reported separately in the profit and loss account as ‘social and infrastructure costs’.

Malaysia has followed a different kind of social policy. In 1969, following the national elections, a target was set, to be achieved by 1990, that 30 per cent of equity in Malaysian industry should be owned by ethnic Malays (the Bumiputras), who traditionally dominated only the agricultural sector. The creation of viable public enterprises which then could be sold to Malays was the means through which this target was to be reached. As a result of this policy, the proportion of corporate equity owned by Malays has risen from under 2 per cent in 1969 to 18 per cent in 1985—though clearly at some cost. Puthucheary describes the methods by which this was achieved, and the contradictions in public policy which occurred.

In India, Reddy describes the public policy objectives as growth, social justice, and national self-reliance. Growth required heavy
investment in public enterprises, with scant regard for economic returns, coupled with regulating the allocation of private investment through physical controls. (At present there is more emphasis on permitting the private sector to compete in areas previously reserved for the state, and on deregulation.) Social justice required a regime of administered prices—dual pricing and a price support mechanism. (Under the New Economic Policy subsidies are now confined to relatively few sectors.) And national self-reliance required quantitative restrictions on imports, import substitution, and managing the foreign debt-servicing obligations within prudent limits.

Some countries, however, have succeeded in overcoming the problems of combining commercial operations with the application of social policy. In Morocco, for example, the government has accepted the principle that it will pay cash for any non-commercial activities, and public enterprises are monitored against targets. This also has long been a feature of the Italian government in its relations with IRI, as described by Ajmone Marsan in chapter seventeen. Indeed, IRI is compensated for these social costs before they are undertaken.

Managerial deficiencies

It is difficult to isolate the efficiency of public sector managers from the circumstances surrounding their work. Comparisons between the management of public and private sectors may be like-with-like only in relation to industrial activity, and cannot easily ‘correct’ for greater government interference in the former. Comparisons of ‘X efficiency’, such as those reported by Adhikari and Kirkpatrick, come closer to a true measure, but even so government constraints may have inhibited, for example, responsiveness to the market and the introduction of new techniques. Unfortunately ‘the government’ is always an alibi for poor managerial performance.

Hiten Bhaya attempts in chapter fifteen to isolate the effect of managerial efficiency in India and finds that, except for return on investment, ‘public sector management efficiency is in no way inferior to the private sector’.

We know that many public enterprises are bureaucratic in form, and that where there is a choice of employment some managers may go into the public sector because it is more secure than the private sector. Also, as Glade has pointed out, managers may take advantage of any confusion in government to benefit themselves at the expense of the system. However, many managers have not been given the opportunity to show what they can do in more favourable circumstances.
Possible solutions

There are only two broad paths to follow: reform or privatization. At first sight the difference between them is clear, but in practice such a simple dichotomy breaks down, and the terms require careful definition.

Reform

Reform has four principal dimensions. First, at the highest level, there is reform of the structure of government itself. Central planning and an extensive public enterprise sector, most notably in Communist countries, but also in India, for example, tend to result in a multiplicity of separate ministerial departments. Each major industry has its own minister and group of civil servants.

The principal problem with this is that ambitious ministers will want to be seen to be active in their role, and if they have only one industry in their command they will want to exercise influence over its management. They will not take kindly to the idea that their role is to agree a three- or five-year ‘contract’, make top appointments, and then let the management get on with it. Nor indeed will their civil servants. They too will want promotion and to have a bit of fun, second-guessing what managers should do—and telling them so—without, of course, accepting responsibility for the results.

Secondly, reform can relate to the policy framework within which individual enterprises operate. Adhikari and Kirkpatrick find that ‘reform of the macroeconomic framework (exchange rates, trade restrictions, and regulations) can contribute significantly to public enterprise performance’.

The holding company is also an important option, providing a sheltering umbrella under which individual enterprises can operate. It has been seen principally as a method of keeping the government at arm’s length, and in Greece achieved some success for this purpose. But, as Marsan brings out in chapter seventeen in his very clear description of the way in which IRI works in Italy, there is much more to be said in favour of this idea.

IRI is a source of competitive strength for its subsidiaries. It has a greater credit capacity than any of its subsidiaries through the pooling of risks and through its scale. It can improve the utilization and development of its top level executives, choosing managers best suited to the needs of each subsidiary, widening their experience and their career opportunities. It can also provide a more professional control system—especially financial control—than can any civil service department.

Marsan also demonstrates that IRI has a particularly effective way of incorporating the Italian government’s social objectives within its business
planning, with costing and decision procedures resulting in a contract to which both sides adhere.

He also emphasizes the importance of allowing time for the learning process in developing the role of a holding company—IIR has been learning since the early 1930s, and new ideas are still forthcoming. However, the sudden swings in policy, which seem to be such a feature in many developing countries, militate against this learning process.

Thirdly, reform can relate to organic relationships between the government and public enterprises. This is both the most difficult area for reform, and the most crucial. The key to success seems to be performance contracts between public enterprises and government.

In chapter thirteen Dr A.H.M. Bennett describes a performance contract as:

an agreed set of mutual commitments which the respective parties expect to be able to meet, to their mutual advantage, with regard to the management of a public enterprise for a given period.

And its purpose is:

to improve the contribution of the public enterprise to national goals through greater clarity on what constitutes performance towards those goals, greater management autonomy on the means used to achieve performance, and incentives for its achievement.

Bennett’s chapter reports on the wide international experience with performance contracting, especially from his personal experience in Sri Lanka and Bangladesh—and includes the ‘do’s and don’ts’. The need for both ultimate goals and specific targets are emphasized, while ‘incentives are the fuel which makes the contracting cycle work’. France, Senegal, Pakistan, and South Korea have the most sustained experience (at least five years), with very positive results—even dramatic in the case of Korea, where the system applies to all public enterprises. Bennett emphasizes that

performance contracts are not devised so that (good) economic efficiency can replace (bad) political goals, but rather so that overt and predetermined political goals (including efficiency) can replace covert and ad hoc political bureaucratic interventions.
Saulniers, writing in chapter eight on francophone Africa, indicates that the generally superior performance of public enterprises (some 2,000 in all) in those countries compared with similar enterprises in anglophone African countries can be attributed—at least in part—to their significantly greater use of performance contracting. No doubt the reason for its adoption was that the system originated in France, and so French associated territories abroad benefited from that experience. (Senegal was one of the first and most successful examples, and French government advisors helped to set up the process there.)

But performance contracting is a tough discipline—on both sides—and, as Saulnier emphasizes, ‘there is a need for high level political commitment to the process, and for good faith negotiating on attainable issues’. Also, ‘periodic contract revisions or rolling contracts may incorporate changes in underlying assumptions…and short, simple plans are easier to monitor’.

After 1987 the contract system became widespread amongst public enterprises in China. It has been received enthusiastically by them, but Hua and Du say that so far it has not proved to be successful. In part this seems to be because self-discipline and commitment have to be accepted by the government administration as well as by the enterprise, and that is lacking at present. As Marsan points out, success can come only with time, experience, and effort.

In India performance contracting has not been successful either, to date. ‘As yet they are more in form than in substance’, writes Bhaya.

Finally, reform can be internal to each enterprise. In this category comes every possible managerial remedy: organization, systems, technical, training, etc. Many of these factors are incorporated in the statistical analysis undertaken by Lioukas and Papoulias for Greece.

Most managers want to do a good professional job, but in this they are often inhibited by circumstances. For successful performance, therefore, good leadership is even more vital in the public sector than in the private.

The key to improved managerial performance is to choose the right people for the top. They, above all others, can make or break an organization—in whichever sector they work.

But here politics immediately enters the equation, since the chairmen and chief executives of public enterprises are normally government appointees, and the motives for such appointments are not always commercial. As Bhaya remarks, ‘in state level enterprises [in India] a number of politicians of the ruling party find places not only on boards but even as executive chairman’.
In India there is a Public Enterprise Selection Board for the appointment of about 500 full-time executive board members of central government enterprises, but ultimately that too is subject to political influence.

In the Chinese ‘asset management responsibility system’, candidates to become the manager of an enterprise compete in offering contractual commitments to achieve the best performance, against which the successful candidate can later be monitored. While this is very imaginative, it has not yet been widely adopted. Nevertheless, in the few years since it was introduced it has yielded ‘certain positive results’.

In chapter eighteen Nick Woodward, while acknowledging the crucial important of leadership from the top, also emphasizes that we must neglect neither the followers nor the cultural context in which leaders operate.

Woodward’s central thesis is both wider and deeper than this. He stresses that ‘it is not transformation or change which is required but renewal—an understanding of the roots of an organization and a subsequent continuous nourishing of those roots’. In these terms ‘renewal’ is a particular dimension of ‘reform’ which emphasizes more spiritual values and the social and cultural context of change.

Privatization

The privatization message has swept the world: ‘If you can’t control public enterprises to achieve efficiency, if they drain the financial resources of the state, if they absorb too much time and energy of senior politicians and civil servants, if reform is too difficult—take them out of government.’

Reddy cites five categories of privatization, including public enterprises which copy the forms of behaviour of the private sector. There is a range of actions, many involving much less than complete divestiture, which may properly be called ‘privatization’. Marsan adds to this list with further subtle variations.

For example, it can relate to liberalization of the external market, permitting the entry of competition where the state has a monopoly, as described by Reddy in relation to India, and by Saulniers in relation to Morocco (where there are 680 public enterprises). ‘Contracting-out’ some internal services to the private sector has also been introduced in many countries.

Even so, there are often practical and ideological impediments to any such solution. Privatization in the sense of divestiture is an option adopted to any great degree in only a few developing countries, including Chile, Guinea, Togo, Niger, Côte d’Ivoire, and (in part) Malaysia. Some have virtually turned their backs on it, including the
Introduction

present government in China, and most of India (where there is no enthusiasm for the private sector), while the majority of developing countries appear to be dithering.

In Malaysia the privatization policy is clear, though its purpose has little to do with improving efficiency and eliminating losses (though these are cited). The government prefers a mixed ownership form of privatization involving the participation of the government itself, multinational companies, and local (ethnic Malay) companies. However, the fact that Malay ownership of wealth is concentrated in relatively few hands is causing concern.

The history, motives, administrative procedures, and practical difficulties of managing a privatization programme in Pakistan are well described by Bokhari, although of some 350 public enterprises only about 30 have been divested to date. (Marsan also describes the procedures which IRI goes through in its divestments, which differ from those in Pakistan.)

At first the priority in Pakistan was to divest the many small and loss-making enterprises. Leasing their assets to the private sector was tried but without success. (In China assets were leased to the enterprise’s manager and its workers; that was also unsuccessful.) To establish a programme of gradual privatization of selected enterprises, including large ones, requires a sound administrative machinery in government, evaluative skills, a means of satisfying pressure groups without jeopardizing the whole endeavour, and private sector institutions, including a stock exchange. Even with many of these advantages, privatization in Pakistan has not proved to be straightforward.

In Chile public policy has swung violently, first from a private enterprise system to wholesale nationalization (1970–3). Some 495 firms were then privatized (1973–82) in two waves, only to be followed by re-acquisition by the state due to bankruptcy. Finally, from 1985, there has been a further, well-ordered privatization programme. This final stage is described in detail by Glade in a series of short case studies. The key to its success seems to have been the role of CORFU, a central government financial institution, run with considerable skill and flair.

Brimmer and Thompson’s case study (chapter three) of British Telecommunications plc (BT) is full of lessons. It is clear that, first, privatizing a monopoly requires long-term regulation to control prices, to create competition through the controlled entry of competitors, to ensure fair competition, and in other ways to protect the public interest. Properly conducted regulation is also extremely complicated, requiring legal authority, expertise, and strong nerves.

Second, what at first sight may appear to be a ‘natural monopoly’ may turn out to contain elements where competition could take place,
and where regulation could have a lighter touch, or even be non-existent. In the case of BT, the economic analysis of markets and of the likely impact of technological change was crucial, but the creation of a competitive environment required conceptual clarity and a strong political will.

Enterprises which are privatized with a high degree of monopoly power and without adequate regulation have in effect a licence to print money. Private exploitation may arise in industries which may have been nationalized to eradicate such behaviour.

This lesson has been learnt the hard way in Chile, although the regulatory processes in natural gas, electricity, and telecommunications appear to be rudimentary compared with those introduced in the UK to control BT.

Román’s analysis of industrial concentration in public enterprise in Hungary shows that in over one-third of 637 product groups covering 75 per cent of manufacturing industry, the largest producer had more than 90 per cent of industry output, and exceeded 50 per cent in two-thirds of product groups. Privatization of these enterprises would create concentrations of economic power which would have important political implications.

A wider question of great significance is raised implicitly by the BT case study: was this privatization really necessary? When BT was a public enterprise, why did the government itself not regulate the industry in the way it is now done through OFTEL (the present regulatory agency), creating competition where that was feasible, enforcing an efficient structure of prices, and regulating in the public interest? It could have done so. Why was an internal reform of the government machinery and of BT itself not undertaken?

The answer perhaps is that the government has several roles. The government department to which BT was held accountable was the industry’s sponsor, there to protect and promote its interests. Civil servants establish close working relationships with the industry, and personal friendships are formed. The public enterprise may even have set out to ‘capture’ them psychologically.

Most civil servants have no experience or training in business management and may not see clearly and with sufficient conviction exactly what should be done. In any event, where is the incentive to embark on a complex regulatory scheme, when the informality of day-to-day communication is so much easier and more pleasant?

The lesson is that regulation must be organizationally quite separate from sponsorship, or the latter will predominate. Then there is the inertia, the vested interests, and in some countries the ideologial hostility of the left to overcome. Privatization is perhaps the only way to break through all of these inhibiting factors.
But Woodward warns that ‘privatization is not enough: it needs an internally driven transformation (or re-affirmation of values) focused on customer sensitivity and an ethos of service’. Moreover, ‘privatization, if imposed without reference to social and cultural context, with the hollow rhetoric of free enterprise, may prove to be yet another fashion, rather than an opportunity for renewal, to refocus purpose and confront the real problems of organization.’

**Helping hands**

The World Bank’s goal is the ‘economic development of its member countries’. Alexander describes the policies being pursued—and the changes since the crisis year 1980—in the thirty-four African countries in which the Bank is involved. The original financing role, still very large, has now been greatly extended into new fields.

In relation to public enterprises (the Bank’s activities extend also to education, health, nutrition, etc.), and recognizing that the Bank cannot finance enterprises which are technically bankrupt, its policies have embraced also the possibility of:

1. changes to the policy framework for public enterprises;
2. changes to their institutional framework;
3. changes in the size and nature of governments’ holdings in public enterprises.

In addition there are reforms aimed at restructuring and improving the performance of specific enterprises.

These policies have also led the Bank to attempt to increase competition, to promote privatization, to support the restructuring and rehabilitation of enterprises, and to try to improve government-enterprise relationships. Here performance contracts are considered to be important. Alexander’s Table 12.2 gives a useful checklist of all the principal types of reform in which the Bank has been directly involved.

The Bank also emphasizes the need for a focal point in each country, to provide guidance and orientation for public enterprise reform, to be a central point for implementation of the reform process and to arbitrate between competing interests.

The World Bank is owned by its member governments, and its funds for public enterprises are channelled through those governments. The International Monetary Fund (IMF) aid programme for public enterprises, mentioned by Adhikari and Kirkpatrick, and the European Community (EC) Commission also work in this way. The aid process therefore tends to become
political, and it reinforces centralizing tendencies in the developing countries, conferring extra power on local politicians and civil servants.

Impediments to solutions

Vested interests

In the latter part of chapter fifteen, Hiten Bhaya writes with wisdom and passion from his wide experience in Indian affairs about why it is in no-one’s interest to change the present situation. Economists cling to their theories, in spite of evidence to the contrary. ‘Why on earth should Ministers and Secretaries be motivated to either initiate or approve real reforms to a system which assures them power without accountability?’ And:

The [public enterprise] managers of today know that they cannot buy or sell, reward or punish according to their best professional judgement. A single mistake can cost them dearly. In a bureaucratic system conformity is the safest way to survival, and survival ensures progress in career since proving merit is as impossible as proving incompetence.

Employees too remain unconcerned ‘as long as the unions fight for increased wages, more manpower, automatic promotion, and protection from discipline’, and the private sector wants to perpetuate a system in which it can sell at a high price to the public sector and buy cheaply from it.

So, says Bhaya, the only hope is change from within, managers and workers coming together to save their enterprise. But he does not sound very optimistic that this will happen in India.

In Pakistan, Bokhari writes in the same vein, emphasizing in addition the problem of inertia. Vested interests and inertia sustain each other. Somehow the vicious circle has to be broken.

Bureaucracy and planning

Bureaucracy is a blight which has smothered initiative and enterprise in many developing countries. Office jobs in government tend to confer status on the individual, provide power to people who have no other source of leverage on society, and offer opportunities for personal gain at the expense of the system. Permits, controls, and requisite authorities are their meat and drink.

Yet physical controls generally fail to achieve their objectives. The problems they create, together with the self-defeating nature of price
controls (well described by Reddy in relation to India), are evident. In
China and in many much smaller countries such policies persist. Planning
and regulation of the economy of some kind are necessary, even in mature,
market-based economies, though their form is different. Also—through
bitter experience—governments are more aware that in the long term
interventions are quite likely to have the opposite effect of what was
intended.

So in developing countries planning should concentrate on the few
essentials, and where public enterprises are involved performance contracts
are the best medium for the execution of government policies.

Ideology

Central planning and public enterprise are the handmaidens of socialism.
In the Soviet Union, China, Eastern Europe, and in many other countries,
the Communist Party has been its driving force.

Now the Communist Party is under threat. The remarkable events in
Eastern Europe in the closing weeks of 1989 herald a new era in the
organization and control of these nations. In the economic sphere, state
enterprises will be centre-stage. The Soviet Union, formerly the hub of
the system, has been overtaken—but may yet catch up.

As socialist countries adopt the market economy, undoubtedly the trend,
the future of public enterprise is uncertain. The contrast is the most sharp
and dramatic in China. Strong central planning and public enterprises
overwhelmingly predominate, while on the coastal fringe in Guangdong
Province there is the runaway success of joint ventures with capitalist
enterprises in the Special Economic Zones. The ideological conflict is
unresolved.

Public enterprise in Hungary has arrived at the crossroads, in the lead
in Eastern Europe. The way forward is expected to be through the market
economy, the growth of smaller and medium-sized firms, and through
reforms in ownership, including some privatization, though—as Román
concedes—the all important details have yet to be worked out.

Corruption

Corruption saps the spirit and destroys the incentive of those who are honest.
It is present to some degree in public enterprises in many developing
countries, but it is rarely admitted and authors are wary of making
accusations. However, the government of the People’s Republic of China
has openly stated that corruption is widespread in both government and
state enterprises and has announced firm measures to eradicate it. Many
arrests have been made. Can such measures be successful?

A necessary condition for honesty in the public sector in any country
is that leadership in the government itself should be seen to act with probity.
That is the prime requisite. A corrupt leadership legitimizes corrupt behaviour lower down the administrative hierarchy, and outside of government contempt for authority is also created.

The heads of state enterprises must also follow the virtuous path. As mentioned earlier, in many countries to be appointed head of a state enterprise is a reward for political support. It may be made in the knowledge and expectation that some unwarranted pecuniary or other benefits will result. As Reddy tactfully remarks ‘subsidies to favoured clientele, not open to Parliamentary control or public debate, through political patronage via public enterprises, are being flagged by academicians for attention’.

However, probity at the top is not in itself sufficient. In both government and public enterprise there also has to be the organization, systems, and requirements which will minimize corruption. For example, a government planning system which requires the issue of a multitude of permits and authorizations, or which supplies material at low fixed prices, creates opportunities for corruption. Badly-paid bureaucrats have both opportunity and incentive to use their power for personal gain.

Within each enterprise there must also be good management information and control systems. Many large enterprises in the West have internal audit departments, accountable to their chairmen, to conduct internal investigations. Computer audit has become a high level skill and critical in combating theft. Where there are benefits from centralized bulk purchasing, the procurement department is likely to be accountable not to the chief executive but to the top finance director—thus separating authorization from action. Such precautions are regrettably necessary, even in a society which is basically honest.

Cultural change

Moving from a bureaucracy towards a business culture is always difficult and often painful. Many employees may have joined a public enterprise in the first place—especially if it is a departmental enterprise (i.e. a government department)—specifically in order not to be in a commercially minded business organization operating under competitive conditions. So liberalization and privatization may be against their very nature.

Young people with energy and a sense of enterprise may readily adapt, but it is the older—and usually more senior—people who find this change so difficult. Many will resist, and when privatization takes place they will leave, or be pushed out.

On the other hand Woodward argues that ‘our contemporary myths of enterprise and wealth creation lack insight into the internal dynamics of organization and society’. In these circumstances, to attempt cultural change would seem high risk.
The way forward

This book begins with a fine analysis in chapter two of what Woodward calls ‘Gaining’ (profitability, productivity, cost reduction, and other materialistic matters). It ends in chapter eighteen with a perceptive and passionate defence of ‘Being’ (a spiritual proposition which argues for a sense of meaning and purpose). To emphasize Gaining at the expense of Being is to promote the acquisition of material benefits while surrendering spiritual value. The way forward must surely recognize that both have their proper place.

What is feasible in an advanced economy, with a pool of skilled and experienced management and manpower, with new technology at their fingertips, competing globally in a world which, broadly speaking, shares their perceptions, may be quite infeasible in a developing country. Indeed, to suppose that all developing countries want to emulate the West in every respect is unwarranted and could pose a great danger to their future.

Yet for a variety of reasons, including altruism and self-interest, the West wants to help the developing nations of the world. In these circumstances what can those of us who write, think, and act as consultants actually do? Analyse with skill and detachment, expose the truth, challenge preconceptions, and in particular feed back the experiences of developing countries in a structured and impartial way to that very same group of countries so that they may learn from each other, and thus find solutions for themselves which they feel are appropriate and right.

There are no easy ways forward. For countries which have reached the crossroads—most notably in Eastern Europe and the Soviet Union—there is no single path which can be recommended. This book contains many ideas and lessons from experience, but as to what will be of most use to any individual country, only its own people can say.
Part two

Surveys of practice and principles
In almost all developing countries the public enterprise sector accounts for a significant share of national output and investment. The origins of the sector’s growth can be traced back to the immediate post-independence period when public enterprises were established to spearhead the drive to industrialization based on import substitution.

Public ownership of basic industries such as iron and steel, chemicals, heavy engineering, and petrochemicals was justified in terms of their strategic importance in providing essential inputs to the emerging manufacturing sector. In other cases, public ownership was a response to the private sector’s failure or unwillingness to undertake productive activities which were critical to the economy’s industrialization process. In addition to these essentially pragmatic responses to market failures, ideological and socio-political factors also contributed to the rapid growth of the public enterprise sector.

The past decade has witnessed a fundamental reassessment of the role of the sector in the development process. Seen originally as a key factor in stimulating rapid economic growth, the public enterprise sector is now viewed by many observers as a constraint on economic development. In part, this has emerged as one element in the general shift in the dominant development paradigm. It also stems from a concern about the perceived weaknesses in the economic and financial performance of the public enterprise sector in Third World countries.

The early 1970s saw the resurgence of the neoclassical perspective as the major influence in development theory and policy formulation. In contrast to the interventionist approach that dominated thinking in the 1950s and 1960s, the neoclassical perspective emphasizes the role of markets and the price mechanism in the development process. Policy prescriptions which flow from the neoclassical analysis involve the removal of various
forms of government intervention in product and factor markets that are seen as ‘distorting’ the price signals and ‘repressing’ the market mechanism. In the context of the public enterprise sector, the neoclassical analysis translates into policy prescriptions directed towards a reduction in the size of the public sector, the removal of government regulation and controls, the fostering of competition, and a greater reliance upon the price mechanism for the allocation of resources.

A second reason for the current reappraisal of the sector’s role in developing countries stems from the widespread belief that its performance has been poor. There are difficulties in measuring performance, and experience differs across sectors and regions. Still, generalizations have been drawn, for example by the World Bank:

Some state-owned enterprises have been able to operate as successful commercial ventures without burdening public finances. In most countries, however, many have drained budgetary resources, contributed to overall public sector deficits, weakened fiscal management, and made negative contributions to value added.

(World Bank 1988a:180)

This chapter aims to take stock of and to assess the issues that have emerged in relation to the current policy debate on the role of the public enterprise sector in developing countries. The objective will be to summarize the empirical evidence on the characteristics and performance of the sector, thereby to create a more informed basis for policy formulation. The following section provides comparative data on the size and characteristics of the sector. The third section contains a detailed review of empirical evidence on the performance of public enterprises, in terms of financial, economic, social, and macroeconomic performance criteria. The chapter concludes with a summary.

The public enterprise sector in developing countries

None of the international organizations publish comprehensive information on public enterprises on a regular basis, and the majority of countries do not identify them separately in their national statistics. The paucity of accurate and systematized data makes cross-country comparisons difficult since one is compelled to rely on data drawn from various sources in which different criteria may have been used.

Table 2.1 provides information on the size of public enterprises in terms of their share in total investment and value added. In 1984–5,
Surveys of practice and principles

Table 2.1 Share of public enterprise sector in total investment and value added, mid-1980s

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<tr>
<th></th>
<th>Total investment</th>
<th>Total value added</th>
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<td></td>
<td>%</td>
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<td>77.5</td>
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<td>69.8</td>
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<td>52.2</td>
<td>29.9</td>
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<tr>
<td>Guyana (1984)</td>
<td>41.9</td>
<td>22.7</td>
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<tr>
<td>India (1985)</td>
<td>41.1</td>
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<tr>
<td>Tunisia (1984)</td>
<td>38.7</td>
<td>24.0</td>
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<tr>
<td>Algeria (1985)</td>
<td>33.4</td>
<td>10.1</td>
</tr>
<tr>
<td>Morocco (1985)</td>
<td>33.1</td>
<td>15.4</td>
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<td>10.6</td>
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<tr>
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<td>Kenya (1984)</td>
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<tr>
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<td>Jamaica (1984)</td>
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<td>Dominican Republic (1984)</td>
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<tr>
<td>Developing countries (1984)*</td>
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<td>10.9</td>
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<tr>
<td>Industrial countries (1975–9)†</td>
<td>9.9</td>
<td>8.0</td>
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Notes: *Twenty-eight countries average for value added and thirty-seven countries average for investment. Value added weighted by GDP. For Burma and all African countries the investment averages are of public enterprise investment to gross investment, in other cases, the ratio is a share of gross fixed capital formation.

†Six OECD countries weighted by 1977 GDP for value added, and for investment thirteen industrial countries.
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<tr>
<th></th>
<th>Agriculture</th>
<th>Commercial services</th>
<th>Construction</th>
<th>Manufacturing</th>
<th>Mining</th>
<th>Transport and Communications</th>
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<td>Ivory Coast (1979)</td>
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<td>Bangladesh (1980)</td>
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<td>South Korea (1974–7)</td>
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<td>Pakistan (1980)</td>
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<td>Sri Lanka (1974)</td>
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<td>Tunisia (1976)</td>
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<td>Argentina (1980)</td>
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<td>Nicaragua (1980)</td>
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<td>Uruguay (1979)</td>
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Source: Constructed from World Bank (1983: Figure 5.4)
Note: *<5%; **<25%; ***<50%; ****<75%; *****>75%; n.a. not available.
their GDP-weighted share in total value added was 10.9 per cent in a sample of twenty-eight developing countries. Data for industrial countries show their equivalent value added share to equal 8 per cent on a GDP-weighted basis for the period 1975–9. The weighted public enterprise share of investment for thirty-seven developing countries was 9.9 per cent.

There is considerable variation across developing countries in the size of the sector. As shown in Table 2.1, their share in total investment ranged from 7 per cent in Dominican Republic to 77.5 per cent in Zambia. Countries where mineral-based activities play a dominant role have tended to show a higher share in total investment. Their size, in terms of share in total value added, ranged from 1.8 per cent in Nepal to 41.3 per cent in Zambia.

Similarly, their number varies widely across the developing countries. There are about 1,000 in India, with about 250 belonging to the central government, their total investment accounting for 9.1 per cent of the GDP for 1987–8 (Gupta 1988). In 1978, twenty-two of the largest twenty-five corporate enterprises in India were publicly owned (Narain 1979). In South Korea, twelve of the largest sixteen enterprises were in the public sector in the early 1970s (Jones 1976); in Brazil, the ten largest firms were all public enterprises (Trebat 1980); in Indonesia, the nine largest domestic firms were in this sector (Gillis 1980); in Nepal most large-scale manufacturing firms were publicly owned, promoted mainly through bilateral foreign assistance (Adhikari 1988b).

The scope of their activities is very wide; they are found in almost all types of economic activity in developing countries. Table 2.2 provides information on their relative importance in different sectors for a sample of developing countries during the early 1980s. As can be seen, public enterprises are still relatively more important in the traditional public utilities sector like electricity, gas, and water; and also in transport and communications. In many developing countries, they also account for a significant proportion of the natural resources sector output. Rood (1976) estimated that by the mid-1970s more than 50 per cent by value of mineral extractive projects in sub-Saharan Africa were in public ownership. They are much less significant in the agricultural and trading sectors, which in most developing countries are dominated by private enterprises. Public enterprises in these sectors often take the form of marketing boards and state trading companies, and can have a significant indirect effect on private sector companies, through their purchasing and selling policies.

In a number of the larger, more industrialized developing countries, the public enterprise sector has emerged as a source of
manufactured exports. Ballance et al. (1982:284–5) report that Indian enterprises export a variety of capital goods to both developed and developing countries. In India they have emerged as important international contractors and consultancy groups, particularly for the Middle East and Nigeria. By 1978, earnings from their exports of goods and services and marketing activities accounted for 29 per cent of India’s total export receipts (UNIDO 1987). In the Republic of Korea, their exports accounted for less than 6 per cent of total exports in the mid-1970s, but when the use of public enterprise inputs in private sector exports was allowed for, their share of exports increased to 14 per cent (Jones and Wortzel 1982). Furthermore, in Brazil they are important exporters of aircraft, armaments and military equipment, steel products and other manufactured exports. In some developing countries, particularly in Latin America and Africa, they are overwhelmingly engaged in exporting oil and minerals.

Public enterprise performance: evaluation and evidence

Because of the substantial share of public enterprise in total value added and investment, their operating performance is of major importance to the overall performance of an economy. Methods of performance evaluation vary from country to country, and from one enterprise to another in relation to their nature, their outputs, and their socio-economic objectives. However, there is a general consensus that they have non-commercial as well as commercial objectives, and that their performance evaluation should be judged in terms of the degree of their success in achieving both sets of objectives (Killick 1983, Fernandes 1983, Fernandes and Kreacic 1982).

Performance can only be defined in terms of the degree of success in achieving specified objectives. In principle, performance evaluation should follow a step by step procedure of identifying the specific objectives for the public enterprise under evaluation, constructing performance indices to measure the degree of attainment of these objectives, and thereby measuring operating performance. In practice, however, there are considerable practical difficulties in implementing this sequential evaluation procedure.

First, government socio-economic objectives for public enterprises are often defined ambiguously; usually the goals are stated in general terms like ‘maximization of society’s well-being’ or ‘increase of living standards’. In some cases the objectives may be inconsistent with each other, and in other cases they are altered in response to political circumstances.
Second, even if a set of objectives can be identified, it will be difficult to devise a satisfactory procedure for multiple-goals performance evaluation.

Third, there are serious difficulties in devising appropriate measures, even of single objective performance. The most widely used measures are based on a set of restrictive assumptions regarding market structure and behaviour; since these assumptions are seldom met in practice, the interpretation of the performance evaluation can be ambiguous, and different policy implications can be drawn from the findings (Kirkpatrick et al. 1984).

Fourth, practical performance evaluation may be opposed by vested interests. Fifth and last, performance evaluation is always very demanding in terms of data requirements. There are often problems in obtaining the pertinent data for empirical estimation and in ensuring that the operating conditions and characteristics of different public enterprises are sufficiently similar to allow meaningful comparisons of performance to be made.

Performance evaluation may be viewed from two broad perspectives: micro and macro. The micro-perspective of public enterprise performance focuses on commercial profitability and financial performance, and on economic performance, usually on an annual basis. Commercial profitability is frequently judged on the basis of operating surplus and return on capital at domestic prices. The economic performance evaluation examines economic profitability in terms of domestic resource cost, economic returns on capital, or unit economic benefit. It also includes other important economic aspects, such as factor intensity and productivity, capacity utilization, and pricing.

The macro-analysis of performance looks at their contribution towards the national economy in terms of value added, savings and investment, employment creation, and foreign exchange earnings. Their financial burden to the national treasury in terms of deficits, subsidies and guarantees, foreign debts and the impact on the balance of payments, and their share in local borrowing, are other concerns of macro-analysis. Performance in terms of their degree of success in achieving specified social objectives may be included in the macro perspective, or dealt with separately. When a quantitative analysis is not possible, the social, objective evaluation should at least be discussed qualitatively. Thus a detailed performance evaluation of public enterprise becomes a multi-disciplinary exercise incorporating evaluation of all aspects of their objectives, management, and operation.

We now turn to a review of the empirical evidence of their performance using the criteria discussed above. Before doing so,
however, it is worth re-emphasizing the problems of measurement and interpretation associated with performance assessment. The real world rarely, if ever, conforms to the conditions, specified by the economic theory underlying the performance measures, and studies differ significantly in the methodology used to deal with these divergences between theory and reality. It is not surprising, therefore, that the empirical evidence on public enterprise in developing countries is fragmentary, and where available needs to be interpreted with care.

Commercial profitability and finance performance

Funkhouser and MacAvoy (1979) compared the performance of a large number of private and public enterprises coexisting in a number of different industries in Indonesia for 1971. Financial profitability was measured as the difference between sales revenue and direct expenditure, excluding depreciation and interest, expressed as a percentage of sales revenue, and the performance of public and private enterprises in eleven industries was compared. These comparisons were made for four sub-samples:

(i) all public and private enterprises;
(ii) all public and private enterprises from those industries in which there were both types of companies;
(iii) public and private enterprises of comparable size only;
(iv) public and private firms ‘paired’ on the basis of comparable levels of sales of the same products.

In each case, the average profit margin for public enterprises was found to be lower than that for private enterprises, and the mean differences were statistically significant.

Trebat (1980) covered fifty of the largest public enterprises in Brazil during 1965–75, representing six industrial sectors (electricity, telecommunications, steel, petrochemicals, mining, and railways). Estimated rates of return on fixed capital investment showed considerable variation across economic sectors, ranging from 41 per cent in petrochemicals to 6 per cent in communications, for 1975. Although the data indicated a declining trend in profitability over the period, the Brazilian enterprises studied generally had been profitable. The empirical evidence also revealed that the selected enterprises were able to finance 40 to 60 per cent of gross investment during 1966–75 using retained earnings and depreciation funds, a figure similar to the 50 to 60 per cent self-financing by Brazilian private enterprises.

Walstedt (1980) examined the financial profitability of manufacturing public enterprises in Turkey. He found the ratio of profits before interest and corporate tax to total investment to be 4–5 per cent for the period
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1967–71. Adjusting for inadequate depreciation rates and for subsidized interest charges on borrowed funds would reduce the estimated rate of financial profitability to zero or negative levels.

Kim (1981) studied the financial performance, amongst others, of public and private enterprises in Tanzanian manufacturing sector during 1970–5. Only those sub-sectors within manufacturing in which both public and private enterprises co-existed were examined. The results showed that, in all years except 1971, public enterprise receipts (excluding subsidies) were insufficient to cover current expenditure (excluding tax payments) and depreciation provision. In contrast, private enterprises recorded surpluses in five of the six years. These differences are partly attributable to the overmanning and higher wages per employee in the public sector, reflecting the influence of objectives other than profit maximization, and government interference in their operations.

The World Bank (1983a) provides cross-country information on the commercial profitability and financial performance of public enterprises in developing countries. The available data for twenty-four developing countries showed a small operating surplus before depreciation in 1977 (p. 74). However, no account was taken of interest payments, subsidized input prices, taxes, or accumulated arrears. Proper provision for these items and depreciation would show enterprises in many countries to be in deficit.

Economic performance

Growth in productivity

Dholakhia (1978) compared the growth in total factor productivity (TFP) in the public and private manufacturing sectors in India over 1960/1–1975/6. Estimates of net output and capital and labour inputs were made for both sectors over time, and an index of TFP was obtained as a residual. The results indicated a significantly higher rate of growth of TFP in the public enterprise sector (4.33 per cent annually) than in the private sector (0.18 per cent annually).

Funkhouser and MacAvoy (1979), in addition to the evidence on financial performance reported above for Indonesia, also present comparative data on costs of production. Comparing average unit production costs (excluding interest and depreciation) for the total sample of firms showed public enterprise costs to be above the overall sample average. However, when a restricted sample was constructed by pairing public and private enterprises of the same size in the same industry, the cost difference disappeared, implying that there was no evidence that public enterprises were less cost-efficient than private enterprises of the same size.
Tyler (1979) studied the technical efficiency of Brazilian steel and plastics industries in 1971, by comparing the estimated maximum possible output with the observed level. The results for the steel industry are of particular interest since public enterprises were prominent in this sector, accounting in 1971 for 54 per cent of production. The classification of the sample twenty-two firms in the industry into foreign (seven), domestic (ten), and public (five) allowed the average levels of technical efficiency to be compared. The results show that the averages of technical efficiency indices were lower for public enterprises than for the domestic and foreign-owned firms. However, attempts to identify a statistically significant difference in technical efficiency levels accounting to firm ownership were unsuccessful. As a further qualification, it may be noted that there was substantial variance in the efficiency indices between firms.

Gupta (1982) compared the productivity performance of public and private enterprises in the Indian fertiliser industry. The analysis was made in terms of both total and single-factor productivity over 1969/70–1976/7. The results indicated that productivity in the public sector had been lower than in the private enterprises, although over time the public sector performance had improved relative to private enterprises. The differences in performance were reduced considerably when allowance was made for higher input costs in the public sector arising from their obligation to use indigenous feedstocks, and for the older, outmoded technology employed. A comparison of performance at the individual firm level indicated that productivity performance in the most efficient public enterprises was comparable to that achieved by the more efficient enterprises in the private sector.

Hill (1982) is a study of the Indonesian weaving industry in 1976. It has two interesting features that make the comparison of productivity levels more meaningful than in many other studies. First, the firms in the industry were engaged in direct competition. Second, only firms using the same production techniques were compared. Two different techniques were considered, with public and private mills in each category. Comparing various performance indicators of the two groups of mills for each technique indicated that the public mills’ performance was consistently inferior. Capital-output and labour-output ratios were significantly higher in the public mills, indicating a lower level of technical efficiency. However, since the public mills were considerably larger than private mills, having on average more than four times as many looms per factory, the observed differences in technical efficiency may in part reflect an adverse influence of scale on average productivity levels. Detailed examination of the performance of individual public mills, operating in an identical economic environment and subject to the same constraints
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and obligations resulting from public ownership, revealed major differences in performance, suggesting that internal management and organization were an important determinant of performance.

Krueger and Tuncer (1982) estimated rates of growth in TFP and absolute levels of single factor productivity for two-digit manufacturing industries in Turkey over 1963–76. Estimates are presented separately for public and private enterprises in each industry, and for the private and public manufacturing sectors as a whole. Public enterprises operated in almost all manufacturing industries in Turkey, and competed with the private sector. By 1976, the public sector accounted for more than 30 per cent of manufacturing value added. The results show that as a whole they had a higher rate of TFP growth (2.65 per cent) than their private counterparts (1.84 per cent). The study also computed the capital and labour use per unit of output for public and private sectors in 1963 and 1976. For both years the estimates indicate a higher level of absolute factory productivity in almost all of the private enterprises; the only sectors where the public sector showed greater efficiency were machinery, textiles, wearing apparel and footwear, and beverages and tobacco. The results of this study emphasize the importance of examining both the levels of and the rates of growth in factor productivity; it is not inconsistent for one sector to have a higher rate of productivity growth, while at the same time being absolutely less efficient than the other sector. If the public sector expanded over time by taking over private enterprises with a higher productivity level, it would bias the productivity growth rate upwards.

Perkins (1983) examined the types of technologies selected by public and private industrial enterprises, and their productivities, in Tanzania. Using a sample of more than 300 enterprises in ten major industries, he established that small-scale, labour-intensive techniques were in use in each of the industries, and showed that the majority of these appropriate techniques were technically (in terms of lower capital to output ratios) and economically (in terms of lower unit production costs) superior to the more capital-intensive alternatives. An examination of the technologies employed by public enterprises showed that the more appropriate techniques were seldom used by them. In each industry, the production techniques were found to be larger in scale and more capital intensive, than those used by private enterprises. Only seven of the thirty-two public enterprises studied were technically efficient; the remainder used both more capital and more labour to produce a unit of output than did privately owned firms in their industries. They were also found to be high cost producers, with unit production costs from 10 to 780 per cent higher than the lowest cost firms in their industries.
Tidrick (1986) in a study of productivity growth in Chinese industry shows that TFP in state-owned industry over 1957–83 declined by 0.2 per cent. This is broadly consistent with the estimates of previous studies (World Bank 1983b, Rawski 1983), showing stagnant productivity growth.

Economic profitability

Economic profitability is usually measured as the difference between benefits and costs at economic efficiency (shadow) prices. In \textit{ex post} evaluation, economic profitability is estimated on an annual basis in terms of the economic benefit-cost ratio (EBC) or economic returns to capital (ERC) ratio or unit economic benefit (UEB). An EBC$>1$, or ERC at least equal to the economic opportunity cost of capital, or a positive UEB indicates economic efficiency. Another indicator of economic profitability is the domestic resource cost (DRC) ratio, the ratio of economic opportunity cost of domestic resources to international value added. A DRC$<1$ indicates economic efficiency in terms of economic opportunity cost of domestic resources incurred per unit of foreign exchange saving or earning. In addition, to examine the policy-induced effects on the value added of public enterprises, the effective protection rate (EPR) measure is useful. EPR is usually measured as the ratio of domestic value added to international value added, and indicates the extent of protection and incentive accorded to public enterprises through trade control and promotion policy measures of the government.

These various measures are based on the static comparative advantage framework and entail shadow pricing of inputs and outputs. They discard the use of domestic market prices on the grounds that they do not reflect the real worth of goods and services to the national economy, since they are distorted by structural disequilibria and wage legislation in the factor market, and trade control and promotion measures, price control, and monopoly or oligopoly in the product market. Therefore, to adjust for distortions, traded goods are valued at their international trading (border) prices, non-traded goods usually at their economic prices reflecting their marginal productivities. These measures of allocative economic efficiency and protection have been widely used in studies of the trade and industrial sector in developing countries.

Steel (1972) studied the economic efficiency of the Ghanaian manufacturing sector using the DRC measure. The manufacturing firms were classified by ownership: public, resident expatriates, and international companies. The results showed that public enterprises tended to have lower
DRCs than firms owned by expatriate residents, and slightly higher DRCs than those owned by international companies. The apparent high DRCs in the firms owned by resident expatriates were believed to be the consequence of overstatement of import bills in order to get foreign exchange out of the country, excess capacity, and relatively high unit costs.

Acharya (1979) for Sudan, Islam (1967) for Pakistan, and Walstedt (1980) for Turkey compared the domestic prices of locally produced traded goods with their respective border prices. The results indicated that in most cases the domestic prices exceeded the border prices, implying that the local production by the public sector was economically inefficient.

Shirley (1983) found considerable differences between the financial and economic rates of returns on capital in the Egyptian manufacturing public enterprises for 1980–1. One half of them showed a financial rate of return of less than 10 per cent, one half of them had a negative economic rate of return.

World Bank (1984) reports that in Morocco, where about half of the manufacturing sector was under public ownership in 1978, DRC for all manufactured goods on average ranged between 1.12 and 1.17, implying economic inefficiency. Except for leather, knitwear, cement, and some transport equipment, all the manufacturing branches appeared to have DRC>1.

Yagci (1984) evaluated the economic efficiency and incidence of protection in Turkish manufacturing sector using EPC, DRC and EPC measures, and 1981 data. The results showed that:

(i) both nominal and effective protection were high and differed substantially among sectors, between public and private firms and between domestic and export firms;
(ii) there was a substantial bias against the private sector due to the substantial interest subsidy granted to public firms;
(iii) DRC was substantially higher in the public sector indicating a higher inefficiency in that sector;
(iv) economic profitability in terms of economic returns to capital was on average higher in the private sector.

World Bank (1985) reports that industrial public enterprises in Ethiopia account for almost all employment, output, export, and value added in medium and large-scale industries. Under the Ministry of Industry there were twelve corporations with 153 enterprises. In 1983 the overall economic efficiency (UEB, DRC) of the sample manufacturing firms was low. Two-thirds of the sample nineteen public enterprises were found with DRC>1; negative value added was found
in many medium to large-scale industries. The study also pointed out that the economic efficiency of these industries does not seem to have substantially improved over the 1972–1983 period.

World Bank (1987) reports that public enterprises in Kenya accounted for 8 per cent of GDP in 1984. Those in manufacturing during 1985/6 were economically inefficient and highly protected. The DRC on average for the manufacturing public sector worked out at 2.16.

Adhikari (1988a, b) found that in Nepal public enterprises in manufacturing as a whole, which accounted for about 40 per cent of the total manufacturing value added, were slightly less than economically efficient in 1980/1; however, in the following year they seemed to have improved the level of their economic efficiency to some extent. Import substitutes like sugar, cement, and pharmaceuticals showed net foreign exchange saving with DRC<1. Jute goods, a major export sector, on the contrary, appeared to have been incurring substantial foreign exchange losses. Moreover, the public sector in general appeared to be relatively economically inefficient as compared to their private sector counterparts.

X-efficiency

The X-efficiency theory of Leibenstein (1978) argues that the efforts of firms to maximize profits and minimize costs vary in relation to the internal management structure and external environment in which they operate. The greater the cost-reducing effort, the higher the X-efficiency. X-inefficiency tends to prevail in the public sector because their losses do not necessarily lead to closure, and cost-reducing effort is low. Other factors sheltering X-inefficiency are seen to be monopoly market conditions, poor organization, and socio-cultural traditions. The concept of X-efficiency has been referred to in a number of studies for developing countries (Kilby 1962, Bergsman 1974, Pack 1976, White 1976, Gillis 1982, Tyler 1979, Kim 1981, Hill 1982), but there are not many empirical attempts to measure it.

Gillis (1982) reports evidence of the prevalence of X-inefficiency in the state-owned mining sectors of Indonesia and Bolivia. Leibenstein (1978) provides several examples from the public sector where firms did not introduce improvements and take advantage of the available opportunities, although it would have been profitable to have done so and would not have contradicted any socio-economic objectives. In a study of public enterprise in Nepal (ISC 1975), it was noted that public jute mills were X-inefficient as they were not producing and selling the correct
proportion of sacking and hessian to maximize profits. When examined in the early 1980s they were found to be incurring huge losses, whilst during the same period, privately owned jute mills were found to be operating profitably (Adhikari 1988a). This is consistent with Leibenstein’s hypothesis that some public enterprises fail to introduce improvements and take advantage of available opportunities for operating more efficiently.

**Macroeconomic performance**

The performance of the public enterprise sector has important implications for the macroeconomy, and the contribution of public enterprises to rising public sector deficits and growing foreign indebtedness has been the cause of increasing concern in many developing countries.

### Table 2.3 Public enterprise sector deficit as share of public sector deficit, 1980–6.

<table>
<thead>
<tr>
<th>Country</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Argentina</td>
<td>41.4</td>
</tr>
<tr>
<td>Brazil</td>
<td>118.6</td>
</tr>
<tr>
<td>Colombia</td>
<td>29.8</td>
</tr>
<tr>
<td>Costa Rica</td>
<td>55.5</td>
</tr>
<tr>
<td>Dominican Republic</td>
<td>136.1</td>
</tr>
<tr>
<td>Ecuador</td>
<td>58.4</td>
</tr>
<tr>
<td>El Salvador</td>
<td>16.3</td>
</tr>
<tr>
<td>Guatemala</td>
<td>38.6</td>
</tr>
<tr>
<td>Haiti</td>
<td>6.3</td>
</tr>
<tr>
<td>Honduras</td>
<td>43.0</td>
</tr>
<tr>
<td>Mexico</td>
<td>28.9</td>
</tr>
<tr>
<td>Peru</td>
<td>55.6</td>
</tr>
<tr>
<td>Venezuela</td>
<td>115.7</td>
</tr>
<tr>
<td>Egypt</td>
<td>54.3</td>
</tr>
<tr>
<td>Turkey</td>
<td>114.5</td>
</tr>
<tr>
<td>Bangladesh</td>
<td>20.7</td>
</tr>
<tr>
<td>Burma</td>
<td>43.4</td>
</tr>
<tr>
<td>Malaysia</td>
<td>64.3</td>
</tr>
<tr>
<td>Philippines</td>
<td>61.0</td>
</tr>
<tr>
<td>Thailand</td>
<td>48.3</td>
</tr>
<tr>
<td>Mauritius</td>
<td>27.5</td>
</tr>
</tbody>
</table>

Source: *Nair and Filippides (1988: Table 2.2)*
The data in Table 2.3 indicate that the public enterprise sector’s overall deficit (accounting deficit plus net flows from government to these enterprises) is often a major share of the public sector deficit. World Bank (1988a) reports that in eight developing countries with comparable data, the net budgetary transfer to public enterprises ranged from more than 1 per cent of GDP in the Dominican Republic to more than 5 per cent in Sri Lanka during 1983–5. In Brazil, the Dominican Republic, Ecuador, Egypt, Turkey, and Venezuela, the public enterprise sector realized deficits larger than the overall public sector deficit, implying that the rest of the public sector would have generated a fiscal surplus without these net transfers.

Public enterprises have been significant borrowers in domestic and foreign credit markets. Where, as commonly happens, the government guarantees the public enterprise debt, a deterioration in its financial performance can have serious repercussions for the government budget. For example, in Senegal, the government assumed responsibility for bank debts equivalent to 15 per cent of GDP when the agricultural marketing board was liquidated in 1980 (World Bank 1988a:170). Public enterprise borrowing from domestic credit markets may have the effect of crowding out private sector borrowers. Blejer and Khan (1984), using pooled cross-section data for twenty-four developing countries over the period 1971–9, found that the effect of public enterprise investment on private sector investment was consistent with the crowding-out hypothesis, although the substitution between public and private investment was not large. Public enterprises have also borrowed heavily in foreign markets. Their direct foreign borrowings accounted for more than one-fifth of total foreign debt in ninety-nine developing countries as a group, and grew faster than the foreign debts of private borrowers during 1976–86 (World Bank 1988a:170). Public enterprises have accounted for more than half of the outstanding external debt of Brazil, Mexico, the Philippines, and Zambia.

Where deficits are met by borrowing from the central bank, it can have implications for money supply and inflation. The public enterprise share of central bank credit varied considerably across countries in the mid-1980s, from less than 1 per cent in Liberia to 23 per cent in Brazil (Nair and Filippides 1988: Table 2.5).

Concern with the impact of public enterprise financial deficit on macro-stability is reflected in the priority given in the International Monetary Fund’s stabilization programmes to improving public enterprise financial performance. In a survey of ninety-four Fund-supported adjustment programmes in developing countries during the period 1980–5, it was found that 72 per cent
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of the programmes included policy recommendations relating to non-financial state enterprises, aimed at improving financial performance (IMF 1986).

Social efficiency performance

The evaluation of social efficiency—the degree of success in meeting non-commercial objectives—is not straightforward, mainly because the social objectives are often vaguely defined, and their achievement may not be quantifiable. Although the statements of social objectives vary from country to country, the common concern of social efficiency has been with income distribution between different income groups and regions (Ramanadham 1988:3–6). This objective can be achieved through several channels such as wages and material inputs policy, pricing of outputs, distribution of financial surplus, and enterprise location. However, where public enterprises have implemented policies to achieve this objective, these have often conflicted with financial and economic objectives. For example, high wage bills and over-manning damage their financial performance; high prices for input suppliers push up the cost of production; low prices for output often fail to benefit the low income groups (World Bank 1983a, 1988a, Jones 1985, Ramanadham 1988).

There are a number of ways in which non-commercial objectives can be explicitly allowed for in public enterprise performance evaluation. One approach is for the government to provide financial support for specified loss-making activities that the public enterprise is required to undertake in pursuit of distributional objectives. The public enterprise is then required to meet a specified financial target. In Senegal, for example, the government negotiated formal agreements with those operating in the transport sector. Under these agreements the government makes a three-year commitment to meet the enterprises’ costs of operating unprofitable ‘social’ services, and gives the enterprises greater autonomy in day-to-day decision-making. In return the enterprises agree to specific targets for financial and productivity performance (World Bank 1983a:79).

A more complex method of incorporating different objectives into an operational performance indicator is to assess public enterprises in terms of their ‘public profitability’ record. ‘Public profit’ can be thought of as financial profits, adjusted for economic efficiency and other non-commercial objectives. Inputs and outputs are revalued at shadow prices to allow for the divergence between market and efficiency values; the costs of meeting non-commercial objectives are deducted before public profit is calculated and treated as implicit subsidies to the enterprise. Enterprises are then judged on the basis of their public profitability performance. This approach has been used in Pakistan, Republic of Korea, and Venezuela (World Bank 1983:82).
The adoption of procedures for setting specific operating criteria and performance targets is likely to help make explicit the costs and benefits of pursuing different objectives, and can contribute to a more rational and informed evaluation of public enterprise performance.

Summary and conclusions

Detailed empirical studies covering all aspects of public enterprise performance in developing countries are still limited. The majority of the studies have focused on financial profitability, but recently more attention has been given to their economic profitability and macroeconomic impact.

The available evidence indicates that in some developing countries certain public enterprises have succeeded as commercial ventures, contributing to public revenues and playing an important role in the process of economic development. Nevertheless, in most developing countries their achievements have fallen short of what was hoped for. Their success has been impaired by the setting of conflicting objectives, government interference in day-to-day operations, lack of fiscal discipline, and protected uncompetitive market conditions.

The weight of evidence surveyed on financial performance seems to support the conclusion that public enterprise performance has been unsatisfactory. In most cases, public enterprises failed to generate sufficient revenue to cover their recurrent costs. Low profitability appeared to have been a consequence of poor organization and management, government interferences in day-to-day operation, and non-commercial objectives which they have to fulfil. Their productivity growth also seems, on average, to have been less than satisfactory. With a number of important exceptions, the evidence indicates that productivity levels have been lower in the public sector than in the private sector, although productivity growth has often been higher in the public sector. Some evidence also suggests that public enterprises tend to be X-inefficient as a consequence of high protection and bureaucratic management structures.

However, any comparison with their private counterparts needs to be made with caution. Public enterprises are often expected to fulfil at least some social objectives, and this can affect their economic performance. Moreover, the sector in many developing countries includes loss-making companies that government acquires for non-commercial reasons, and these are often located in slow-growing basic industries. Therefore, it is arguable that the relatively poor performance of the public enterprise sector can partly be explained by their
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closeup concentration in product lines and basic industries (such as steel, automobiles, oil, and fertilisers) that have experienced little growth in recent years, or in developing new industries where it performs a departmental role. However, it is still true that these industries have contributed significantly to the macroeconomic problems, particularly external debt, experienced in many developing countries.

The empirical evidence on their social efficiency is extremely limited, but what is available indicates that their use as an instrument to achieve social and redistributational objectives may not only adversely affect their financial and economic performance, but may also have perverse distributional consequences.

It is beyond the scope of this chapter to provide a detailed review of the burgeoning literature on alternative policy initiatives to strengthen public enterprise performance in developing countries. However, several key points can be distilled from the literature and presented as a conclusion to this chapter. First, it is now generally recognized that the degree of public ownership does not itself determine the performance of an enterprise:

the key factor determining the efficiency of an enterprise is not whether it is publicly or privately owned, but how it is managed. In theory it is possible to create the kind of incentives that will maximize efficiency under any type of ownership, but there is a great difference between what is theoretically feasible and what typically happens. As a commercial entity, a state-owned enterprise must sell in the marketplace. As a public organization, it is given other objectives and is exposed to pressure from politically powerful sectional interests. State-owned enterprises are often operated as public bureaucracies, with more attention to procedure than to results; and ready access to subsidies can erode the incentive for managers to minimise costs. (World Bank 1983a:50)

The implication is that public sector reform, rather than changes in ownership, is likely to be the major focus for public enterprise policy in the coming period. This process of public sector reform will consist of two main components. The first will be directed towards improving the organizational and managerial structure of the public enterprises. Greater managerial autonomy and the establishment of "a management philosophy that is less control-oriented and procedure-bound and more concerned with judging managers on the basis of enterprise viability" (Ayub and Hegstad 1987:6) are now recognized as key factors in improving performance.
The second area of public sector reform relates to the economic policy environment within which the public enterprise sector operates. Reform of the macroeconomic framework, in the areas of the exchange rate, trade restraint measures, and industrial and financial sector regulations, can contribute significantly to an improvement in public enterprise performance.

One of the main effects of the shift in development orthodoxy towards a neoclassical market-oriented perspective has been to draw attention to the often disappointing performance of the public enterprise sector and the importance of devising policies to improve the sector’s contribution to the development process. The reform of the public enterprise sector cannot be perceived, however, simply in the terms of devising appropriate institutional, organizational, or economic reform measures. In practice, ‘what ought to happen invariably is subordinated to, and conditioned by, internal political and administrative processes which determine what actually does (or does not) happen’ (Cook and Minogue 1989).

Brett’s (1988) comment on privatization is apposite to the wider issue of public enterprise reform in general ‘the failure of the state to control its servants should not simply be seen as an economic problem to be resolved by privatization (i.e., try dismembering the state), but also as a political problem to be resolved by improving the political and administrative mechanisms which have failed’ (1988:52). Improving the performance of the enterprise sector in developing countries is ultimately as much an issue of political economy as of economic policy.

Notes

1 These results are similar to those reported by Short (1983), who estimated 8.6 per cent and 9.6 per cent for a sample of developing and industrial countries for the period 1974–7.


3 Having reviewed the evidence on productivity growth Millward (1988:157) concludes that ‘there is no evidence of a statistically satisfactory kind to suggest that public enterprises in LDCs have a lower level of technical efficiency than private firms operating at the same scale of operation. On a less formal level the tendency seems to be nevertheless pointing in that direction’.

4 For a useful summary of reform measures, see World Bank (1988a: chapter eight).


6 For discussion of the impact of structural adjustment policy reforms on the public enterprise sector, see World Bank (1988b) and World Bank-UNDP (1989).
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Chapter three

Some issues of principle: the case of British Telecom

Esther Brimmer and David Thompson

For those guiding the destiny of public enterprises, on arrival at the crossroads there are many possible ways forward. The purpose of this chapter is to consider some of the issues of principle involved in selecting the right path.

Our subject is the role of privatization as a policy instrument for improving the performance of public enterprises. Concern with performance is a theme which has been central to the debate on public enterprise policy. In the words of the Treasury minister in the UK responsible for privatization policy ‘our main objective is to promote competition and efficiency’ (Moore 1983). This concern with performance is a theme which is echoed in the many countries around the world where public enterprise policy is being re-evaluated.

The practical example chosen is British Telecommunications plc (BT), which was the first important state enterprise to be privatized in the UK. From 1912 the telephone system was a government department (part of the Post Office) staffed entirely by civil servants. In 1969 it became a public corporation, losing its civil service status. In 1981 it was split from the Postal Service, with a degree of liberalization in its activities, and in 1984 it was privatized: it was made into a company, and a majority of its shares were sold to the public.

Policy-makers seeking to reform the public enterprise sector in the UK faced three key decisions:

1. Should competition be introduced in sectors which, hitherto, had been statutory monopolies?
2. How should enterprises be regulated in sectors where competition is infeasible?
3. Should the incumbent enterprises be privatized?

It is these questions, as they developed in the UK telecommunications sector, which we discuss in this chapter. In the following section we take a brief look at the history of telecommunications in Britain. Then we
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consider the introduction of competition in telecommunications and later we address the inter-related issues raised by BT’s privatization and the new regulatory framework which was established. We look at the developments since privatization, before examining the performance of the reformed telecommunications sector.

The UK telecommunications industry

The telecommunications industry can be usefully divided into three different types of activities:

1. Manufacturing and supplying customers’ equipment, for example, telephone exchanges or handsets;
2. Operating networks, i.e. connecting households and businesses to each other (networks operate at a local, national and international level);
3. Supplying services which use the network, traditionally voice communication, but with other types of service now becoming more important.

In the past it was generally assumed that telecommunications were a ‘natural monopoly’ (Sharkey 1982). Natural monopoly arises when there are economies of scale (or scope) in production which mean that a single firm is able to serve the market at lower unit costs than if the market were divided between several firms. If a potential entrant would face large ‘sunk’ costs in entering the market, i.e., costs which could not be recovered should the entrant subsequently decide to exit the market, then the incumbent enterprise will be able to exercise significant monopoly power unless constrained by regulatory intervention. This type of natural monopoly is most likely to occur in industries with extensive distribution networks: for example, the costs of two separate gas pipelines serving the same street are, in aggregate, likely to be very much greater than a single larger volume pipeline. Moreover, the sunk costs of building a new network would be substantial. At first sight, this suggests that telecommunications, with its significant network activities, falls into this category.

However, even if a natural monopoly exists for one type of telecoms activity, this does not necessarily mean it exists for other types. Both the impact of changing technology and the rapid growth in demand for their products have eroded the natural monopoly characteristics of the industry. It is clear, for example, that there is no natural monopoly in producing terminal equipment. The more widespread use of plug-in telephones has made it easier to add different handsets. As long as the handset can be safely connected to the network, anyone can produce it. In contrast, running a telephone network has a tendency to favour monopoly service
because fewer separate networks mean less duplication, more direct transmission, less switching, and thus less equipment. However, in recent years the technology of networks themselves has started to change. The network used to be a system of copper wires or coaxial cables. They were laid underground or hung from telegraph poles. In the handset the voice was converted into analogous electrical waves which travelled over this network of copper cables and was changed back into a voice in the receiver’s handset. Since the 1960s networks have also used satellites and microwave radio as well as copper cables. Nevertheless, the voice was carried by the analogue system.

New technology has now allowed a voice to be translated into binary digits. Computers read binary digits as information. Thus if an integrated digital telephone system were used, voices, text, television, and computer data could all travel more quickly over the same network, making it more versatile. Moreover, if optical fibres were used instead of copper cables, the volume of calls could be increased, because such fibres have a greater capacity: messages are transmitted as pulses of light or electricity, and can be sent more quickly with the digital system, so that more messages can be fitted into the same size of cable.

These new ways to carry information (optical fibres, satellites, and cable) make other types of telephone networks possible. Instead of electromechanical switches, whose moving parts often caused faults, the new systems use digital switching run by software programs. This innovation makes the interconnection between networks easier, and thus increases the opportunity to develop rival networks, even though interconnection may still take place at analogue exchanges.

There has also been a substantial growth in demand for telecoms services, averaging 12–15 per cent per annum over the last decade in the UK. The consequence is that the level of demand has become sufficiently high to make more than a single network financially viable. In other words, demand is now greater than the minimum efficient scale of a single network.

Technical innovation has also created scope for competition in the third area of telecommunications: special data and information services. The supplier of ‘value added services’ (VAS) buys access to a network like a regular customer, but then uses it to provide a service, such as sending or transcribing electronic mail, to a third party. The supply of these services is potentially competitive because there is no inherent natural monopoly in their provision, once the network capacity has been purchased.

As the underlying economic characteristics of the telecommunications industry were being transformed, there were also changes in government and thus in policy towards the public enterprise sector. In 1979 a Conservative government was elected, determined to pursue a more radical
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approach to the long-standing issue of public enterprise performance. As a result, in 1981 BT was separated from the Post Office, and the first steps were taken towards opening up telecommunications to competition. In a 1982 speech to the House of Commons, the Minister responsible for BT, the Rt Hon. Patrick Jenkin, MP, stated how the government’s commitment to the market economy would shape its telecommunications policy:

> It is the government’s aim to promote consumer choice. Wherever possible, we want industrial and commercial decisions to be determined by the market and not by the state. We believe that consumer choice and the disciplines of the market lead to more stable prices, improved efficiency and a higher quality of service.

(Jenkin 1982:1)

From the government’s point of view, some of the public sector companies were not only inefficient, but expensive. The accounting rules for the public sector counted their investment as public expenditure. Therefore, even though BT financed much of its investment itself, the cost of its investment had implications for the public sector borrowing requirement (PSBR). But the Conservative government attached a high priority to reducing the PSBR, and in 1982 alone (the year in which the government decided to privatize BT), the company planned to spend £2,200 million on investment to introduce the new types of digital equipment described above (Jenkin 1982). Furthermore, as a public sector organization, BT could not raise money on the capital markets. It had two other sources of funds: its own earnings or government loans. To generate its own funds for new investment it could raise its rate to customers. Ninety per cent of its investment was financed from internal sources.

The government was worried that BT would continue to raise its charges, that its investment would increase public expenditure and the PSBR, and yet it would still not have enough money to complete its modernization programme (Jenkin 1982). The government considered a number of ways out of this dilemma, including relaxation of the PSBR rules, and the introduction of a new type of government security specifically linked to telecoms, the ‘Buzby Bond’ (named after the cartoon character which advertised BT’s services). Privatization of BT provided a solution to the problem by taking the financing of BT’s investment outside the PSBR. This is of course a presentational issue. It is likely that the effects on interest rates and on inflation of private borrowing are much the same as those of public borrowing for the same project (see Mayer and Meadowcroft 1985).
Thus by the early 1980s many new factors had emerged in the British telecommunications industry. New technology made new services available and this, together with a rapid growth in demand, challenged the idea that telecoms were a natural monopoly. The new government was ready to reconsider the status of public sector monopolies because the Conservatives wanted to increase competition and economic efficiency. They also wanted to reduce the PSBR. These various developments ultimately prompted the privatization of BT. Initially, however, the government considered how to introduce competition into telecommunications.

**Introducing competition**

In July 1980 the Secretary of State for Industry, Sir Keith Joseph, told the House of Commons that the Government was considering allowing companies to use the BT network to provide new services. Two months later the Government asked Professor Michael Beesley of the London Business School to examine the possibility of liberalizing the use of BT’s network for resale. The government was not at this point questioning BT’s role as the supplier of the national telephone network; rather it wanted to know if other companies could be allowed to purchase capacity on BT’s network in order to sell services to customers.

In his landmark report *Liberalization of the Use of British Telecommunications Network* (1981), Beesley expanded the study to include the whole question of reselling telecommunications capacity for all purposes; that is the transmission of basic network voice services as well as other services, such as data transmission. The question was whether BT would be the only company allowed to supply this capacity or whether other companies could buy this capacity from BT and then sell it on to third parties.

In discussing the case of resale he noted that technological factors supported it, because the scope of monopoly could not be easily defined. When considering equipment, technological innovation made it hard to distinguish between the transmission of voice and of other services.

Beesley examined the likely impact of unrestricted resale on economic efficiency. He reviewed evidence that BT’s monopoly had delayed the introduction of new services and equipment (Beesley 1981: 6, para. 16). According to these witnesses the telecom monopoly interfered with other firms’ ability to modernize their services. For example BT had prohibited direct links between companies’ computer files that would have facilitated transfers between corporate customers and their banks (para. 17).

Experience in other countries suggested that resale could significantly change the nature of telecommunications. Customers would have the freedom to lease telecom capacity and use it how
they liked (for example, linking up to their bank). Such changes could affect the structure of the industry. Beesley studied the more liberal American telecom industry and the less liberal European ones. He noted that while the American system was different from that in the UK,¹ the process of liberalizing the market in data services had ended up creating competition also in voice services (Beesley 1981:29, para. 111).

He considered BT’s reasons for opposing unrestricted resale and its defence of its monopoly. BT was primarily concerned about loss of revenue from telephone calls: 90 per cent of its revenue came from voice services. BT did accept that resale could be useful in areas where it did not provide a service, but it wanted to be sure that ‘there is no net financial disbenefit to BT’ (Beesley 1981:6, para. 15). In addition to a financial case, BT posited an economic one: it argued that the cost efficiencies of a natural monopoly would be lost. In his evaluation of the effects of resale on BT, Beesley acknowledged that BT would lose revenue to competitors, but doubted that it would be as large as BT claimed and noted that by itself such a loss would be small relative to the improvement in service to the customer (Beesley 1981:21, para. 78). Competition would also encourage BT to increase its efficiency by moving towards cost-based pricing (para. 84).

Having examined the possibilities of liberalizing the market, Beesley’s conclusions supported liberalization of unrestricted resale. In addition, he noted that the Government should consider allowing more companies to build transmission and switching networks because this would increase competition between networks and make regulation easier (for a full list of his conclusions, see Beesley 1981:36, 140). In essence he favoured promoting competition by liberalizing the market. This conclusion challenged the status quo by questioning the idea that telecommunications was a natural monopoly.

Following that report the government started to implement a liberalization strategy with the 1981 British Telecommunications Act. The legislation liberalized market entry in relation to each of the three types of telecoms activity by:

1. beginning the process of complete liberalization of the sale of equipment to customers (initially BT retained a monopoly over the supply of the first phone attached to the network by a customer [the prime instrument] but this restriction was also eventually liberalized);
2. opening the way for competing network suppliers by providing for one other national fixed link supplier (Mercury was the company eventually licensed), and by providing also for the licensing of innovative networks, e.g. cellular phones;
3. providing for competition in services.

However, the government decided that some restrictions on resale were desirable, in contrast to Beesley’s recommendations, and defined the market in which competition would be allowed as Value Added Network Services (VANS). In order to compete in this market the service offered had either to alter the format of the message transmitted, or in some other way to add value. Crucially this restriction prevented firms competing by reselling capacity in the voice market.

Beesley’s recommendations in favour of unrestricted resale of BT’s network capacity were thus rejected by the government. It announced that resale would not be permitted until 1989 (or later). Essentially, there were two concerns. The first was that BT might lose revenue, not because its costs were high through inefficiency, but because its charges for private circuits were, at that time, set too low in relation to costs. The second related concern was that immediate liberalization of resale would lead to a rapid re-balancing of the outmoded tariff structure, and that charges for long-distance calls would fall, against significant increases in charges for local calls.

The strategy of liberalization did not, however, directly relieve the pressure on the PSBR. As long as BT was a public sector company its investment programme would be counted as public expenditure and affect the PSBR. As a public sector company BT was denied access to the capital market, but it needed to make large long-term investments.

In his statement to the House of Commons Patrick Jenkin noted that while the government had liberalized the market, more radical measures would be needed to relieve the financial pressures on BT.

Unless something is done radically to change the capital structure and ownership of BT and to provide a direct spur to efficiency, higher investment would mean still higher charges for the customer. The Government, BT, and the general public would find that unacceptable. We need to free BT from traditional forms of Government control.

We will therefore take the earliest opportunity to introduce legislation which, while keeping BT as a single enterprise, will enable it to be converted into a Companies Act company, ‘British Telecom plc’. The legislation will allow sale of shares in that company to the public. It is our intention, after the next election, to offer up to 51 per cent of the shares on the market in one or more tranches.

(Jenkin 1982:1–2)
Privatization and regulation

The government privatized BT as a single company in November 1984, selling 50.2 per cent of its shares to the public. Before the sale it stated that it would not use its remaining 49.8 per cent to interfere with the company. Instead it would retain a single non-voting Special Share which would entitle the government to veto changes in the company’s Article of Agreement (such as the requirement that the Chief Executive be a British citizen). The Special Share also permitted the government to appoint two people to the Board of Directors. They would be allowed to vote on matters when the Crown was involved.

The government offered 3.012 billion shares for sale at a cost of 130p a share. They were many times oversubscribed. Not only did the sale raise £3.9 billion (paid in three instalments), but it showed that flotation of a large public enterprise could be implemented successfully.

Although BT was no longer in the public sector, its operation still involved questions of public policy. In particular, despite the liberalization initiatives implemented in 1981, the newly privatized BT remained the dominant firm in each of the markets it served in the UK. The government was concerned to prevent exploitation of this monopoly position and to ensure the development of fair competition. As the Secretary of State put it:

BT plc will nevertheless dominate the British market for telecommunications for some years yet. The government considers therefore that there will be a need for regulatory arrangements for the industry to balance the interests of those supplying telecommunications services, their customers, their competitors, their employees, their investors, and their suppliers.  
(Jenkin 1982)

These various concerns can be categorized into three groups of regulatory issues:

1. How to meet social objectives;
2. How to develop competition;
3. How to prevent monopolistic behaviour.

The statutory basis for regulation was provided in the Telecommunications Act 1984 (See Gist 1988 for a discussion of the regulatory framework). This required that BT have a licence to operate. BT’s licence stipulated the conditions under which it could provide a nationwide telecom network in Britain (excluding Hull, which had its own, municipally owned service).

To implement the regulatory scheme a new body, the Office of Telecommunications (Oftel), headed by the Director General of
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Telecommunications (DGT) Sir Bryan Carsberg, was created in July 1984. The legislation gave the Director-General two general duties:

1. To ensure the provision of telecoms services throughout the UK to meet all reasonable demands, including various specified services (e.g., call boxes or emergency services);
2. To ensure that the suppliers of these services are able to finance their provision.

The legislation also specified eight additional guidelines which included, in particular, promoting effective competition and promoting efficiency and economy.

Oftel’s job is to promote the achievement of these various—not always mutually consistent—objectives. Its most important tool is its power to monitor and enforce the conditions in the licences held by BT and other telecoms operators. Oftel also advises the Secretary of State on whether to issue new licences.

Oftel has several sanctions available to achieve its objectives. It can issue court orders to ensure compliance with licence conditions. It can seek to modify licences in order, for example, to prevent particular cases of anti-competitive behaviour. Licence modifications can be negotiated with the licensee, but where the licensee and Oftel fail to agree the case can be referred to the UK competition authorities (the Monopolies and Mergers Commission) for adjudication. Oftel’s final and most extreme sanction is to revoke a licence. These tools were used to tackle the three regulatory issues identified above. We will consider each in turn.

Meeting social objectives

Social issues are intrinsic to the nature of the industry. Communications are part of the web that holds an advanced industrial society together. It was considered important that everyone should have access to the telecoms network, in particular to the emergency services. Whilst BT was in the public sector this objective was met by delivering telecoms services to sparsely populated rural areas at a standard tariff, by maintaining a national system of public call boxes, and by providing free lines to the emergency services. Not all these activities were profitable however. Once BT was privatized the question arose as to whether, and how, these services should be maintained.

In the event, the responsibility for social services was placed on BT’s shoulders. Condition 1 of BT’s licence relates to the ‘Universal Provision of Telecommunications Services’, and it is obliged by Part 2 of Schedule 1 of its licence to supply directory assistance, and to provide rural, emergency, and maritime services, as well as call boxes across the country.\(^2\) BT already had such a network of services in operation. As a private
company, BT might want to cut back some of the services to reduce costs, but the licence restricted the company’s actions in this regard. For example, BT could only remove a call box if it earned less than £185 a year. These requirements only appear in BT’s licence, not in that of its competitor, Mercury Communications. Thus even though BT was a private company it was assigned special social responsibilities, and if these proved to be unprofitable, BT might believe that it had been handicapped relative to its competitors. However, the licence does make provision for an access charge to be levied on all telecoms customers to finance such activities if BT is unable to finance them.

**Promoting competition**

We noted earlier that with the 1981 Telecommunications Act the government commenced its strategy of liberalizing the entry of new competitors. Entry into telecoms is not, however, straightforward. Setting up a new network engenders large sunk costs which are irrecoverable should the venture fail. Furthermore, the successful entrant needs to draw customers away from the market reputation BT established during the decades when it was the only supplier of telecoms services. BT, of course, has a natural interest in deterring new competitors from entering its markets and in encouraging the exit of firms which have already entered.

The second task of regulation is thus to ensure that competition in the newly deregulated markets is fair. To achieve this the Government took steps which went beyond the application of the normal provisions of its competition policy. In other words, BT’s strong incumbent position was recognized explicitly by treating it as a special case (see Gist 1988).

There are various conditions in BT’s licence which are aimed at ensuring that BT competes fairly with new entrants. In particular, it is required to publish its charges, and undue preference and undue discrimination are prohibited. BT is also required not to cross-subsidize unfairly any one off our specialized businesses (including apparatus supply and VAS) from its other activities. To help police this requirement the licence also requires BT to provide separate accounts for its network, VAS, and apparatus supply businesses.

Nevertheless the task of introducing competition in telecoms is likely to prove formidable. For example, enforcement of the prohibition against undue preference and undue discrimination requires an assessment of whether or not a particular charge structure is ‘undue’. The technical resolution of this question is not straightforward in an industry such as telecoms, where many costs are incurred jointly by several different activities. These make measurement of the cost of any particular activity or product technically uncertain and open to disputation (see Culham and Hartley 1988, Cave and Hartley 1989). To regulate the industry, Oftel must rely on BT for much of the information it requires, and challenge
the resources of BT, which has an annual turnover of £6,000 million, with only an initial budget of £1.5 million and a staff of 120.

Preventing monopolistic behaviour

As a result of the liberalization strategy, BT faced emerging competition in network services, in apparatus supply, and in the supply of value added services. Nevertheless, it was clear that its position as a dominant company would be eroded only slowly. The third task of regulation was thus to curb the possible exploitation of this monopoly power at the expense of the consumer. In the period when Mercury and the other new companies were still establishing themselves, consumers had little effective choice but to go to BT for the required services. In these circumstances BT could charge high prices or reduce standards of service with little serious danger of losing business. Therefore, without any incentives to reduce its costs or to improve its service, the monopoly could be inefficient and still make a profit.

In October 1982, Stephen C. Littlechild, Professor of Commerce at the University of Birmingham, was commissioned to examine alternative regulatory mechanisms to reduce the scope for BT’s exploitation of its monopoly power. Before developing his own approach, which became known as the (RPI-x) formula, he examined three other options: a maximum rate of return, an output-related profit levy, and a ceiling on profits (Littlechild 1983).

In the absence of regulation BT would be able to fix prices at high levels and achieve very high profits. Therefore controlling BT’s profits might seem an obvious way to control monopolistic behaviour. One proposal was to set a maximum rate of return (MRR) which could be earned by BT. It was suggested that this be specified in BT’s licence (Littlechild 1983:14, para. 7.2[1]). Rates of return would be set for local, trunk, and international calls. Profits would be monitored by Oftel and amounts in excess of the MRR would be rebated to customers. BT would have little incentive to charge very high prices since it could not keep excess profits above the set rate. Moreover, consumers would recover the benefits of any excess BT did make. The MRR was similar to methods of regulation used in other countries, notably in the United States, where private ownership of utilities is widespread, and its strengths and weaknesses could thus be examined on the basis of empirical experience.

The basic problem with rate of return regulation is that it does not promote efficiency. Whatever action the management takes to improve performance, the benefits are not returned in increased profitability—the incentive central to private ownership—but instead are returned to the customer. Conversely poor performance would not lead to low profits, and consequent pressures from shareholders, but would be cushioned by the regulatory permission to increase prices to a level sufficient to earn the permitted rate of return.
Poor performance might be manifested in several ways. Littlechild noted that it could be in BT’s interests to set the price for a call irrespective of the time of day and routeing, or other factors which determine cost (Littlechild 1983:17, para. 8.11). BT’s prices might be inflated further by the ‘burden of regulation’ since the company would pass on to the customer the costs incurred in defending itself from Oftel.

Nor would an MRR necessarily promote innovation. If BT researched and invested in a technical innovation that increased efficiency and reduced costs any gain in profits would be ‘taxed’ away in rebates to customers. The improved level of efficiency would be taken as the norm when setting the MRR, giving BT no extra profit. Therefore, BT would have little incentive to be efficient by keeping costs down since these costs would change the base for the MRR. Likewise, increasing capital investment would increase the base on which the MRR itself was calculated, a worthwhile strategy provided the allowed rate of return exceeded the cost of capital. This could lead to over-capitalization (see Averch and Johnson 1962).

Aware of the weaknesses identified with rate of return regulation, Littlechild developed an alternative approach. His idea was to put a ceiling on BT’s prices. Littlechild suggested linking BT’s prices to the retail price index such that prices could not rise faster than RPI-\(x\) where \(x\) was a pre-specified number set for a term of five years (Littlechild 1983:34, paras 13.4, 13.5). This proposal focused on the issue of monopoly pricing directly by setting a limit on the rise in consumer prices in markets where BT was deemed to have significant monopoly power. Compliance with the pricing formula could be easily monitored by Oftel. It would not need to calculate rates of return or future costs each year. Littlechild initially proposed that RPI-\(x\) would apply only to local tariffs and rentals. Liberalization of entry into other markets, particularly that for trunk services, was considered by Littlechild to provide a sufficiently competitive threat to prevent BT from exploiting its dominant position.

The main strength of the RPI-\(x\) proposal was perceived to be its effect upon incentives to efficiency and innovation. Under this scheme, if BT were able to improve its performance over the five-year period more rapidly than had been anticipated when setting the value of \(x\), then BT would be able to retain the benefits in increased profits. Of course the strength of this incentive to efficient performance is conditioned by the degree to which BT has incentives to increase its profits. It has been argued that these incentives are far weaker than is the case for most private sector companies (Vickers and Yarrow 1988). BT’s size, its specialized nature (there are no similar companies in the UK market with which to make comparison), and the various provisions on the maximum size of shareholdings, together mean that the threat of bankruptcy or hostile takeover is weak. The specialized nature of its products and the regulation
of its prices in some markets mean that it is particularly difficult for shareholders (and the analysts who advise them) to determine whether the company’s record reflects good or bad performance.

This perceived weakness has led to the suggestion that it would have been advantageous to break-up BT prior to privatization (see Vickers and Yarrow 1988 Hammond et al. 1985, on the analogous case of British Gas). Divestment, similar to the break-up of AT&T in the USA, would have created a multiplicity of separately owned local networks, and an incumbent long-distance operator competing with Mercury. In these circumstances hostile takeovers of under-performing companies would have been easier, because each of the companies would have been far smaller than BT. Both shareholders and Oftel would have been able to reach better informed judgements on whether a particular company was performing efficiently or not, by making comparisons with other similar companies.

In the event the difficulties associated with restructuring BT were considered to be too great, and BT was privatized as a single company. Littlechild’s local tariff reduction scheme (RPI-\(\times\)) was adopted, with one important modification, and incorporated into BT’s licence. The formula covered rentals and inland local calls as recommended by Littlechild, but also covered trunk calls. Within the overall bundle of regulated prices, an undertaking by BT, at (RPI+2), limited increases in residential rental rates. Thus regulation covered about 55 per cent of BT’s turnover. The other 45 per cent of prices were unregulated. The value of \(\times\) was negotiated with BT at the time of BT’s sale and was set at 3 (i.e. RPI-3). Thus BT had some input into the scheme designed to control its pricing.

**Developments since privatization**

We now turn to consider what has happened since these various reforms were implemented. First we will consider the markets where entry has been liberalized, looking in turn at the three groups of activities: customer equipment, networks, and value added services. Then we will look at the regulation of BT’s monopoly power, and consider the treatment of social objectives.

**Liberalization of customers’ equipment**

The most significant sector for equipment is private branch exchanges (PBXs). Even though BT did not manufacture PBXs, it held a monopoly in their supply to customers. In practice, however, whilst it exercised this monopoly for much of the PBX market it did not engage in the supply of the largest PBXs (over 134 lines) but left this market to the manufacturers.
Following liberalization, a whole range of companies entered the PBX market. By the beginning of 1986 there were over 50 supplying firms. Seven out of fourteen manufacturers sold their products entirely independently of BT (see Gist and Meadowcroft 1986). Nevertheless, BT retained a high share of the liberalized market, 80–90 per cent, while also successfully entering the market for the very largest PBXs. By 1986 it was clear that, since liberalization, prices had fallen in real terms and that the range of products available had increased, although it was unclear to what extent those favourable effects were a consequence of the underlying technological advances or the liberalization of market entry (Gist and Meadowcroft 1986).

In 1985, however, BT launched a takeover bid for Mitel which manufactured 52 per cent of the PBXs then being supplied independently of BT. The takeover was investigated by the Monopolies and Mergers Commission, but was approved subject to various conditions aimed at minimizing any potential adverse consequences for competition in the PBX market. BT completed the acquisition in March 1986. In July 1989 the Government announced that, on the recommendation of the competition authorities, it was relaxing the various conditions imposed on BT at the time of the acquisition.

**Liberalization of Networks**

As noted earlier two types of entry have been particularly important, the first resulting from the licensing of cellular networks (that is mobile phones, in particular car phones), and the second from licensing a second terrestrial network, Mercury.

The two cellular networks (Cellnet and Vodafone) were launched in January 1985 and licensed for 25 years. The number of subscribers is now over half a million, with 94 per cent of the population located within the networks’ reach (see Geroski et al. 1989). Vertical separation was imposed and the cellular networks are required to sell their services through separate service providers. A highly competitive market has developed in service provision and there are now about fifty suppliers. Despite vertical separation a price structure has been implemented—in which the prices of equipment are set ‘low’ and the price of airtime ‘high’—which has encouraged rapid growth in the use of cellular networks. Recent calculations suggest that in 1995 the return on capital employed by the two network owners could range between 80 and 130 per cent, although this must be balanced against the losses made in the early years of operation. Nevertheless, this raises the question of whether, and when, it would be appropriate to licence further cellular networks. A third licence has recently been granted to Mercury to commence in 1991 (Geroski et al. 1989).
The terrestrial network was also established as a duopoly by allowing a new operator—Mercury Communications plc—to set up a rival network to BT. Mercury was created in 1982, initially by a consortium, but by 1988 it had become a wholly-owned subsidiary of Cable & Wireless. Mercury has spent over £200 million to date to build an 800-mile fibre optic loop connecting English cities.

However, Mercury still needs to use BT lines to connect calls to points not on its network. As BT has a virtual monopoly on local networks, this means that Mercury needs to connect to BT’s network in order to be able to offer its services to most telecoms customers, although a small number of subscribers can connect to Mercury’s network directly. The terms and conditions under which Mercury can interconnect with BT’s network are thus crucial to its effectiveness as a competitor. Indeed Oftel’s most significant ruling so far has dealt with interconnection.

BT’s licence requires it to interconnect to rivals, and in 1984 BT and Mercury signed a ‘Heads of Agreement’ regarding interconnection. In 1985 Mercury asked the DGT to rule on how the systems should be interconnected. BT then challenged in court the DGT’s right to rule on the matter, arguing the ‘Heads of Agreement’ should stand. The courts upheld the DGT’s right to rule and denied the agreement any legal validity. However, it was not until October 1985 that the DGT could make a ruling on how BT and Mercury should be connected. Thus it was nearly a year after BT’s privatization before Mercury could plan its investment strategy, since this depended on the conditions of interconnection.

Oftel ruled that BT must connect Mercury for national and international calls, and it established a timetable and payment schedule. BT was to charge Mercury only the cost, as specified in the schedule, of carrying the call. Connection costs were to be borne by Mercury, which also was to pay half the cost of the new capacity that their business would require. This requirement to pay some capital charges gave Mercury an incentive to develop their own network where it was economic to do so. By the end of March 1986 the networks were linked at thirty-six exchanges and by 1988 Mercury advertised that customers would have a choice of telephone companies.

Following Mercury’s entry into the market there has been a significant realignment in the structure of BT’s charges within the overall RPI-x ceiling. The prices of some products have been increased more rapidly, whilst other prices have been reduced. Previous studies had suggested that BT’s pricing policy was inefficient because trunk charges were set far higher than costs, while charges for local calls and exchange line rentals were set at a low level in relation to costs. A similar pattern was observed in several of the larger European countries, and it was suggested that this reflected a failure to realign charges to the changes in cost-levels which resulted from technological development (see Kay and Meadowcroft 1985).
An indication of the size of realignment which has taken place since liberalization is the fact that between 1984 and 1986 the price of peak-rate local calls increased by 35 per cent, while the price of peak-rate trunk calls decreased by 32 per cent (Oftel 1988a). It seems probable that this realignment, which has followed the entry of Mercury, reflects a significant improvement in the allocation of resources. A study of Oftel in 1986 concluded that the realignment between local and long-distance calls had not been carried beyond the point justified by costs (Oftel 1986).

**Liberalization of VAS**

As noted earlier, at the time of privatization the government chose not to allow unrestricted resale of telecom capacity until July 1989, thereby restricting the provision of VAS. The principal reasons for this arose from the imbalances in BT’s price structure which would have enabled entrants to operate successfully by leasing underpriced, private circuits without necessarily offering any efficiency advantage over BT.

In January 1989 Oftel reconsidered the restrictions on the resale of capacity. Oftel suggested that there may no longer be a strong case for restrictions. As already noted, BT’s prices for local and long-distance service had been brought closer into line with costs, as had the charges for private circuits.

Moreover, there was an increasingly strong case against restrictions. New services from the public network made it harder to distinguish basic services from value added ones. For example, the use of digital codes to carry voices made it hard to separate them from other forms of data traffic. Furthermore, the complexity of the regulatory rules added to the cost of doing business in Britain. Therefore, Oftel stated that the burden of proof had shifted to those who wanted to keep restrictions on the resale of private circuits. If a good case were not made, then the restrictions on resale would not be renewed when they expired in July 1989. This is what happened. Now, any company can operate under a new licence without restrictions on the use which it makes of its private circuits.

**Meeting social objectives and regulating BT’s monopoly power**

The story about social obligations is straightforward. The only significant development has been a decision by Oftel to allow Mercury to provide a public call box service in competition with BT. The decision was supported by an Oftel survey which found that 23 per cent of BT call boxes (38 per cent in London) were out of order in 1987. BT continues to provide the various unremunerative services identified earlier out of its own financial resources. The consequences of this provision for competition in telecoms services, and the possible implications for the introduction of an access charge, are not yet determined.
The formula established to regulate BT’s charges, RPI-3, was due to expire in 1989. In the event Oftel and BT reached agreement in July 1988 on a new formula avoiding the need to seek the arbitration from the competition authorities which would otherwise have been required. The new formula set \( x \) at 4.5 for four years from August 1989 with a price freeze up to that date (see Oftel 1988b). Oftel’s evaluation of the new formula illustrates several general issues raised by the RPI-\( x \) regulatory framework:

1. What should \( x \) be and how should productivity growth should be targeted?
2. What should be the scope of the price control basket, and should there be any caps on individual products?
3. Should quality of service be considered in the price control formula?

What should \( x \) be?

In setting \( x \), Oftel wanted to choose a figure which would allow BT an adequate rate of return, recognize the risks of investment, and encourage BT to increase its efficiency. Although the price cap formula was based on the retail price index, Oftel still had to think about what would be an acceptable rate of return, since the cost of capital is a factor in estimating unit costs.

Oftel used a variety of measures to assess BT’s productivity, including comparison with the performance of other utilities in the UK. The DGT noted that while there had been an overall improvement in BT’s labour productivity, this was less evident in local services. The central problem which Oftel faced in assessing BT’s performance was the absence of comparable companies to provide a benchmark. While comparison can be, and indeed was, made with overseas telecoms operators, such analogies are fraught with uncertainty (see Foreman-Peck and Manning 1987). It has been argued, however, that uncertainty about BT’s productivity performance might weaken the effectiveness of the formula as a constraint which requires BT to perform efficiently (see Helm 1988).

The scope of the basket

Since 1984 the ‘basket’ of services covered by the formula has included residential and business rentals, and direct-dial local and national trunk calls (but not those made from call boxes). These services account for just over half BT’s revenue.

In 1988 Oftel considered changing the services in the basket. The DGT noted that a case could be made for narrowing the basket by removing trunk calls, since BT now had competition in this area. However, he rejected this idea because Mercury did not yet provide services throughout the country and therefore does not compete against BT in all markets.
Nothing was taken out of the basket, but some services were added and others were subject to their own price cap (see Oftel 1988 for details). In particular, Oftel noted that because rental prices were limited by the price cap, BT had shifted some of the costs of new lines to connection charges which were not included. Indeed since 1984 connection charges had increased 35 per cent and rental charges had gone up 20 per cent. The DGT considered high connection charges to be more of a deterrent to extending telephone service than high rental prices. While some form of price control on connection charges was needed, simple incorporation into the basket of prices would not provide sufficient restraint. In July 1988 the DGT determined that instead of being included in the basket, connection charges would be subject to an individual price cap of RPI+2.

Oftel also reconsidered the pricing of telecoms for the emergency services and for people with low incomes. In 1986 BT introduced a scale of charges for repair services for hospitals and emergency services which previously had been free of charge. In 1988 Oftel had to decide whether these services should be included in the basket. If these increased prices were put in the basket, other prices in the basket would have to fall to meet the RPI-x target. Oftel decided not to add these services to the basket. Oftel also considered continuing the rebate to people with low incomes. However, Oftel decided that low-volume users, in addition to low-income people, would qualify for a new special exchange line rental fee of 60 per cent of the normal tariff.

Quality of service

Improving the quality of telephone service is one of Oftel’s objectives. However, providing a poor service could be a cover for BT’s inefficiency. Once prices are regulated by the RPI-x formula, one way to make a profit is to be more efficient; the other is to reduce costs by providing a poorer service. Some commentators regarded this as a significant loophole in the RPI-x framework (see Vickers and Yarrow 1988 for a general discussion, and Cave and Hartley 1989 on telecoms).

After BT’s privatization customers did not see any improvement in service. Indeed the quality declined. The worst problems occurred in fault repair and the installation of new services. While some of BT’s difficulties can be traced to the engineers’ strike in 1987, the problems persisted well after the strike. In the 1988 review the DGT considered establishing a financial penalty for poor service quality.

Before Oftel decided whether to impose such a financial penalty, BT agreed to accept contractual liability for fault repair and the prompt installation of new lines. From the end of March 1989, BT agreed to pay customers £5 a day if it took more than two working days to repair a fault, or if it was more than two days late in installing a new line. This provided a direct incentive to BT to maintain or improve these two important aspects.
of quality. It also provided direct recompense to those customers disadvantaged by the shortfall in service quality. BT also undertook to publish biannual reports on its service quality, which would also include other problems such as missed connections.

Performance of the reformed telecommunications sector

The Treasury Minister responsible for privatization had said that the ‘main objective is to promote competition and efficiency’. The success or failure of the policies which we have described is not therefore, we believe, to be measured by the implementation of the various reforms—the liberalization strategy, setting-up Oftel, selling-off BT. Rather the key question is whether or not these reforms have had the anticipated impact upon the performance of the telecoms sector. That is also a relevant question in the context of this book.

Any assessment at this stage is necessarily provisional. It is clear that the telecoms sector is still subject to significant change. Additional suppliers of cellular networks will be licensed over the next few years, and decisions will also shortly be made on whether to license additional terrestrial network(s). Complete liberalization of the resale of BT capacity is now being implemented. Over the longer term technological developments may further widen the range of feasible competing services.

Future change in the telecoms sector is thus inevitable, but the impact of past change—the reforms which we have detailed—is still in the process of being full worked through. Nevertheless, even at this stage several provisional conclusions are appropriate.

First it seems clear that the introduction of competition in sectors where it is technically feasible has proved beneficial. Developments since the 1981 Telecommunications Act show that liberalization has lead to marked changes in the UK telecoms industry. Liberalization of equipment supply has been followed by a significant number of market entrants, increased product range, and falling real prices. The licensing of Mercury and of the two cellular operators has been followed by a substantial restructuring of BT’s prices; these now appear to be aligned far more closely with the costs of provision, and are thus likely to secure more efficient resource allocation. Competing cellular networks have resulted in a higher utilization of cellular phones in the UK than in almost any other country in the world. Similarly, the liberalized market in VAS in the UK accounts for between a third and a half of the total volume of these services in Europe as a whole.

This experience adds to, and is consistent with, a wide body of empirical evidence which shows that competition is a significant incentive to improved industrial performance (see for example, Bailey 1986 on deregulation in the US, and Thompson 1987 on deregulation in the UK).
Surveys of practice and principles

The implication of these findings is that forms of government intervention which have the effect of artificially suppressing competition in those sectors where it is technically feasible (that is, where natural monopoly does not exist, and where entry costs are low) carry a significant danger of reducing industrial efficiency (an outcome known as regulatory failure).

The second conclusion, however, is that the developments in these liberalized markets underline the advantages which benefit incumbents in recently deregulated markets. The crucial regulatory issue is ensuring that, in the face of these advantages, fair competition takes place. The interconnect agreement between BT and Mercury, and BT’s takeover of Mitel, are the two most important of a range of issues upon which the regulatory authorities have had to consider intervention.

Third, in sectors where competition is infeasible, or remains highly imperfect, the significant changes which have been made to the methods of regulating monopoly power have had a favourable impact upon performance. These changes have come in two stages. The first, applicable to all of the UK’s public enterprises, focused central importance upon the achievement of pre-specified targets for financial and productivity performance. The second, which accompanied privatization, involved detailed statutory specification of BT’s obligations and duties. The statutes also specified the methods by which these duties were to be regulated, and established a regulatory authority which was both separate from government and, because of the statutory specification of its own role, independent from it. This framework provides a firm and clearly expressed basis for BT’s future, with provision for regulatory intervention as time-determined restrictions expire. The framework offers substantially greater certainty on both the nature and timing of regulatory intervention than did more traditional forms of public enterprise regulation. This provides a foundation upon which business decisions can be made according to business principles.

The requirement to regulate BT’s prices in markets where competition is absent or in its infancy has prompted the development of an innovative regulatory scheme. This offers the possibility of avoiding the familiar problems of rate-of-return regulation. How successful the new RPI-x framework will prove to be in this respect—and we have noted that it has its critics—will only become clear over time.

The ultimate effectiveness of these changes to the regulatory framework lies in whether or not they are able to secure a faster increase in BT’s efficiency than would have otherwise have been achieved, and to do this without an adverse effect upon service quality. To date the growth of productivity achieved by BT has been clearly greater than that achieved in earlier years, although this matches an up-turn in performances which has also occurred in other public enterprises over this period (see Bishop and Kay 1988, Molyneux and Thompson 1987).
Notes

1 Even when the dominant supplier, American Telephone and Telegraph (AT&T) was unified it was not the only telephone company. Other companies operated regional networks interconnected with AT&T. For example, GTE was the exclusive supplier in the state of Hawaii, and in parts of other western states.

2 ‘Licence granted by the Secretary of State for Trade and Industry to British Telecommunications under Section 7 of the Telecommunications Act 1984’ [hereinafter BT Licence], Schedule 1, Part 2, Conditions 1, 2, 3, 6, 7, 8, 11.

3 BT licence, Schedule 1, Part 2, Condition 11.7(c).

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Surveys of practice and principles

Part three

Country experiences
Chapter four

State-owned enterprise reform in China

Hua Sheng and Du Haiyan

State-owned enterprises play a predominant role in the Chinese economy. In 1978, the year just before economic reform started, state-owned enterprises accounted for 21 per cent of industrial output and 92.3 per cent of retail sales. The rest was provided by collectives, with the private sector offering nearly nothing, save for agricultural produce. Furthermore, collectives are by no means genuine co-operatives, but are public enterprises attached to a lower administrative hierarchy and therefore less privileged. The economic reform process has witnessed the rise of the private economy, which accounted for nearly 5 per cent of output in 1988; but on the whole reform has changed the environment in which these enterprises operate rather than the ownership structure as such.

A comparison of characteristics of the enterprise system before and after reform

It is rather difficult in a non-market economy like China’s, where prices are distorted and interference from non-economic factors abounds, to define and conduct any statistical analysis of efficiency. There has been an increase in the productivity of both capital and labour between 1978 and 1988, although exactly by how much is uncertain because official statistics are difficult to interpret.

The pre-reform era

Prior to reform, enterprises had no independent objectives or interests. Policies with regard to all aspects of their business, ranging from first investment to final close-down, were all decided by government planning and supervisory departments. The excessive centralization of the planned economy turned state-owned enterprises virtually into government branch offices, with little power over their own personnel, finance, material supplies, and
income distribution. The performance of an enterprise had no connection with the income and welfare of its staff, and daily operations were mainly determined by the mandatory plan. Moreover, organization within an enterprise was under the control of the Communist Party Committee, which assigned duties to the key members of the enterprise leadership. The manager was only an administrator of the Communist Party Committee decisions.

Such an enterprise system was considered to be suited to the early stage of mass production. However, with the development of the economy, the problem of its low efficiency became increasingly apparent. Enterprises met with no competition outside and issued no rewards inside. As a result, they were characterized by poor management, indifference to changes of the supply-demand pattern, slow response to price fluctuations, and far from optimal use of resources.

After reform

The quest for the greatest possible short-term benefit became a major feature of state-owned enterprises since, as part of the reform of old income distribution system, they were granted rights to retain a certain percentage of their profit and to distribute bonuses. Workers and staff began to associate their own interests with the performance of the enterprise in which they worked. Moreover, enterprises had their profit targets.

The underlying logic is that, when central planning has given way to market mechanisms, enterprise competitiveness and concern for self-development will grow. However, the rational behaviour of state-owned enterprises is confined to their desire for short-term incomes only because wage earners (both workers and managers) are more concerned with short-term profit than with long-term development, in the knowledge that the state as ultimate owner may eventually take all the profits and would cover all losses. With the absence of a comprehensive reform of the country’s economic structure in the true sense of the word, there is a lack of effective discipline of the enterprises’ behaviour.

Approaches to enterprise reform

At the beginning of the enterprise reform process some economists proposed that enterprises should have independent rights, obligations, and benefits. They developed the idea of decentralizing economic administration and transferring the decision-making power from the central authorities to the individual enterprises.

However, there has been disagreement on how best to achieve this end over the past decade. This disagreement may be represented by three
basic scenarios. The first held that the state should make the enterprise itself autonomous, based on worker and staff decision-making. This scenario played a dominant role during the reform process between 1979 and 1984. The second was tailored to the enterprise manager, separating the rights of ownership and management. This scenario has gained dominance since 1985. The third, which was discussed only when the political climate seemed right, advocated dismantling state ownership.

Decentralization towards the rebuilding of genuine enterprises

At the outset of reform, the influence of East European theories and experiments, including those from Yugoslavia, was considerable. The lack of a participatory management system was held to be the root cause of the state-owned industry’s low efficiency. The traditional system had failed to transform the interests of workers and staff into a concern for management of the state’s assets. There needed to be a new form of people’s ownership featuring the improvement of their status and the expansion of their democratic rights. The most well-known theory in this regard was the ‘enterprise status theory’, which was the main source of inspiration for the first stage (1978–84) of the reform of state-owned enterprises. This involved increasing the decision-making power of enterprises, and experimentation with various responsibility schemes.

So in the fourth quarter of 1978, the Sichuan provincial authorities, headed by Zhao ZiYang, the premier (1980–7) and the Party General Secretary (1987–9), began a pilot project in the Ningjiang Machinery Factory and in five other state-owned enterprises. These were the very first attempts at enterprise reform in the People’s Republic of China. Though initiated by a few key figures in local government, they were encouraged by the favourable attitude which began to dominate at the top. By the end of the year, the experiment had spread to 100 enterprises in Sichuan. In July 1979, the experiment was introduced to eight large or medium-sized state-owned industries in Beijing, Tianjin, and Shanghai.

Before the end of 1979, the number of enterprises in the experiment increased nationwide to 4,200. It further increased to 6,600 in 1980, making up 16 per cent of the enterprises covered by the state budget, 60 per cent of the nation’s industrial output value, and 70 per cent of its profit. How much these enterprises could retain from their profit and how much their workers and staff could earn was decided by the results of their performance. Also enterprises were given a certain discretion to choose suppliers and buyers within the state plan, to adjust prices of their products to a small extent according to government regulation, and even to market their products above the requirements of the state economic plan.
In 1981, these experiments were extended to 36,000 industrial enterprises, which included the majority of large enterprises covered by the state budget. (All commercial enterprises had been allowed to retain a percentage of their profit since 1979.) Within industrial enterprises, the rights of factory directors were strengthened, and workers’ congresses installed. The process mentioned above loosened up the state’s control over enterprises. Profit-sharing, mainly in the form of a bonus, led managers and workers to take notice of their performance. After the introduction of the Dual Track Pricing System in 1985, enterprises could also have a free hand to set prices and to sell or buy goods outside the state plan.

However, at the same time, the promotion of autonomy gave rise to a series of problems. In response to the continued ‘soft budget constraint’, rampant irrational activities emerged such as over-investment and bonuses that ate up an increasing portion of profit. Guidance given on the use of retained profits was ineffective. The all-round concession to the workers and staff eroded state revenues and financial capability. The basic underlying problem was that the government could not find a fair rule on profit-sharing to impose on hundreds and thousands of apparently different enterprises. They competed for a high profit-sharing rate through endless bargaining with government departments.

In order to iron out these problems, in 1983 China started to try to replace the case-by-case profit-sharing system with a newly designed taxation system. The taxation system was expected to serve two purposes. First it was to heighten the enterprise’s sense of responsibility for contributions to the state revenues. The second purpose was to provide an equal footing to all enterprises, so that conditions would be in place for them to compete in the field of production.

To achieve this goal, two steps were envisaged. The first step was to impose a fixed rate of income tax on all enterprises. The second was to be taken in conjunction with reform to correct the distorted price system, together with taxes on natural resources, assets, and value added taxes in some industries.

On 1 June 1983 the first step was launched. All large and medium-sized state-owned enterprises were required to pay 55 per cent of their profit to the state. The after-tax profits were shared through bargaining between the government and enterprise. Their actual profit in 1982 was taken as the bottom line for this part of their contribution, valid for three successive years.

The second step of the tax reform was taken in October 1984. Its operation deviated from the original plan. Due to the difficulty in calculating the tax rates on natural resources, in valuing assets, and
in eliminating the irrationality in the price system, what was adopted was only the regulatory tax, whose rates resulted from the government’s bargaining with individual enterprises. Therefore, the tax reform as a whole failed to set an equal footing for all the enterprises: it simply reduced the bargaining scope from total profit to after-tax profit.

In the fourth quarter of 1984 the inflation of investment and income became so serious that the government appeared unable to assert its macroeconomic control. This seemed to indicate that the simple reform of the state’s concession of power and interests to the enterprise had come to a dead end. The vague concept of enterprise autonomy began to reveal its internal incoherence and (even) contradiction.

Separation of ownership and management

The tendency of managers to pursue the well-being of their workers and staff rather than that of the state (the owner) was widely considered to be one of the main contributors to the failure of the first stage of reform. This led people to attach importance to the role of the manager, to rebuild the incentive mechanism, and to promote the manager’s sense of responsibility for the use of state assets. A large number of experiments was started to increase managerial power which paved the way for the so-called managerial revolution. The major experiments were the leasing system, contractual management, and the assets management responsibility system. These experiments were aimed at reducing administrative interference with the enterprise affairs, supporting the manager’s leadership status, and raising the efficiency of the state assets by extending incentives to managers.

The leasing system

This was applied mainly to the small firms that were barely profitable, if not in the red. Indeed, the leasing system was originally an arrangement to correct the chronic financial losses of some enterprises. The government’s trade administration decided the leasing terms, including the amount of leasing fees, and transferred each enterprise to a voluntary leaseholder. Usually this was the manager. After paying the fees, the net income would be totally at the disposal of the lease holder.

In a gradual process this was developed into a new form of state-owned enterprise management. In this process the leaseholder changed from an individual to a group of individuals, and even to the entire staff of the enterprise. The fees also changed, from a fixed amount to a floating rate, little different from the other profit-sharing system.
The leaseholder was at first granted the power to reform the enterprise management, after the obligations and incomes were all clearly specified. But soon he tended to seek only maximization of profit on his own terms. Moreover, the conflicts between leaseholder and workers had been increasing.

The ‘assets management responsibility system’ (AMRS)

Under this system the enterprise leadership was no longer appointed, as it always had been, by the trade administration. Instead, as with an auction, competition for the top management position was encouraged, and candidates specified the performance they would achieve, generally over a five-year period. This also involved valuing the assets of the enterprise in competition for the management of the second term, through renewed public bidding. The main advantage was the existence of criteria for examining the pragmatic achievements of the manager, thus restraining his short-term behaviour.

This system was first proposed in 1985 and implemented on a trial basis in about twenty cities in 1986 and 1987, yielding certain positive results. However it was seldom the choice of the enterprises themselves because of its strong constraints, the minor concession of state interests, and its complicated operation. In fact no more than 1,000 enterprises have thus far adopted this system.

The contract system

This was an early product of the enterprise reform process. The contractual guarantee of the profit handover to the state, after enterprises gained relatively autonomous status and independent decision-making power in 1979, was the inchoate form of what was later called the ‘contract system’. After tax reform in 1983 this practice ceased in most enterprises.

The contract system became widespread after 1987. Nearly all state-owned enterprises have adopted it. The new contracts usually stress the following three points:

1. the profit share to the state;
2. technological improvement;
3. the linkage between the enterprise’s total wage bill (including bonus and managers’ salaries) and its profit contribution to the state.

Thus when the contractual targets are met both manager and workers can enjoy a substantial increase in income. The contract system also sometimes borrows the AMRS competitive system for the top management positions. Contracts usually last from three to five years instead of only one year as
in the past. Negotiating contract targets is a complicated bargaining process, but when public bidding for the top management position was introduced, targets could be very competitive and the discipline on the winning bidder was very effective.

However, neither the officers who had the power to appoint managers nor the managers themselves were interested in fair competition. As a result, although there were certain items in the contract which disciplined managers when targets were not met (for example, salary reduction or even dismissal) managers could always find alibis for poor performance in government interference or in its macroeconomic policies. On the other hand, workers and staff in Chinese enterprises not only earn cash income but also obtain pensions and welfare for their families, according to need. Thus the state has to shoulder responsibility, no matter what happens.

The contract system resulted in greater enthusiasm for both management and labour, yet it failed to bring about the anticipated progress. This was due partly to the fact that government administrators, as representatives of the owner, not only failed to regulate the enterprise’s behaviour effectively, but also sometimes tried to jeopardize the manager’s independence. And the desire for the maximum welfare level for employees (which is extended to their families) did not cease to exert heavy pressure on management, and prompted more widespread short-term-oriented activities. The necessary conditions for normal business competition were still not created when the enterprise was made responsible for its gains, but not for its losses. The lack of a guarantee for the efficiency of the state-owned sector continued.

The experience of China’s enterprise reform seems to indicate that the separation of ownership and management based on Western private property rights would run into insurmountable difficulties in China. Because of the confusion of the roles of the owner, management, and labour (who are supposed to be the true ‘master’), whatever encouraging signs reform in organization and operation have produced can only be of temporary significance. Soon after the introduction of a new management plan or operational technique, its distortion or even emasculation is common.

The explanation for this is to be found in the endless bargaining between the state and its enterprises.

**The consequence of the non-existence of the property rights and the possibilities of further reform**

The difficulties facing enterprise reform have led Chinese economists to consider property rights. They have come to realize that the inefficiency of the state-owned sector lies in the absence of property rights. These
would set the pattern of enterprise behaviour and open the opportunities for business competition. This is, so to speak, a ‘congenital defect’ of state ownership. Is it possible to separate the dual role of government as owner and as administrator when the state sector dominates in the economy?

The separation of powers

Some used to argue that the separation of these two functions would prevent or diminish administrative interference. They proposed a series of rules to govern this division of power, and made a few practical attempts to effect their proposals. But the results proved their naivety. When the government plays the dual role of economic administrator and enterprise owner, the ownership would unavoidably function in a way determined by the use of administrative power and the workings of the administrative organization. But government officials have no direct interests in the efficiency of the state assets, which are extremely difficult to value. Their true market value is largely associated with the people using them, and administrators can never effectively regulate tens of thousands of enterprises at the same time.

With the idea of limiting the government role, people began to explore the possibilities of recreating the owner within the framework of state ownership. Proposals have been made along two lines. The first, usually called the ‘legal person right’ theory, proposes that a board of directors should be established to consist of representatives of the owner, the manager, and the workers. The underlying rationale is that by dividing the powers of the legal person owner and the ultimate owner, and by building up a mechanism of mutual checks between the two, the legal person owner may generate a resistance to the administrative interference and set up a balance of different interests within the enterprise. But the reform so far has indicated that such a fictional board of directors cannot truly live up to its expectation. Even worse, when the board is organized under the auspices of the trade administration, it would even accentuate administrative interference. Despite the weakness of this experiment, the ‘legal person fantasy’ still holds its influence on some Chinese economists and their experimental efforts.

The second line is referred to as the ‘owner organization theory’, proposing that a state assets administration should be established outside the enterprises and other government departments. Functioning as the owner of state assets, this new organization would have the rights to choose the managers, receive benefits from the state investment, and dispose of its earnings and assets—virtually
all the rights to which an owner is legally entitled. The experiment began in 1987 to organize the state assets management bureaux. Yet it is only too easy to imagine how difficult this artificial division of the government’s dual role will be. The problem is not only that no government departments want to relinquish their power, but also that there is nothing to prevent the new assets management administration from degenerating into a new bureaucratic disaster—with no incentives to encourage it to improve its efficiency.

The construction of a competitive market system

The inefficiency of state ownership lies in the deficiency of competition, as all have recognized. The foregoing reforms have resulted in competition for maximal incomes, but have failed to make state-owned enterprises responsible for their financial losses. Because there is no independent owner, the risk of competition is to be borne only by the government. Competition cannot automatically weed out those enterprises with poor management. The bankruptcy law, though in place, has been applied seldom to the state-owned sector.

To tackle this situation, there has been the proposal for a number of state assets stock companies, rather like holding companies with issued shares. They would manage the assets under their control according to their independent risk-benefit considerations. This proposal has not been tested, because of the widespread fear that it would reintroduce the danger of administrative interference when the effect of a stock company under the state ownership is still uncertain. The idea of the stock company became fashionable in the latter half of 1985 as a result of the financial strains caused by the austerity policies of the central authorities.

However a number of enterprises sought to raise funds through issuing shares (which were more like bonds) approved by their respective local leadership. But due to the overlap between the rights of ownership and of management noted above, and the remaining influence of the argument for workers’ ownership, the focus of attention was on the so called ‘enterprise collective shares’ as a guarantee of the workers’ benefit. In practice, little was done to implement a modern share-based economy. Most of the shares had guaranteed principal, interest, and dividends and represented no risk. They only provided new opportunities for people within an enterprise to gain more than wages, salaries, and bonus, and they forced the government to stipulate a rule that the rate of share interests should on no condition exceed 15 per cent.

Now that the majority have agreed that the evil is the void of management ownership rights the question arises as to how China’s enterprise reform process can be deepened to the point where these
rights effectively constrain the enterprises’ behaviour, embody competition, and bear the risk. The country is faced by two alternatives: to continue along the scenario of the separation of the rights of ownership and management, or to break away from the traditional framework of state ownership and carry out a privatization programme.

**How far can the separation scenario go?**

Although this scenario has been the most popular strategy for enterprise reform, the definition of the word ‘separation’ has never been clear. Even without the economic problems mentioned above, this strategy will work only on the precondition that the assets owner (the government) will demonstrate at least some efficiency and honesty in politics, taking responsibility for the state assets when there are no incentives for anyone else to do so. In reality, however, the inflation of government power is almost unchecked, and is frequently seen as administrative interference with the long-term efficiency of its assets, because it has no interest in doing otherwise.

**Privatization**

During the previous reform endeavour, people tended to think first of the possibility of remaining within the framework of state ownership. All the complicated reform plans were aimed at changing either the macroeconomic organizational form, or the incentive structure. It was only after these complicated plans ran into unexpected difficulties that people began to ask themselves about whether the traditional framework also needed reform: privatizing state assets was suggested. In 1988 more discussion was heard on the re-creation of ‘individual ownership’. This was an essential difference from the way the reforms were studied previously. If made possible, this reform strategy would produce a very great impact in China.

The new scenario of privatization consists of two major aspects. The first is the selling of small state-owned enterprises. In terms of the country’s economic realities as well as ideological flexibility, the implementation of this part of the scenario will not encounter great difficulties. But it is hard to forecast, when nothing is done about the large and medium-sized enterprises, whether a minor adjustment of this kind can substantially raise the efficiency of the entire ownership structure.

The second is the division of the assets of large enterprises. This move would have a bearing on the entire society and was a most controversial idea—controversial not only because of its economic practicability, but also because of its political and ideological sensitivity. Even if it were accepted, it would pose difficulties in the operational field, namely the
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rules and procedures governing the division of the state assets, and the execution of justice.

Prospects for the Chinese enterprise reform process

A fundamental change of state ownership should be set as the most important goal of the enterprise reform. This would lead to a series of new developments.

The reform of state-owned enterprises will generate a pluralistic change of society’s ownership structure. The proportion of the state ownership should first be reduced to spheres of ‘natural monopoly’. All other enterprises should be converted into non-state companies, jointly owned by communities and individuals, or co-operatively owned by the workers. Joint ownership would be the dominant form of property rights, while co-operative ownership would probably also play an important role. Only by separating the ownership of one enterprise from that of another can effective competition come into being.

The stock company should prevail, reflecting a high level of compatibility with a modern economy rather than being based on unclarified property relations and turned into something of little significance, as it is at present. The enterprises under state ownership should be very few, and they should introduce public bidding for managerial power and the yard-stick of competition, therefore operating in a way no different from the predominant non-state enterprises.

The events in Tian An Men square have brought enterprise reform to a standstill. The theory of separation of management from ownership has been critically scrutinized and the management revolution has been heavily attacked, as has the ownership reform process. However, the collapse of the central planned economy is inevitable. Political events could interrupt this process, but it accumulates greater momentum in the long run thereby. As far as economists are concerned, we have to persist in working on a scheme which is workable and sensible when its time comes.

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Chapter five

Four decades of public enterprise in Hungary

Zoltán Román

As a latecomer to the industrial revolution and loser in both the First and Second World Wars, Hungary started to reconstruct in 1945 after the heavy war damage from a relatively low level of GDP per capita, to revitalize the economy, and to build a new democratic society. With regard to this latter task, the attribute ‘democratic’ soon faded out, to be replaced by ‘socialist’.

Now, forty-five years later, the quest for democracy is a national priority again, and it is a matter of acute debate as to what the term ‘socialist’ does and should mean. In the constitution which the new Parliament is to approve in 1990, should ‘socialist’ be omitted, should the term ‘democratic socialism’ substitute for it, or should something else entirely be used?

Hungarian economy and society, including the political and public enterprise systems, are in transition. To facilitate an understanding of these fundamental changes and the state of public enterprise now, a historical perspective is necessary.

A brief survey of four decades

It will be useful to recall the major characteristics of the boundary years of these four decades in Hungary: 1948, 1958, 1968, 1978, and then the year 1988.

1948 At the beginning of that year the big banks and the mining industry, as well as the four largest heavy industrial corporations were already nationalized. In many significant fields of the economy there were indicative rather than directive three-year plans being implemented. All industrial enterprises with more than 100 employees were nationalized in March of that year, and the collectivization of agriculture was announced in August. It was the year when the monolithic power of the one-party system was institutionalized, and all other components of the Soviet model of this time (the Stalinist model) were quickly introduced (see Berend and Runki 1988): it was indeed ‘the year of change’.
1958 One and a half years after the defeat of the 1956 uprising and revolution (for three decades thereafter officially designated a counter-revolution) the economy showed signs of consolidation, which unhappily was achieved in political life only years later. Most of the economic reform proposals of 1956 and early 1957 were dropped, and only partial adjustments were introduced. However, the material well-being of the population was among the first priorities for the coming decades.

1968 This year saw the introduction of comprehensive economic reform. It was aimed at an optimal combination of plan and market—the best components of both systems (in UN terminology, centrally planned and market economies). This optimism seemed to be verified by the economic results of the next few years, often labelled ‘the Golden Age’ (albeit short) of the Hungarian economy. At the same time, however, 1968 was also the year of the Warsaw Pact military intervention in Czechoslovakia (later condemned by both the Hungarian government and the Parliament of Poland), an event which overshadowed the prospects for Hungarian reform.

1978 This was a period of change in economy policy orientation. Due to the delay in adjustment to the changes in the world economy and to the prolongation of forced economic growth and overspending, US$8 billion dollars debt accumulated in convertible currency. To achieve a surplus in the balance of foreign trade became—and still is—the dominant priority. Further steps in the implementation of the economic reform of 1968 were also envisaged, in anticipation of a backlash.

1988 A year of deep economic, political and social crisis. After some years of improvement in the balance of foreign trade, there was now a US$17 billion debt in convertible currency. This was equivalent to 63 per cent of GDP, and servicing this debt took around 50 per cent of export earnings in convertible currencies. There were also declining real wages and real incomes, near to 20 per cent inflation, discontent with the government, with the Communist Party, with the past, the present, and with future prospects. The result was a movement towards a multi-party political system, with a majority consensus on the need to transform Hungary into a market economy.

Industrial organization and the reform process

The pattern of industrial organization, like all other major components of the economic and political systems, was copied from the Soviet Union at the end of 1940, in Hungary as in the other Eastern European nations.

The enterprise is the core of industrial organization in the ‘classical’ Soviet system. After a short period of transition, the Soviet Union realized that production of commodities can be organized and managed only via economic entities with ‘independent accounting’ (hozraschot). The enterprises in this system, however, do not have real autonomy. They must follow the obligatory indicators of the plans; market signals are of
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marginal significance for them. This model postulated that to achieve this situation—in harmony with other ideological and political considerations—private ownership must be eliminated by nationalization or possibly by establishing large centrally controlled co-operatives.

Two further concomitants were derived from the logic of the system:

1. both research and development, and trade functions were to be separated from the production units of enterprises and given to other specialized organizations, working according to their own plan indicators;
2. since market competition was not needed, monopolistic situations were perfectly acceptable—or even desirable. They facilitated the exercise of power and control for both the economic and political centres.

In the relatively short period until 1953–4, the model of the ‘centrally planned economy’ seemed for most economists, as in Hungary, to be not only feasible alternative but also potentially superior to the capitalist market economy. Experience proved this belief wrong.

How was the system to be changed? To a limited extent by adjustment, but to do so fundamentally required comprehensive reform, combining both planning and market. Berend (1988) distinguishes three stages in this process:

1. intellectual antecedents of reform and the first steps of adjustments, from 1953 to 1969;
2. the period of the reform-decision in 1966 and then the years of the comprehensive reform, with many setbacks and reversals;
3. the return to reform, accompanied by delay, ambiguity, and a new turn in the 1980s.

Other authors, especially Agnes Ungvarszki, have tried to identify cyclical changes in these events. Ungvarszki (1989) describes the alteration between three ‘doctrinaire’ and three ‘renewal’ courses between 1948 and 1984, each with specific policy and economic policy orientations.

Looking back to 1968, we continually ask why we did not succeed with reform. Why had we to wait twenty-one years to recognize that instead of achieving a combination of the best components of the two systems, we ended up with a mixed bag of many of the unfavourable corollaries of both systems: inflation, unemployment, inflexibility, bureaucracy, and corruption?

Politicians and representatives of the administration on the one side, and research workers on the other, give markedly different responses to this question. The former stressed only the unfavourable external changes, like the fall in oil prices, the end of the ‘Golden Age’ of the world economy, terms-of-trade losses, and problems in CMEA integration and co-operation. On the other hand, the latter pointed out the negative impact of the stop-go
cycles in the reform movement due to both internal resistance and external influences. Then there were the universally recognized failures of economic policy, bad investments, and delays in structural adjustment. In recent times the increasing glasnost has revealed under the surface the severe damage caused by the dominance of political institutions and political power on economic decisions, thereby distorting planning, regulation, corporate management, and allocative and operational mechanisms (see Román 1987).

There have however been some changes in Hungary as a consequence of the reform process. There is progress in re-integrating R & D, production, marketing, and sales activities into the enterprises. The role of the market, the real entrepreneurial freedom of movement of the enterprises, has also increased—but only to a moderate extent.

We have also seen minor changes in the shares of the social sectors of the economy and—in spite of criticisms from the mid-1950s, adjustments in the 1960s, and the comprehensive reform in 1968—minor changes also in the centralized pattern of the state-owned sector, in the institutional pattern of the economy, and in the power of the administration.

Hungary is now coming up to a free parliamentary election with about a dozen competing political parties, who have only roughly-sketched economic programmes. Common to most (but not all) of these programmes is the promise to create a market economy and a democratic welfare state. In detail, however, many of the basic features of these ultimate goals have yet to be clarified.

Changes in the share and statute of the state-owned enterprises

Economic structure

Changes in the share of the state-owned sector in originating national income since 1960 (the year before the collectivization of agriculture) have been rather small (see Table 5.1).

The share of the co-operative sector was 17.0 per cent in 1960 and invariably around 23 per cent in the other years quoted. The rest consists of the contribution of the private sector and of the auxiliary activities of the population (see Table 5.2).

In Hungary we distinguish three types of economic activity:

1. the formal or ‘first’ economy;
2. the ‘informal’ or ‘shadow’ economy;
3. the ‘second’ economy.

The first economy is as published by the Central Statistical Office, and is derived from the principal activities in the economy. The informal economy
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is relatively small, although after the introduction of a steeply progressive personal income tax in 1988 its growth has accelerated.

The second economy includes all non-illegal activities performed either as second jobs of people employed (beyond their normal working hours) or by non-active earners of the population.\(^1\)

Table 5.1 Shares of state-owned sector in national income

<table>
<thead>
<tr>
<th>Year</th>
<th>Share</th>
</tr>
</thead>
<tbody>
<tr>
<td>1960</td>
<td>67.4</td>
</tr>
<tr>
<td>1970</td>
<td>70.7</td>
</tr>
<tr>
<td>1980</td>
<td>69.8</td>
</tr>
<tr>
<td>1986</td>
<td>63.4</td>
</tr>
</tbody>
</table>

According to different estimates around 25–30 per cent of the total labour force will be engaged, and about 20 per cent or more of the GDP will be generated (see Revesz 1986). It requires more precise clarification as to which part of the second economy is registered as originating in the state-owned and co-operative sectors, and which part might not be adequately taken into account at all.

The second economy helps to make life more tolerable, and compensates for stagnating and declining incomes and real wages; it contributes to the elimination of shortages on the market, and serves as a school and incubator for entrepreneurship and small businesses.

But it also increases dissatisfaction with jobs and incomes in the state-owned and traditional co-operative sectors, and participation can involve 50–60 (or more) working hours per week. Health, family life, and other considerations do not allow this to continue in the long run, or in a period of rising unemployment. But, increasingly and inevitably, low productivity and low income in the first economy will be compensated for by working and earning in the second.

Table 5.2 Shares of private sector and auxiliary activities in national income

<table>
<thead>
<tr>
<th>Year</th>
<th>Private sector</th>
<th>Auxiliary activities</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>1960</td>
<td>9.0</td>
<td>6.6</td>
<td>15.6</td>
</tr>
<tr>
<td>1970</td>
<td>2.6</td>
<td>3.1</td>
<td>5.7</td>
</tr>
<tr>
<td>1980</td>
<td>3.5</td>
<td>3.7</td>
<td>7.2</td>
</tr>
<tr>
<td>1986</td>
<td>7.0</td>
<td>7.6</td>
<td>14.6</td>
</tr>
</tbody>
</table>
Two important qualifications need to be added here. First, the original document of the comprehensive reform declared as its fundamental feature the organic connection, the combination of the planned, central guidance of the economy and of the active role of the market, on the basis of the socialist ownership of the means of production (Central Committee of the HSWP 1966:92). Only in recent years has a majority view emerged of the need for a much higher share of private ownership, partly by promotion of the growth of small business and partly by the privatization of state-owned enterprises.

Secondly, the former interpretation of ‘social’ and state ownership has been questioned. The hierarchical dependence of the state-owned enterprises on the sectoral supervising ministries had been cut in 1984–85 for nearly two-thirds of enterprises and they obtained a new statute. They are now governed by Enterprise Councils, composed 50 per cent of members elected by the employees, and 50 per cent nominated by the general manager. He himself will be elected (and eventually dismissed) by this Council. However, mixing ownership and participation, governance and management, in an environment without market competition weakened managerial authority, heated up short-term income pressures, and so did not prove to be a sound decision.

Cutting the hierarchical dependence of the state-owned enterprises from the sectoral ministries somewhat reduced (but did not eliminate) the power of the administration. It shifted dependence to the functional ministries, principally to the Ministry of Finance.

In 1988, Parliament approved the Act VI which widened the choice of legal forms of enterprises, including those with mixed state, foreign, and private ownership, and raised the limit of the number of employees in a private enterprise to 500. Act XIII, approved by Parliament in the spring of 1989, regulated, with the intention to facilitate and to promote, the transformation of enterprises from one statute to another.

Ownership

For state-owned enterprises the joint stock company is now considered as the optimum form, and their conversion is declared necessary. This requires a far-reaching ownership reform which is now only at the stage of discussion.

Ownership reform is a complete departure from the situation when everyone’s property is no one’s property, and therefore the functions of the true owner must be restored. There are also serious doubts about the assignments of civil servants of state authorities, even under democratic control. Their powers must be limited. Foreign and domestic private capital can fulfil a proper role, but access to the former and the
accumulated wealth of the latter are insufficient. To overcome this second barrier there are proposals to distribute the shares of public wealth either to the employees or to all citizens.

Another suggestion is to distribute shares and stocks of public wealth to communities and to pension funds. This is based on the trend towards institutional shareownership in many countries. (A similar proposal is described and elaborated in Statham 1977, 1987.)

All these however postulate the existence of real commodity and capital markets and the functioning of a market economy. This is where Hungary is heading, albeit very slowly. The decision on the ownership issue cannot be postponed for much longer. Most probably we have to start with a wide spectrum of ownership and governance patterns, including the variants mentioned above, as well as the more traditional forms of state holdings and the cross-ownership of enterprises.

It is clear that additional measures are needed. They should be elaborated in detail, in order to avoid the familiar traps inherent in self-management and the lightning-fast redistribution of wealth.

**Concentration and competition**

**Concentration**

Centrally planned economics usually prefer large organizations for both economic and political reasons. For many decades this was also true in Hungary. Although the economic reform in 1968 accepted and declared that a more balanced size profile for enterprises was needed, change has been slow.

The number of state-owned enterprises is shown in Table 5.3.

Between 1970 and 1979 the number of industrialized co-operatives decreased from 821 to 673, the number of state farms from 194 to 131, the number of agricultural co-operatives from 2,241 to 1,350, and the number of domestic trade organizations from 946 to 603.

In 1980 the government stopped the process of centralization, and proclaimed its intention to reverse it. This was one of the few occasions when—in an upswing period of reform—repeated research findings and protests succeeded in bringing about a governmental decision.

Nevertheless, decentralization went on with modest results. In 1987, in the state-owned industry sector, 4,869 establishments were in operation, in a total of 1,043 enterprises. This means that the overwhelming majority of enterprises are multi-plant firms. The number of state farms and agricultural
co-operatives is the same today as it was in 1979. Now this high degree of centralization system of agriculture, as elsewhere, is being questioned.

Due to the high concentration of the state-owned industry sector, generating more than 80 per cent of total output, the market share of the largest producers in most cases indicates a dominant position. The market share of the three largest producers in 1975 was more than 50 per cent in thirty-eight of the fifty-four branches of manufacturing industry. This share exceeded two-thirds in twenty-four branches (see Román 1981).

Aware of the fact that branches are too heterogeneous to assess the actual degree of competition, I prepared a survey for 1982 of 637 product groups covering 75 per cent of Hungarian manufacturing industry (Román 1985). The share of the largest producer in total production exceeded 50 per cent in 419 out of the 637 product groups. In 323 product groups this share was more than two-thirds, and in 219 more than 90 per cent. Taking the three largest producers, the same categories of the 637 product groups included 568 with over 50 per cent, 508 with more than two-thirds, and 390 with over 90 per cent of industrial output.

In addition, perhaps even more important, in a small country like Hungary the minimum efficient scale for a great number of products does not permit competition among domestic producers: they should meet competition in export markets and via import penetration.

Too much emphasis on exporting, however, limits this kind of competition, and since a surplus on foreign trade at any price is invariably the first priority of the Hungarian economic policy, positive effects on competition cannot be expected from this side. On the other hand, import restrictions are being reduced. Step-by-step liberalization gives more hope for positive stimuli from import penetration. Further

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**Table 5.3 State-owned enterprises, 1960–87**

<table>
<thead>
<tr>
<th>Year</th>
<th>Enterprises</th>
</tr>
</thead>
<tbody>
<tr>
<td>1960</td>
<td>1,338</td>
</tr>
<tr>
<td>1965</td>
<td>850</td>
</tr>
<tr>
<td>1970</td>
<td>812</td>
</tr>
<tr>
<td>1979</td>
<td>702</td>
</tr>
<tr>
<td>1987</td>
<td>1,043</td>
</tr>
</tbody>
</table>
progress in this direction depends heavily on the balance of international payments, and on debt management.

Small and medium-sized enterprises

Aiming to increase the number of sellers and buyers, great significance is attributed now to small business and to small and medium-sized enterprise (SME) promotion. The share of the SME sector is quite significant at the present time, although still about one half of the share in market economies (see Table 5.4).

Today the SME sector has a significant and positive role in the Hungarian economy. In addition to its contribution to national income generation, providing employment (and second jobs), eliminating shortages, and widening the assortment of consumer’s choice, it offers a greater potential for autonomous work and entrepreneurship, and for the natural, positive, and increasing ambition of a significant part of the population, than do larger organizations. On the other hand, it is not yet dynamic and innovative enough to have a marked impact on structural adjustment.

Table 5.4 Percentage shares of the SME sector in the Hungarian economy

<table>
<thead>
<tr>
<th>Social sector</th>
<th>Share in national income</th>
<th>Share of SMEs in each sector</th>
<th>SME contribution income</th>
</tr>
</thead>
<tbody>
<tr>
<td>State-owned enterprises</td>
<td>63.4</td>
<td>8</td>
<td>5.1</td>
</tr>
<tr>
<td>Co-operatives</td>
<td>23.0</td>
<td>60</td>
<td>13.8</td>
</tr>
<tr>
<td>Employees’ auxiliary</td>
<td>6.6</td>
<td>100</td>
<td>6.6</td>
</tr>
<tr>
<td>production</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Private sector</td>
<td>7.0</td>
<td>100</td>
<td>7.0</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>100.0</strong></td>
<td><strong>n.a.</strong></td>
<td><strong>32.5</strong></td>
</tr>
</tbody>
</table>

Most small firms are innovative in finding market and regulation niches. From many thousands, however, only hundreds are based on (and are introducing further) technological innovations. Direct export in the small business sector is still marginal, though its contribution as subcontractors and via intermediate goods is not negligible. The inclination to invest in small business is weak. In order to change this attitude a programme for SME promotion is being developed.
This programme presupposes a more favourable economic environment for all enterprises, creating confidence and proper motivation for work and entrepreneurship. In addition it should eliminate all political, administrative, and economic barriers to start-ups, and to the survival and growth of private small businesses. Measures for the privatization of state-owned enterprises are being prepared, as well as the creation of a system of small business promotion, including information, training, consultancy, infrastructure, finance, and incentives for innovation and export.

**Behaviour and performance**

**Behavioural assumptions and practice**

Textbook models of centrally planned economies do not take into account possible variations in the behaviour of enterprises. They are based on two assertions, and on one which may better be left unstated. The two assertions are:

1. that enterprises, both management and collectives, identify themselves with the overall national plan and with the obligatory targets which are derived from it;
2. that the monetary and other ‘material’ incentives for fulfilment and over-fulfilment of the plan can be made to work adequately.

What is not so often mentioned is that if the above motivation does not work, coercion will ensure that enterprises follow the central targets.

The validity of these assumptions, as well as the legitimacy of the methods of enforcement, had been questioned in the mid-1950s, and in restrained, then louder voices ever since.

Experience shows that identification with national plans can be a strong motivational force, but for a limited timespan, and when common goals do not conflict with or dominate individual and group interests.

In the system of obligatory plan indicators, the rewards for the fulfilment and over-fulfilment of plans encourage easy tasks, which means ‘underpinning’. In addition, the plan indicators might be misleading, contradictory, or distorted, and the possibilities for the wide scope of bargaining, manipulation, and manoeuvre are great.

In the two decades following the introduction of the comprehensive economic reform in 1968, we were not able to eliminate the role of bargaining, manipulation, and manoeuvre in
enterprise behaviour. Bargaining about prices, subsidies, tax-exemptions, preferences, and special rules of regulation, were substituted for bargaining about plan targets. Manipulation of indicators and reports on the fulfilment of plans have been replaced by manoeuvre in the jungle of the rapidly changing rules on pricing, wages, taxation, prohibitions, and bonuses. Market competition took over neither the regulatory nor the stimulatory function to the extent expected. Weak market competition has been accompanied by increasing non-market competition. Among the non-market forms of competition, a distinction is made between formal and informal competition (Román 1986). Formal or open competition means that in the course of planning and control, various proposals will be elaborated on R & D and investment projects, subsidies, grants, etc., and then evaluated, compared, and ranked. Some will be accepted, some rejected. Those submitting the recommendations, the representatives of the enterprises and institutions concerned, compete for a favourable decision.

I call it informal or hidden competition, or an informal medium of non-market competition, as enterprises and institutions try to influence these decisions through personal networks and other clandestine means, including return services which look suspiciously like corruption. We cannot completely exclude this informal competition when the system offers too much scope for it, and the moral inhibitions are weak. But we face a risky situation.

All this does not mean that ambition for honest work is not present, nor that there is no market orientation in some segments of the economy. Market competition has gained ground, but is still in the stage of ‘indirect bureaucratic control’, as Janos Kornai described in his analysis of the Hungarian reform process (Kornai 1988).

Performance

Given these critical comments on structure and behaviour, one cannot expect anything but poor performance. Until the mid-1970s, however, the Hungarian economy mostly had a good image in the eyes of international experts, in particular in the years following 1968. This indicates that we should not underestimate either the impact of factors beyond structure and behaviour nor, as far as behaviour is concerned, the role of ambition for honest work, and at some time the role of nationalist feelings and impulses.

On the other hand we must be aware of the constraints of performance appraisal. Behind the impressive growth rates and improvements in the standard of living, rising tensions were hidden: neglected infrastructure, a widening technological gap, and from
the early 1970s overspending and a lack of flexibility. The postponed but inevitable slowdown was followed by stagnation, exhaustion, and decline.

In consequence, we encounter now in Hungary three difficult tasks to be solved simultaneously:

1. we have to narrow the technological and managerial gap, improve the performance of the economy, raise productivity and quality, and accelerate structural adjustment;
2. we have not simply to improve some of its core elements, but to transform the system by which the economy functions;
3. changes in the power structure and in the political system should be realized as smoothly and as quickly as possible.

Each of these tasks involves many conflicts and tensions: any single one of them would create enough obstacles. These three tasks are, however, closely interrelated; they cannot be scheduled for successive implementation.

The international environment is—and hopefully will remain—favourable for these changes, but the burdens of ineptitude are more pressing than ever before. The programme of the government for stabilization and consolidation published in September 1987 could not have been implemented. The new programme of the partially reformed government is under elaboration; it promises radical steps in creating a market economy in Hungary. According to this programme, the share of state-owned enterprises in the competitive sphere of the economy will be much lower. Each enterprise will have to work within real market conditions, ruled by statutes in harmony with this environment, where industrial organization will be characterized by clear relationships and responsibilities, adequately stimulating and rewarding entrepreneurship, and performance.

Notes

1. Auxiliary agricultural production makes about half of these activities.
2. After the implementation of the enactment 22/1984 from the 1,009 state-owned industrial enterprises, 236 remained under state supervision, 131 under trusts, 332 were under the Enterprise Council, 257 under employees' assembly (another variant of the former statute), 24 were foreign-owned, and 29 classified as 'other' ownership.
3. The annotation to the Transformation Act clearly pointed out that ‘...it is evidently not equal with the ownership reform, cannot substitute for it...its scope is much narrower’. For this reason the Act has been attacked by many economists, lawyers, and opposition parties both before its tabling and after its approval by Parliament.
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Chapter six

Liberalization and privatization of public enterprise in India

Y.Venugopal Reddy

Planning: the role of the state and the market

In 1947, at the time of Independence, there was virtual unanimity on the need for planning and for the dominance of public enterprise. Planning provided—and continues to provide—the framework within which public enterprises operate in India.

The process of planning in India has always been undertaken within the context of a parliamentary democratic framework which recognizes the continuing existence of various interest groups. The interventionist role of the state in the economy is divided between the central government and the twenty-five provincial governments. More important, the whole process is based on the concept of a mixed economy where the government provides the stimulus and direction and itself participates in some activities, while the market—subject to regulation by the government—operates in determining supply, demand, and prices. Thus economic development is carried out through a mix of planning, state intervention, and market forces.

The approach of state intervention through the planning mechanism in India can be summed up as follows. First, an attempt is made towards comprehensive planning by developing econometric models which arrive at internal consistency. There is an iterative process both between sectors and between the central and provincial governments through the mechanism of working groups. This helps in detailing the plan into projects and programmes, particularly in the medium-term planning of material balances.

Second, emphasis is laid on capital-output ratios, and hence on the way investments are allocated between different sectors or activities.

Third, the total investment is divided into public and private sectors. The resources for allocations within the public sector are worked out in detail. This detailing includes the division of resources and activities between the central government and the twenty-five provincial governments in the light of the constitutional division of powers. Public
sector investments are determined through the investment approvals of the governments concerned.

Fourth, private sector investment is influenced during the plan period by a variety of instruments. On the positive side these include the provision of infrastructure, mainly by the provincial governments, and making finance available—mainly through central government or the banking sectors. On the regulatory side it involves physical controls through the licensing of organized industry, quantitative restrictions on imports, exports, and the regulation of foreign exchange by central government. To an extent, fiscal instruments are used to influence the private sector by both central and state governments. Further, the process of correcting market inefficiencies and ensuring social justice involves the use of a regime of administered prices, including dual pricing and a price support mechanism.

In terms of objectives, growth, social justice, and national self-reliance continue to be the explicit objectives, though with differing emphasis depending on circumstances. Serious gaps are often noticed between the priorities, plan content, and implementation. The basic thrust, however, has been to use public investment—particularly in public enterprises—coupled with regulating the allocation of private investment through physical controls to ensure growth.

Special programmes of credit, subsidy, employment, and area development, coupled with a public distribution system for essential commodities under a controlled price regime, constitute the thrust towards social justice. Non-tariff barriers, import substitution, regulation of foreign exchange, and managing the foreign debt-servicing obligations within prudent limits, provide the basic framework for self-reliance.

While the basic framework of planning in a mixed economy has continued since the beginning of the planning era, with the public sector holding the commanding heights of the economy, the relative emphasis of the public and private enterprise sectors has changed. Four distinct periods have been identified.

First, the ‘commanding heights’ phase lasted from 1950 to the mid-1960s. The scope of public enterprise expanded, especially in heavy industry and infrastructure.

Second, from the mid-1960s through to 1977, both the international climate and a series of droughts led to a strain on resources and to ‘plan holidays’. Banks were nationalized, followed immediately by the general insurance sector. This meant that most of organized financial intermediation fell into the public domain, giving access to financial resources to the public sector as a whole. This helped to finance public enterprises. In the industrial sector, the need was realized for promoting the private corporate sector in partnership with the public sector, resulting in the concept of joint sectors in industry. Thus a promoter’s equity participation in the corporate sector was shared between public and private
sectors, simultaneously providing institutional mechanisms for possible disinvestment later.

The third phase, roughly 1977–84, was a difficult one for public enterprise. There were international forces affecting the balance of payments, an unfavourable aid climate, and domestic forces creating strains on the budget. This was a period of review, both of the planning mechanism and of the role of public enterprises.

The result was the fourth phase—called the New Economic Policy—from 1985. This attempts to achieve a new balance between the state and the market. Although it is still built round the three objectives of growth, social justice, and self-reliance, the means by which these are to be realized is being changed. Growth is sought by increased production, brought about by allowing the private sector to enter new areas hitherto reserved for the public sector, by deregulation, by emphasizing efficiency in the public sector, by a hi-tech bias, by introducing more competition in the economy, and by promoting savings, investment, and capital markets. Public enterprises were given direct access to capital markets.

In addition there is an intense debate going on about the coverage, relevance and appropriate forms of privatization, with no progress so far on the actual transfer of ownership. The long-promised government White Paper on public enterprises has yet to be finalized.

**The scale of public and private enterprise**

Public enterprises are a sub-system of the public sector. They comprise activities carried out by entities, most of which are legally separate from the government but which invariably maintain a separate account of all their financial transactions and present them in the form of a profit and loss account. The public enterprise sector can be divided into three broad categories: departmental enterprises, non-departmental enterprises established through general laws governing all corporate bodies, and those established through special laws, called statutory corporations.

It is important to note that all public enterprises, in whichever category they fall, are regarded as an ‘extended arm of the state’. Their employees are treated as if they were civil servants, and thus are subject to civil service protections (in departmental enterprises they are of course actually civil servants).

In the context of an agro-based, rural-oriented developing economy like India, the distinction between the organized and unorganized segments of the economy is very significant: the organized sector is derived from the census, and includes only those who are formally employed by identifiable legal entities. Ninety per cent of the workforce is in the unorganized segment—mainly rural agriculture and small unregistered businesses. Of the organized 10 per cent, the public sector accounts for 7
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per cent and the private sector for 3 per cent. Within the public sector, public enterprises occupy about one third and so account for just over 2 per cent of the total workforce—approximately five million people.

There are six large departmental public enterprises (dominated in scale by the railways and telecommunications) and over 200 central government non-departmental enterprises (largely in manufacturing, petroleum, airways, and trading). These include many loss-making ex-private-sector companies taken over by the state (principally in textiles and jute), some of which are themselves holding companies with large numbers of subsidiaries, accountable to the Bureau of Public Enterprises. In addition, there are about 500 separate public enterprises responsible to provincial governments (where power and transport predominate, and where manufacturing is relatively unimportant). In addition central and local governments hold a minority percentage of the equity in most medium-sized and large private manufacturing companies.

The public sector is almost totally dominant in railways, telecommunications, banking, insurance, electricity, gas, water supply, petroleum, external trade, airlines, mining, and quarrying, but has only about 16 per cent, of the net domestic product generated in manufacturing, and about the same percentage in construction.

In the last thirty years investment in the public sector has grown enormously, savings have been showing a downward trend in the recent past, and employment has been increasing, at a disproportionate rate to the general trend. Expansion of staff and increased emoluments to functionaries—particularly in departmental enterprises—have led to a substantial growth in the services component of the national income.

Most of the profits in central government enterprises are generated in the petroleum sector, which has a virtual monopoly. There is an intricate mechanism of government-administered prices and linkages of the outputs of public enterprises with the outputs of other such enterprises as part of the planning process so that efficiency is difficult to assess and the true extent of competition is hard to differentiate. A large part of the turnover of public enterprise is contributed by the trading organizations such as the Food Corporation of India, Mines and Minerals, and the State Trading Corporation. These perform agency functions for the government on the basis of agreed margins.

The return on capital employed in central government enterprises is around 7.5–8 per cent, not far short of that in the private sector, although returns in provincial government enterprises are very low.

Liberalization

In the last two to three decades the public sector in India has contributed to a large capital base, diversified industrial structure, a degree of self-
reliance, and widespread managerial as well as entrepreneurial talent. However, by the 1980s a transformed picture had emerged. The private corporate sector broadened and matured. The fiscal crisis forced a re-examination of costs and the optimal means of achieving social objectives. The high-cost economy was attributed to government regulation and to the performance of public enterprises. The mixed economy came to be described as a ‘mixed-up’ economy, and led to a review of the mix.

What were the factors which led to such a review of the mix and to an economic policy tilted towards liberalization? In respect of controls, these were: the difficulties of administering physical controls; the self-defeating nature of price controls; and the fact that markets in India have tended to develop both extensively and intensively.

In fiscal terms, large-scale tax evasion resulting in ‘black money’, inelastic tax revenues, high cost of subsidies, and low returns from public enterprises resulting in negative balances on current revenues, deficit financing, and inflationary potential, led to a view of the fiscal policies.

In the monetary sphere, inadequate tapping of savings, the existence of complicated, administered interest rates, ‘sick’ industries, and underutilization of capacities attributed to the high cost and delayed availability of credit, the inefficiency in public sector financial systems, and the repressed growth of capital markets also compelled the review.

In the area of trade, persistent problems of balance of trade were attributed to inadequate export attractiveness, cumbersome procedures, particularly of a discriminatory nature, and the high cost of import substitution.

In addition, generally, public enterprises came to be identified with unplanned and unwarranted expansion, inefficient operations, poor service, and large financial losses.

Overall the stagnation in industrial development since the mid-1960s, the high capital-output ratio, persisting imbalances in external trade, technological obsolescence, and low-productivity of labour were all being attributed to two basic factors: the regime of government regulation and the government’s management of public enterprises. The broad purpose of policy changes was therefore to move away from regulating the private sector, and from controlling public enterprises.

The foundations of the changes in policy broadly described as the New Economic Policy were laid through the reports of a series of high-level official committees in the early 1980s, on public enterprises, controls, trade, monetary policy, and ‘black money’. The thrusts of these reports found formal admission in the VII Plan document (1985–90). It emphasized competition among producers, and suggested that all private companies (and even public enterprises on a selective basis) be encouraged to bid for resources in the to-be-strengthened capital markets. Apart from
deregulation and liberalization as instruments of encouraging competition, other elements, such as introducing contracting-out or franchising, have been selectively recommended in the Plan.

As a result, impressive policy changes have occurred in the 1980s with regard to the liberalization of both private and public sectors. In the private sector, those with a short term impact can be identified as follows. Entry conditions to Indian industry have been relaxed by diluting licensing requirements (the financial limits for a licence requirement has been raised from Rs 20 million to Rs 150 million (=US$9 million). Exit conditions have also been opened up through the Sick Industries Act 1985. The definition of a large group requiring close control has been raised from Rs200 million to Rs1,000 million (=US$62 million). A wide range of price and distribution controls have been relaxed or (for commodities like cement and steel) removed.

Simultaneously, though there has been no formal devaluation, the value of the rupee is being aligned to a realistic level. It has depreciated in the last five years at an average of around 10 per cent per annum in terms of the US dollar or the pound sterling. Foreign investors have become interested in collaborations with equity participation—roughly a doubling in value in five years. The capital markets have been spurred suddenly into action: approvals for capital issues have risen fifteen times in value, 1981–8. Corporate takeovers and mergers are a more frequent phenomenon. Public sector banks have started capital funds. Mutual funds and venture capital have mushroomed. The Securities and Exchange Board of India has been established to promote the orderly development of capital markets. Indian funds have been floated in the international market, and the day may not be far off when the equity shares of individual companies may be allowed to be traded in the international market.

In fiscal and monetary policies there have been considerable relaxations and rationalization in income tax and wealth tax rates, in addition to relaxation in the administered interest rate regime of the nationalized banking sector.

In a more restricted way, there have been changes in defining the roles of the public and private sectors. The private sector has been permitted to enter core sectors like oil and natural gas refineries, power generation, and telecommunications for the first time. And there has been a new reluctance to nationalize ‘sick’ industries in the private sector.

Public enterprise reform and privatization

The major elements of the New Economic Policy in the public sector are: a reduction in the proportion of public sector outlay and smaller budget support; opening new areas for the private sector; a more arms-length relationship between public enterprises and government; where possible
competition between public enterprises; new forms of public enterprise; the introduction of contracting out or franchising, as in road bridges and port operations; and charging for productive services and the avoidance of subsidies. Some loss-making public enterprises are being liquidated (a start has been made with Scooters of India Uttar Pradesh).

Given these policies and the dominance of public enterprises in the core sectors of the Indian economy, especially in the public utilities, their overall larger scale than the private organized sector, and the inherent difficulties of financing the further expansion of public enterprises, there has been some movement towards privatization. In the Indian experience there are five possible approaches, which we may call

1. divestiture;
2. ‘greenfield’ privatization;
3. ‘cold’ privatization;
4. ‘internal’ privatization;
5. privatization of the public sector other than public enterprises.

On the first of these there has been no formal policy of divestiture (sale of shares in public enterprises to the private sector). In fact the Dr Arjun Sengupta Committee, which considered involving private investments in the equity of central government enterprises, dismissed it as not desirable. While the Committee did not recommend the selling of shares, financial autonomy is given by permitting selected public enterprises to obtain ‘bonds’ when their chief executives recommend that 49 per cent of their shares should be made available to the public and workers, and that these shares should be traded in the stockmarkets. The public sector trade unions opposed this wholesale. Private corporate industry, which has been critical of public enterprises, has not made convincing offers for purchasing equity in them. No major political party has come out publicly to support the sale of public enterprises—except one provincial government, that of Andhra Pradesh. However, there have been sporadic cases of sale of manufacturing units, on a case-by-case basis, restricted to loss-making and non-viable units such as Allwyn Nissan Ltd, and attempts in regard to Scooters India Ltd, Bharat Electronics Ltd, and A.P.Scooters Ltd. Perhaps both the state of capital markets and the slender base of the private corporate sector do not permit such sales on a large scale. The paid-up capital of non-government companies (i.e., with private shareholding of at least 50 per cent) is only about one fifth of government enterprises.

As already mentioned, avenues hitherto reserved for the public sector are being made available to the private sector: this may be termed ‘greenfield’ privatization. These include defence, electronics, aviation, communication equipment, etc. Two petroleum refineries which were originally proposed to be established in the public sector are now being
moved to the joint sector (Karnal Refinery from Indian Oil Corporation has become a collaboration between Indian Oil Corporation and Tatas, and there is a similar arrangement for Mangalore Refineries). There are continuing efforts to attract private-sector investment in major roadways. The emphasis on greenfield privatization appears to be a necessary consequence of the policy of liberalization and of fiscal crises.

A major area of public enterprise reform in India may be described as ‘cold’ privatization, inasmuch as the effort is to retain public ownership, but to ensure that each enterprise mimics private enterprise in its behaviour, i.e., maximizing profits and being answerable to the ‘bottom line’ principle. The major instruments towards cold privatization are: increasing attention to profitability; giving public enterprises access to bond markets on concessional terms with tax benefits; autonomy in taking decisions with regard to some new projects; appointing some private enterprise leaders to the boards of public enterprises; reluctance by the government to encourage the takeover of ‘sick’ industrial units by public enterprises; reduction in budgetary support of the government departments such as telephones in Bombay.

There have also been policies of ‘internal’ privatization: public enterprises themselves taking recourse to privatization techniques in their internal operations. The first set of measures relates to the increasing recourse to contracting-out of operations by large public sector organizations like railways, oil, the Natural Gas Commission, ports, etc. Even the Marxist government in West Bengal has permitted large-scale franchising of city bus services in Calcutta. The second set of measures are financial. India has a tradition of what has been termed the ‘joint venture sector’, where equity is held partly by the government or public institutions, and partly by the general public. In the recent past, efforts have been made to disinvest the shares held by public institutions in the joint ventures already floated, and government institutions have been reluctant to take up fresh joint ventures (except in areas which were hitherto reserved for the public sector).

Finally, a relatively unnoticed area of privatization relates to the development of charging policies by some public-sector services. The major areas of expenditure by the government in public sector services are in the fields of education and health. In both the government finds it difficult to cater for the mounting demand requirements of a growing population. The private sector has always been present in these areas, but the large public-sector services were virtually free. Of late, however, in a few cases the government is considering charging for services rendered in some specialized hospitals. More important, the public financial institutions are extending liberal financial assistance to private companies which offer these services. Legislative and other institutional devices have been adopted in the state of Andhra Pradesh to charge the ‘non-poor’ for
medical services. Of lesser significance is the effort to contract-out some of the services which were being provided in-house in the Government.

**Present issues and policies in India**

Any analysis of privatization in India must be based on a clear understanding of the socio-political and economic context. The pressures towards privatization in India can be attributed to a number of factors, including the fact that India is a sub-system of the world capitalist system. More specifically, the disenchantment with the working of the large public-enterprise sector is a prime mover. There is an intensive debate as to whether the blame should be on government interference, or on the inherently low levels of operational efficiency of the public enterprises, and whether the latter leads to the former. Further, there has also been concern at the way the regulatory framework has been used to achieve results totally contrary to the stated objectives of reducing the concentration of economic power and ensuring allocation of resources of investment towards socially desirable goals. The persistent trade deficit and the increasing dependence on foreign savings for financing the current account deficit makes the plea for review of the role of the state in the context of the international economy even more urgent. At a socio-political level, there has been a greater assertion of the pluralistic nature of the Indian polity and pressures towards decentralization of decision-making. This is reflected in the changing character of the parties that are elected to different levels of government, a plea for a review of central/provincial government relations and the variety of measures suggested or implemented towards government decentralization to local bodies, autonomous agencies, and voluntary organizations.

There has been opposition to these pressures mainly on the grounds of the effect privatization will have on the polity due to the increased presence of Big Business and multinational corporations. Equity issues are also flagged. Further, the disappointing performance of the private sector is also cited.

Contrary to the pressures in the USA and UK, there is no public articulation in India to impose cuts on welfare provisions by the government. The funding of such welfare activities by the government is supported universally, though there may be at the margin some advocates for encouraging private provision. If at all, the public pressure in India is towards greater funding and provisions of welfare, partly due to political compulsions and partly due to the argument for removing demand constraints. Of late, there have been questions raised on the levels of outlay on defence (which have doubled in real terms in the last ten years), but the provisions for welfare at large are seldom seriously questioned. In brief, supply-side economics in regard to the management of public finance in India is not applicable to the expenditure side.
There has been an emphasis on increasing public investment rather than rolling it back. The demand for public investment far outstrips the availability of resources, and the privatization debate is to be viewed in the context of providing greater resources for public investment (and perhaps public consumer expenditure also in terms of welfare provision).

The issue of subsidies is coming to the fore. The major areas where subsidy is provided by the central government relate to food, fertilisers, exports, and interest payments. In provincial budgets it relates to irrigation, and indirectly to power and transport. While concern is expressed in a general way, and a plea is made to charge the beneficiaries for the services rendered, the roll-back by the state in terms of its participation is an issue which is more or less restricted to the Road Transport Corporation sector.

Of greater relevance to the Indian situation is the issue of concealed subsidies in the operations of public enterprises and the pricing mechanisms. Subsidies to favoured clientele, not open to Parliamentary control or public debate, through political patronage via public enterprises, are being flagged by academicians for attention.

The largest area that is commanding the attention of the government relates to the review of the area of operations of public enterprises, their objectives and their functioning. The areas of control and autonomy are put at the fore (cold privatization) but the roll-back in terms of area of operations of existing enterprises is a non-starter. However, a number of areas hitherto the monopoly of public enterprise are now being opened up for the private sector (greenfield privatization) and these enterprises themselves are taking recourse to privatization techniques for efficiency (internal privatization).

In terms of the regulatory atmosphere, maximum attention is paid to this aspect, and there appears to be almost universal support to the idea of removing physical controls and replacing them with non-discriminatory controls. One area of serious disagreement relates to the large industrial groups and the accommodation that is being shown to them in the process of liberalization. This is a matter closely related to issues of political economy.

In its international dimensions, the privatization debate relates to liberalization, and here the controversy is intense. Areas of concern relate to the possible harmful role of multinational corporations in the Indian economy, and more important in Indian politics. These are seen as the harmful effects of such liberalization on consumption and demand patterns, the effect of imports of capital and intermediate goods on the Indian capital goods industry, the question of relaxing foreign exchange regulations and promoting collaborations and their effects on the economy, and, in the limited context of public enterprises, the concerns expressed at the threat to their markets, in particular to BHEL (the large manufacturer of power generation equipment).
In sum, most of the privatization debate relates to industry and only marginally to infrastructure. More important, the thrust is towards a review of the role of public enterprises, the functioning of the government in relation to them, and regulation of the private sector. There is nothing in the debate to indicate a positive orientation towards the private sector as a more effective, efficient or viable option to the public sector. Indeed, the thrust towards privatization is meant to enable greater public investment to take place, rather than to reduce the role of the government in investment and in welfare. Finally, there is a growing feeling that, in the Indian context, the privatization debate has helped only to divert the attention of the nation away from the more pressing and urgent issues of poverty, unemployment, land distribution, and regional development that affect the most vulnerable (and largest segment) of India’s population.

Contrary to the socialist image, Indian policy has always been pragmatic, with public and private enterprises co-existing even in sectors like steel, cement, and power generation. Currently, there is disappointment with public enterprise, but it is not wholly matched by enthusiasm for the private corporate sector. The consensus, therefore, is for a cautious shift in the balance to enhanced efficiency in public enterprise, larger opportunities for private sector, and wider scope for collaboration between the two.

Thus Indian policy is poised towards a structured change in the balance between state and market, openness and national self-reliance, public and private enterprise. It has elements of privatization, in terms of wider scope for the private sector, but only marginally in terms of share transfers. In matters relating to a direct attack on poverty and making available private and public consumer goods to the great mass of people below the poverty line, one can certainly expect a countervailing expansion in the government.

Bibliography


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Chapter seven

The public enterprise sector in Malaysia

Mavis Puthucheary

There are three stages in the development of public enterprises in Malaysia: first, the colonial period, when public enterprises provided infrastructural and public utility services to promote economic growth by the private sector; second, the transitionary period, when the role of public enterprise focused on providing various forms of assistance to the rural Malays; and third, the present stage, with the direct involvement of public enterprise in the commercial activities on behalf of the Malay community.

This chapter focuses on that third stage. It analyses the nature of the controlling social forces in the government, and the introduction of a policy which resulted in the expansion of public enterprises with socio-political and commercial objectives. In the next section, there is a brief examination of the performance of these enterprises. In the last part it is suggested that the rise of state capitalism has facilitated the growth of a Malay ‘state bourgeoisie’ which has access to and control over considerable resources, and influence over private sector companies. This process is likely to continue in the future with the creation of a large number of mixed ownership companies, both as a result of public enterprises setting up new joint ventures with the private sector, as well as through the partial forms of privatization that have been introduced.

Background to the New Economic Policy

The separation of political and economic power by race has been the main source of inter-ethnic conflict in the country since independence. The Malays claim that they should have special political rights by virtue of their status, because their ancestors were in the country when the British colonized it. They call themselves ‘sons of the soil’, or Bumiputeras, to distinguish themselves from the other ethnic groups whose ancestors were immigrants to the country. The other groups claim equal political rights with Malays on the basis that they are now a settled community with undivided loyalties to Malaysia as the country of their birth. This political schism is intensified by the identification of race with economic function.
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While the Malays were, until recently, concentrated in agricultural activities with a small middle-class group in the civil service, the non-Malays, particularly the Chinese, are located mainly in the modern, urban sectors of the economy.

However, the tension between the different communities caused by different perceptions of their political rights was eased by the common understanding between the leaders of the main political parties that represented the different ethnic groups. The formation of the Alliance Party, a loose coalition of three ethnically based parties, and its continuation in office since independence has been the major factor which contributed to the stability of the government. There was only one short period when this stability was broken, in 1969.

Two events took place in 1969 which had the effect of changing the leadership in the coalition government and with it a change in economic policy. The first was the national elections held in May 1969, which resulted in an Alliance Party win, but with a substantially reduced majority. The second event was the eruption caused by ethnic riots that broke out in Kuala Lumpur following the elections. These two events provided the catalyst for the New Economic Policy which envisaged a direct role for the government and a new role for public enterprises.

The role of public enterprise under the New Economic Policy

The New Economic Policy (NEP) was designed to achieve explicit ethnic redistributional goals. It aimed to improve the share of Malay participation in the modern urban sectors of the economy through a number of strategies. One strategy was through the involvement of public enterprises in commercial activities, with the purpose of creating viable business which could be sold to the private (Malay) sector at a later date. The economic justification for the new policy was stated in the Report of the Economic Committee of the National Consultative Council as follows:

In the past, there had been heavy reliance placed on the private sector as a vehicle for industrial development which inevitably benefitted the non-Malays more than the Malays. Malays, due to lack of entrepreneurship and capital, have lagged behind in terms of ownership of capital and employment in the modern urban and rural sectors. Thus, the policy of relying solely on the private sector for economic development has led towards development that is lopsided and which had contributed greatly to the racial economic imbalance. Since there are very few Malays capable of establishing industries in the private sector, it is critically important, if the Malays are to participate effectively in the modern sectors, for the
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government to pursue a policy whereby government present limited participation in the private sector must be [sic] intensified.

(Economic Committee 1970)

Public enterprises, in the form of wholly-owned and joint-venture companies, were the main instrument for the implementation of the NEP. It was assumed that surpluses earned by public enterprises would be accumulated on behalf of the Malay community and would eventually be transferred to them; although how this was to be done was not clear at the time the NEP was first formulated. Nevertheless it was assumed that government capital would be converted into Malay capital through the outright sale of shares of Malay individuals and companies. It was hoped that in this way Malay share capital in limited companies would increase from less than 2 per cent in 1969 to 30 per cent in 1990.

As the main purpose of these public enterprises was to engage in private sector activities, it did not matter in which industry they entered as long as they could show that by their participation profits could be earned and accumulated. In fact several public enterprises were set up as holding companies or statutory corporations with investments in a number of subsidiary and associate companies engaged in a wide range of economic activities: agriculture, manufacturing, transport, construction, finance, and service industries. For example the Majlis Amanah (MARA) had fifty-nine agencies, while the eleven State Economic Development Corporations had a total of about 250 subsidiary companies and agencies. Many of these public enterprises had almost identical functions, and were engaged in the same economic activity. In some cases several public enterprises shared ownership of the same company. In 1988 it was estimated that there were 1,133 companies in which government had equity interest. The breakdown of these companies by economic sector is shown in Table 7.1.

Although it was assumed that the government would set up productive enterprises and thus contribute towards the economic growth of the country as well as the restructuring objectives, many public enterprises soon began to invest in existing private sector companies. There were several reasons for this. First, it was relatively easier to achieve the 30 per cent restructuring target through the acquisition of shares in existing companies that had a proven track record, than to manage a company from birth.

Second, as part of its strategy to achieve the restructuring objectives, the government had introduced a number of regulations requiring private sector companies to reserve a certain proportion of their new share issues
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Table 7.1 Government companies by industry and status

<table>
<thead>
<tr>
<th>Industry</th>
<th>Active</th>
<th>Inactive</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Agriculture</td>
<td>108</td>
<td>35</td>
<td>143</td>
</tr>
<tr>
<td>Building and construction</td>
<td>89</td>
<td>40</td>
<td>129</td>
</tr>
<tr>
<td>Extractive industries</td>
<td>19</td>
<td>16</td>
<td>35</td>
</tr>
<tr>
<td>Financial institutions</td>
<td>102</td>
<td>12</td>
<td>114</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>250</td>
<td>82</td>
<td>332</td>
</tr>
<tr>
<td>Services</td>
<td>226</td>
<td>71</td>
<td>297</td>
</tr>
<tr>
<td>Transportation</td>
<td>53</td>
<td>16</td>
<td>69</td>
</tr>
<tr>
<td>Others</td>
<td>–</td>
<td>14</td>
<td>14</td>
</tr>
<tr>
<td>Total</td>
<td>847</td>
<td>286</td>
<td>1,133</td>
</tr>
</tbody>
</table>

Source: Ministry of Finance (1989:96)
Notes: 1. Government here is defined to mean the Federal Government, State Government or their agencies
2. Inactive companies are defined as companies which have ceased operations, closed down or are dormant, under liquidation, in pre-operation stage, under receivership, suspended, or are just ‘shell’ companies

for Malays. As private Malay capital was scarce, public enterprise was required to take up these shares reserved for Malays. Large sums of money in the form of equity or loans were provided by the government for this purpose.

Third, through mergers, acquisitions, and takeovers of existing companies, the government was able to shift ownership and control of the plantation and tin-mining sectors from foreign to local hands. These acquisitions, regarded by some as ‘backdoor nationalization’, were seen by others as one of the most successful aspects of the NEP.

One of the largest investment companies to be set up was the National Equity Corporation (PNB). This company was originally established to take shares in private companies that were to be restructured under the Ministry of Trade and Industry. But soon PNB began to seek investments from other, more profitable, sources. By 1978 68 per cent of PNB’s investments had been acquired through purchases from private institutions and through normal stock market operations, 13 per cent were from government agencies, and only 19 per cent were from share allocations made through the Ministry of Trade and Industry.
PNB’s source of funds also expanded. Originally set up with a grant of M$500 million from the federal government under the Third Malaysia Plan (later increased to M$1,500 million [=US$540 million] in the Fourth Plan), its main source of funds since 1982 has been the unit trust scheme Amanah Saham Nasional (ASN), which it incorporated as a wholly-owned subsidiary. By December 1987 the unit trust scheme managed by PNB amounted to M$4.3 billion in 108 companies. This, together with PNB’s investments of about M$489.5 million in 1987 makes PNB the largest investment company in the country. PNB’s operating profit increased from M$145 million in 1986 to M$259 million in 1987 (PNB 1987). Part of these profits were distributed to unit trust holders in the form of dividends and bonuses. The unit trust scheme has paid out more than M$2.4 billion in dividends and bonuses since 1981.6

In addition to the ASN, PNB has recently set up a property trust scheme called Amanah Harta Tanah (AHT). This scheme hopes to mobilize the savings of the more well-to-do sections of the Bumiputra population. It is geared more to the urban market, unlike ASN, which is marketed strongly in the rural areas.

The involvement of PNB and other public enterprises in the acquisition of shares in existing private sector companies has resulted in the formation of a new breed of company in which ownership is shared between the government and private sector. For the private sector the participation of the government has opened up new opportunities for investment, reduced the level of risk, and in some cases given protection to the new industry. In fact, far from fearing government intervention in their businesses, the private sector welcomed state participation. The expansion of the public enterprise sector was phenomenal during the period of the NEP. About 450, more than half of all public enterprises, were created during the 1975–85 period. A World Bank study estimated that the public enterprise sector accounts for about 29 to 31 per cent of the GDP. Malaysia has one of the largest public enterprise sectors in the non-socialist world.

These government companies were allowed to operate with a considerable degree of operational autonomy. The government did not wish to exercise tight control over them and Parliamentary controls were ineffective because of the small opposition in Parliament. The freedom from government controls is reflected in the response of the Chairman of PERNAS to a question on the extent of government control over his organization. When asked whether PERNAS works under the government, he replied:

‘It does not. We are a commercial organisation. We are left alone. There is no government interference, except that it wants us to help realise its objectives.’7
Country experiences

Table 7.2 Government equity in companies (M$ million)

<table>
<thead>
<tr>
<th>Government equity (%)</th>
<th>Number of companies</th>
<th>Authorised capital (M$)</th>
<th>Paid-up capital (M$)</th>
<th>Paid-up by government (M$)</th>
</tr>
</thead>
<tbody>
<tr>
<td>More than 50</td>
<td>565</td>
<td>30.529</td>
<td>14.671</td>
<td>12.531</td>
</tr>
<tr>
<td>30–50</td>
<td>117</td>
<td>3.258</td>
<td>1.620</td>
<td>0.639</td>
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<tr>
<td>20–30</td>
<td>88</td>
<td>4.429</td>
<td>1.592</td>
<td>0.438</td>
</tr>
<tr>
<td>Less than 20</td>
<td>77</td>
<td>4.030</td>
<td>1.769</td>
<td>0.210</td>
</tr>
<tr>
<td>Total</td>
<td>847</td>
<td>42.246</td>
<td>19.652</td>
<td>13.819</td>
</tr>
</tbody>
</table>

Source: Ministry of Finance (1989:96)

The company form of these public enterprises, simulating private law company, and the establishment of management boards, created a structure in which the boards of public enterprise tended to assume the same degree of autonomy as that exercised by private boards. But the fundamental difference between a public and private enterprise, that of separation of ownership and control in the case of the former, was overlooked. In the case of private enterprise the directors usually have personal stakes in the enterprise sufficient to identify their interests with those of the enterprises’s ‘residual risk bearers’, i.e. the general body of shareholders (Garner 1988:30). In the case of these public enterprises it was assumed that the boards of directors would make decisions that were in the best collective interest of the Malays and other Bumiputeras. This was of course not always the case, as evidenced by the numerous instances when boards made decisions that benefited individuals (who often happened to be Malay) rather than Malays as a whole.

The performance of the public enterprise sector

How successful has the public enterprise sector been in achieving the general targets of the NEP? The restructuring objectives of the NEP are stated primarily in terms of increasing Malay share of the corporate sector. During the 1971–80 period, Malay (Bumiputera) ownership in public limited companies showed the highest rate of growth—31.4 per cent per annum compared with an annual growth rate of only 18.8 per cent for other Malaysian residents. The Bumiputera share of the total equity in

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public limited companies (at par value) increased from 4.3 per cent in 1971 to 12.4 per cent in 1980, and to 17.8 in 1985. Although the target of 30 per cent has not been reached yet, some writers believe that there has been considerable under-reporting of Bumiputera assets in the official figures (see Mehmet 1988:103). But even if we accept the official figures, there is no doubt that the improvement in the Bumiputera share ownership in limited companies is impressive. Bumiputera shares in limited companies jumped from a meagre M$280 million in 1971 to M$13,547 million in 1985, and is expected to reach M$26,309 million by 1990. A major portion of these shares are held by public enterprises which are classified as ‘Bumiputera Trust Companies’ in the government documents.

What is the cost of these public enterprises both in financial and social terms? Mallon points out that measurement of the opportunity cost of government contributions of equity capital and loans to public enterprises must also include the direct subsidies (via preferential terms) and the indirect subsidies (via guarantees of commercial borrowings) (Mallon 1982:320). There are however considerable difficulties in evaluating the real opportunity cost of capital to public enterprises as Mallon discusses in his article. Apart from these difficulties, it seems that social cost-benefit analysis is of limited value in the Malaysian context, simply because it is also extremely difficult to quantify the social benefits, especially when they are to be measured in such general terms as ‘achieving inter-ethnic harmony and national unity’.

For these reasons a more limited assessment will be made of the performance of public enterprises, in terms of financial profitability. In addition, as government policy towards these enterprises waivers between financial profitability targets and socio-economic targets, the next section discusses the implications of the contradictions of policies on public enterprise operations.

Financial performance

The financial performance of public enterprises has been disappointing on the whole. Financial data reveal that nearly half of them are incurring losses. Out of a total of 770 companies examined by the government, only 387 companies recorded profits, while 383 companies suffered losses. A number of the loss-making companies had even registered negative shareholders funds. The profits of the profitable companies were not enough to offset the losses of the loss-making companies. While profits amounted to M$4.6 billion in 1988, losses were a staggering M$5.6 billion. A breakdown of the performance of government companies by size of government equity is shown in Table 7.3. If the government-owned oil company is excluded from the list of profitable
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What has been the cause of the poor financial performance of public enterprises? The major problems identified include their high gearing ratios, over-exposure to external liabilities, less than optimal capacity utilization, weak management, increasing input costs, and, in some cases, inadequate technology (Ministry of Finance 1989:95). A World Bank study report identified poor management as the main reason for their poor financial performance. In particular the inadequate evaluation of management stemming from a diffuse control structure, lack of incentives, and easy access to funds have been identified as major contributing factors.

Public enterprises were of course set up primarily to accumulate assets for eventual transfer to Bumiputera individuals and companies. As money was easily available from the government, enterprises had competed amongst themselves to set up businesses in whatever economic activity they chose. Applications for grants and loans on easy terms had to show a reasonable chance of achieving success, but the government relied on figures produced by the public enterprises themselves. Direct and indirect subsidies were also provided.

Enterprises had been allowed to expand their operations at a rate that was clearly not in keeping with the level of their experience or with their technical and managerial capabilities. Civil servants were transferred to public enterprises to try to make good the shortages, but the few good managers were called upon to run several

<table>
<thead>
<tr>
<th>Government equity (%)</th>
<th>Number of companies</th>
<th>Accumulated profits (M$)</th>
<th>Number of companies</th>
<th>Accumulated losses (M$)</th>
</tr>
</thead>
<tbody>
<tr>
<td>20–30</td>
<td>55</td>
<td>283</td>
<td>33</td>
<td>107</td>
</tr>
<tr>
<td>20–50</td>
<td>70</td>
<td>377</td>
<td>47</td>
<td>392</td>
</tr>
<tr>
<td>More than 50</td>
<td>262</td>
<td>4,208</td>
<td>303</td>
<td>5,111</td>
</tr>
<tr>
<td>Total</td>
<td>387</td>
<td>4,868</td>
<td>383</td>
<td>5,610</td>
</tr>
</tbody>
</table>

Note: Financial statements that contain information on accumulated profits and losses are available for 770 companies only.
companies. When financial results failed to match expectations, the government was reluctant to cover the losses by closing down a company, and in an effort to ‘save’ it more funds would be supplied.

Concerned with this poor performance, the government then made serious efforts to revamp the management of public enterprises, and improvements have taken the form of rationalization of public industry, cost reduction, and product diversification. In some cases private sector management—both local and foreign—has been brought into an organization. For example, a Chinese entrepreneur was appointed recently as the executive chairman of Perwaja Trengganu Berhad, a steel production company which had been losing millions of dollars. In the case of the National Automobile Company (PROTON), a management team from Japan has been appointed to enhance the local management. In addition, some public enterprises have been privatized, while others have been closed down.

**Contradictory policies towards public enterprises**

Public enterprises have multiple objectives which make evaluation of performance extremely difficult, especially as the objectives shift in importance from time to time within the same organization. Furthermore, in the absence of any clear sectoral policies, each public enterprise acts as an independent discrete unit, so that decisions made by one enterprise may thwart the efforts of another and so prevent it from achieving its objectives. The operational policies of public enterprises may also have the effect of contradicting government policies relating to economic growth and industrialization. The following two case studies, one drawn from the batek industry and the other from the automobile industry, illustrate these contradictions.

**The Batek industry**

When the Rural and Industrial Agency (RIDA) was set up in 1951, one of its first tasks was to promote the batek industry, an industry dominated by small-scale Malay entrepreneurs. In addition to providing credit facilities and technical assistance to batek makers, a subsidy in the form of preferential duty of 10 per cent on imported white cloth was approved (the duty on imported white cloth for other purposes was 25 per cent). RIDA administered the subsidy scheme as part of its assistance programme.

In 1965 RIDA (under its new name MARA) expanded the scope of its activities. In addition to promoting Malay entrepreneurship, MARA set up several subsidiary companies. One wholly-owned subsidiary, Batek Malaysia Berhad (BMB) was set up to modernize the industry by introducing new designs and techniques which could be copied by batek makers; but like any other company, BMB was expected also to make profits.
Thus BMB had dual functions which contradicted each other. On the one hand, as the agency designated to look after the interests of the batek makers, it was given the responsibility of administering the preferential duty subsidy scheme. On the other hand it was also competing with the batek makers for sales. In this competition BMB had a distinct advantage over the other batek makers. As the organization administering the scheme, BMB was able to obtain all its supply of cloth through the scheme, while other batek makers were told that supplies had been depleted. They were forced to purchase white cloth at the higher market prices. In addition BMB had other advantages over private batekmakers. As a large-scale organization (in relation to the small handicraft type of industries of the local batek makers) BMB had access to more capital and better equipment. Even with these advantages BMB was not able to cover its costs, mainly because of poor management. Thus neither its financial nor its socio-economic objectives were achieved. It is now one of the projects earmarked for privatization.

The automobile industry

Prior to setting up the National Automobile Industry (PROTON), the Malaysian industry had consisted of importing completely built-up cars (CBUs) or assembling completely knocked-down parts (CKDs). In line with its industrialization policy, the government encouraged the growth of local industries by increasing the local content of imported cars through regulations. A mandatory deletion policy was introduced requiring certain components in the imported CKD packs to be excluded so that these items would be produced locally. It was assumed that locally assembled cars would eventually replace CBUs. But the government had also promoted the participation of Malays in the automobile industry through the granting of permits to import a wide range of imported cars. Thus the two objectives, that of promoting the local car parts industry and that of promoting Malay participation in the industry, contradicted each other.

This contradiction in policy was compounded when the government decided that Malaysia should manufacture its own car in partnership with a Japanese company. It seems that in the negotiations with Mitsubishi, the Japanese partner, important matters such as the future local content levels, CKD prices and royalty payments were left vague, giving opportunities for Mitsubishi to exercise its own discretion on these important matters. In fact it appears that in the hurry to produce the national car, many important details which would affect the future growth of the local automobile industry were not worked out.
Mavis Puthucheary

What effect did the national car have on the local automobile industry? First, in order to ensure the financial success of the national car, certain administrative measures were taken. The national car, Proton Saga, was granted tariff exemption of 40 per cent, while import duties on CKD packs jumped threefold for other brands. The incidence of these duties raised the price of CKF packs for non-Saga cars by about 100 per cent by the middle of 1985 (Doner 1988:15). As a result the share of Saga to non-Saga sales in the domestic market increased. The Industrial Master Plan had estimated that the ratio of sales of Sagas to non-Sagas in the domestic market would be 55:54. By 1988 PROTON had captured 73 per cent of the whole passenger car market and 86 per cent of the 1100cc to 1500cc range. Thus the introduction of the national car had adversely affected the local automobile industry.

Second, although all the motor firms were affected adversely, it appeared that some were more affected than others. The more established firms (mainly Chinese-owned) were able to cushion the drop in sales better than the smaller firms (mainly Malay-owned). Thus while the larger firms moved into new lines of production, such as concentrating on sales of commercial vehicles and/or higher priced passenger cars that were not in competition with the Saga, several of the smaller firms were forced to close down. It was estimated that by the beginning of October 1985 Saga sales and tariff increases on non-Saga CBUs had resulted in the demise of ten Bumiputera motor firms. The NEP-inspired national car project thus began to crowd out some of the very interests it was inspired to promote. [Doner 1988:18]

Privatization and the NEP

Like many other countries Malaysia has embarked on a privatization policy. The usual rationale for privatization (to improve efficiency through competition and better management, to stimulate private entrepreneurship and investment, and to relieve the financial burden of the government) have all been repeated in the official documents. In addition, privatization in Malaysia has another objective: it is expected to contribute towards meeting the objectives of the NEP. Thus privatization is seen as another strategy towards achieving the same goals.

Paradoxically, both strategies (that of enlarging the scope of government through public enterprise and that of reducing the size of government through privatization) are seen to have the same objective— creating Bumiputera wealth. As Milne observes:

What seems to be unusual about Malaysia is that it provides a ‘two-act’ case study of changes in economic policy intended
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to help a particular ethnic group. The Malays and other Bumiputera benefited from the NEP and the mechanism set up to implement it and are also benefiting now from the reverse process of privatisation.

[Milne 1986:131]

In fact the process of privatization started even before the policy was introduced. It started when the government decided to classify certain government companies as ‘Bumiputera trust companies’ 13 Thus with the stroke of a pen several public enterprises became classified as private institutions. But the announcement of the privatization policy and the form it has taken, as well as the companies which have been selected, reveal that privatization is merely another strategy for achieving the objectives of the NEP.

Since the emphasis has been on ownership rather than management, partial forms of privatization have been preferred to the outright sales of assets to the private sector. Partial privatization has taken several forms: the sale of a limited number of shares as in the case of the Malaysian Airlines System (MAS); or contracting-out, where new projects are developed by the private sector, while the government continues to be responsible for provision of the activity or service, such as the construction of roads. The government has also leased to the private sector certain services such as the maintenance and repair of Royal Malay Airforce aircraft and tourist facilities at the National Park. By November 1987 ten projects had been privatized, while another fifteen projects have been approved for privatization.

It is expected that in some of the smaller companies the government will sell part of its share ownership to private sector companies. It is likely this will result in the further expansion of the mixed-ownership companies. The large number of mixed-ownership enterprises has blurred the dividing line between the public and private sectors, and has hidden the extent of government influence over business. For although the government strenuously denies its influence over normal business operations, there is no doubt that considerable control is exercised through the appointment of chairmen and/or directors of the boards. In addition government influence is exercised through the various administrative committees that regulate business operations.

Conclusion

The role of public enterprises in Malaysia has changed to reflect the particular economic policies and priorities of the controlling forces within the government. Even during the implementation of
the NEP, there have been significant shifts in the operational policies of public enterprises. In the early years of the NEP the focus of policy was the setting up of productive public enterprises. In the second half of the NEP period, the emphasis shifted to the use of public enterprises as an instrument to acquire shares in existing private sector companies. The present trend is to consolidate the many disparate public enterprises into larger, more efficient units. Also, the move seems to be in the direction of large-scale, mixed-ownership enterprises involving the participation of government, multinational companies, and local companies. This tripartite arrangement is seen as the most suitable. The participation of the government ensures a measure of overall control, the participation of the multinational ensures proper quality control and marketability of the product, while local (Malay) participation is seen as essential to fulfil the objectives of the NEP.

Already, several public enterprises, such as PETRONAS and the Heavy Industries Corporation of Malaysia (HICOM), have set up joint ventures with private (foreign) enterprises. It is expected that as the enterprises become financially viable, some of the shares held by the government would be sold to the private sector, in accordance with the NEP. It is also expected that the privatization policy would be implemented with greater vigour in the future, so that the private sector would be provided with more opportunities to participate in large-scale industries such as the electricity generation and road construction. Thus, it is likely that the public enterprise sector will continue to expand in some fields at the same time as the privatization policy will reduce the size and presence of government in other fields.

Public enterprises have been the main vehicle for the establishment of a state capitalist framework. So far, at least, the movement towards the state capitalism has been compatible with the participation of the private sector, both foreign and private. It seems that the small group of men who control positions of power within the state apparatus, the ‘state bourgeoisie’, have common interests with multinational managers and large-scale Malay and Chinese entrepreneurs. There is therefore a degree of integration of large-scale business interests.

There are, however, signs of conflict between private Malay capital and public enterprises. The direct role of public enterprises in the economy is seen as antithetical to the promotion of Malay entrepreneurial development, one of the primary objectives of the NEP. In addition, the present leadership has been criticized for implementing policies that have benefited only a small group connected to it.
The criticism of the Malay business groups is a salient problem to Malay leadership, as these groups can influence changes in leadership through the party elections. It is therefore likely that private Malay capital would be able to pressure the government for a more limited role for public enterprises in the future. In particular, public enterprises which compete with private Malay capital would be eased out through privatization. The privatization process would be extended to include even large publicly owned monopolies. It is also expected that, in an attempt to spread the benefits of privatization to a wider section of the Malay community, the projects for privatization will be broken down into smaller units. A system of sub-contracting will also be encouraged. At the same time, the participation of foreign capital would be welcomed.

It is too early to tell whether all these efforts to assuage Malay business demands will be successful. The state leadership cannot afford to appear to be ‘selling out’ either to multinationals or to local Chinese business interests. At the same time, it is under considerable pressure from influential Malay business interests to limit the role of public enterprises to that of assisting and promoting the development of private business instead of competing with the private sector. In these demands, the Malay business groups have the support of the Chinese business groups and academicians who see a chance for a return to the ‘free enterprise’ version of capitalism.

The continued domination of the process of accumulation, whether state capital or private capital, does not change the fact that the process has tended to concentrate resources in the hands of a small group while the rest of the population does not seem to benefit, or to benefit only marginally. As Evans, writing on the experience in Brazil, wryly observed:

The fact that the capital involved is more ‘public’ than in a ‘free-enterprise’ version of capitalism does not change the fact that it is managed by a small, tightly-knit group whose interests may well diverge significantly from those of the mass of the population.

(Evans 1977/8)

Although not, perhaps, as extreme as Brazil, Malaysia is also finding that economic growth has been accompanied by increasing inter-ethnic and intra-ethnic inequalities.

The biggest challenge to the present leadership is whether it will be able and willing to use the considerable resources accumulated as a result of public enterprise involvement in the economy to develop programmes that will benefit the more disadvantaged groups in the society, of whatever ethnic background. Already the ASN has been the channel for the distribution of some of the benefits to a wider section of the Malay (Bumiputera) population. Perhaps some of the resources accumulated as a result of the spending of
public funds by public enterprises should now be directed at improving the socio-economic position of the poor of all communities.

Notes
1. For a socio-political analysis of public enterprise see Ahmad 1982.
2. The population of Malaysia is made up of several ethnic groups, but the inter-ethnic conflict seems to be seen as a more or less equal division between the Malays and other ‘Bumiputeras’ on the one hand, and the Chinese and Indians (non-Bumiputeras) on the other.
3. The Malays form the largest group among the Bumiputeras and are dominant at the federal level. This study uses the two terms, ‘Malays’ and ‘Bumiputera’ synonymously.
4. The Alliance Party, which was made up of three ethnically-based parties, changed its name to the Barisan nasional in 1970, when it enlarged its membership to include several more political parties. The position of UMNO as the dominant party in the coalition remained unchanged and indeed was strengthened in the large coalition.
5. Both the Malay-based party, UMNO, and the Chinese-based party, MCA, suffered losses in terms of the number of seats and the number of votes obtained. The inter-ethnic riots which took place in Kuala Lumpur immediately after the elections resulted in the suspension of parliamentary democracy, giving an opportunity for the new leader in UMNO to work out a solution to the inter-ethnic conflict.
7. Interview with Tengku Razaleigh in Suara PERNAS Vol. 1, No. 3.
8. There have been several cases of mismanagement of funds in public enterprises and government-controlled banks involving billions of dollars.
10. Batek is a process for transferring designs on to cloth. Most of the information for this section was obtained from newspaper clippings and interviews with former MARA officers.
11. This section relies heavily on information given in Doner 1988.
13. Official figures on ownership of share capital of limited companies classified as ‘Bumiputera’ shares held through institutions classified as ‘trust agencies’ such as PNB, PERNAS, MARA, and the State Economic Corporations. In addition, it includes ‘the amount of equity owned by Government through other agencies and companies which have been identified under the Transfer Scheme of Government Equity to Bumiputera’ (Fifth Malaysia Plan, 1986–90, 107).

References
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Chapter eight

Public enterprises in francophone Africa

Alfred H. Saulniers

Most experts would rank the financial performance of francophone Africa’s public enterprises below that of either multinationals or private local firms. This chapter suggests that public enterprises may have improved during the mid-1980s, leading to a changed ranking. Before doing so, it examines their origins and importance. Later, it looks at two reform issues which set them apart from anglophone Africa’s public firms: privatization and contract plans.

Origins

The public enterprise portfolios of francophone Africa owe their origins to a colonial heritage. The pre-Second World War efforts to exert control over natural resources and other key sectors of the colonies’ economies provided the core around which they later grew. Thus, mining, transportation, and exporting often formed the early public portfolio. For example, Morocco’s phosphate processor, Office Chérifien des Phosphates (OCP), currently and for many years the country’s largest firm, was founded in 1920 as a public enterprise (El Midaoui 1981:23–4).

After the war, Africa’s portfolio growth lagged behind Europe’s. In particular, France’s retributory nationalizations, which boosted the number of public firms after 1945, had at that time no African counterparts. There, colonial governments created agricultural marketing boards, industrial ventures, and a wide range of support firms in the service sector.

Retribution came after independence when, in an effort to africanize the economy, new governments took over firms, or placed them under heavy controls. Often sectors that were held mostly by ‘foreign elites’ from the ex-colonial power, or by those who had collaborated with it, including locally born Asians and Levantines, were subject to africanization.

Later, new firms were added to the enlarged portfolios to provide essential services, and to aid in the post-independence thrust to industrialize. In the absence of a national private sector capable and willing
to provide the levels of capital, risk-taking, or technical expertise deemed necessary by government authorities to achieve the hoped-for industrialization, post-independence African governments invested heavily in large, capital-intensive industries, including steel, fertilizers, basic chemicals, and petrochemicals.

Portfolios also grew as existing public enterprises created subsidiaries, often to escape government controls over their operations, or as publicly owned investment banks took minority shares in private ventures. ‘Rolling privatization’ in selling those shares, once the companies had shown the capacity to survive, and reinvesting the proceeds in new ventures lagged behind expectations, resulting in even more growth.

Today’s portfolios consist of the remnants of the historical process. From an economic standpoint, some public enterprises were created for rational motives. Others became public accidentally—as subsidiaries of firms swept into the portfolio in broad sectoral nationalizations. The firms are heterogeneous in size and composition, and widely distributed through many sectors of the economy. Portfolios are far from optimal and consequently require major efforts at rationalization.

**Importance**

Francophone Africa’s 2,000 or more public enterprises account for an average of 16 per cent of national GDP and 34 per cent of gross fixed capital formation, slightly more than in anglophone Africa, where the figures are 13.4 per cent and 24.6 per cent respectively. In 1987, the top 100 public enterprises, ranked by employment, had a labour force of 225,000 (‘Les Leaders’ 1988). For the few countries with information available for 1987, their share in domestic credit is low, approximately 3 per cent, well below the anglophone African average of 17 per cent. No comprehensive data are available on their share in international borrowing.

**Rankings**

Public enterprises occupy positions in francophone Africa’s industrial rankings. Of the twenty-one francophone countries listed in a recent survey, wholly-owned public enterprises rank first in sales in six and majority-owned ones rank first in another eight. Only in one country, the Côte d’Ivoire, does the government not have at least a minority share in the top-ranked firm.

Apart from the top position, non-financial public enterprises are scattered throughout rankings by sales, assets, profits, losses, or employment, which prompts several observations. First, with one exception, there is no type-clustering. Most notably, multinationals
are not all profit-earners, nor are public enterprises the only losers. While for individual countries, public enterprises may ‘dominate the economies’ (Nellis 1986:4), for francophone Africa as a whole the case is not so clear, since public enterprises only make up about half of every ranking.

Second, public firms are slightly more asset-heavy, measured in part by their net worth, an expected finding due to government investment in infrastructure and primary industry. The conclusion is heavily qualified, however, because financial data may not accurately reflect asset values: countries with high inflation rates may not provide for mandatory periodic revision of the book value of assets; governments may have forced firms to rely on the capital market by refusing to provide funds at the time of creation; or previous losses may have eroded a firm’s net worth.

Third, the one exception to the unclustered data is employment, where public firms are the top employers. Two mining firms each have more than 30,000 employees: Morocco’s OCP and Zaïre’s Générale des Carrières et Mines (GECAMINES). Moreover, at the top ranks public enterprises outnumber all others combined. But if public firms are capital intensive, this does not necessarily mean that they are not a major source of employment (Nellis 1986:8). Indeed, the data provide tentative support for the hypothesis that they are prone to overstaffing (Shirley 1983:19).

Fourth, wholly- or nearly wholly-owned public enterprises are francophone Africa’s biggest losers. A Congolese sugar mill, a Côte d’Ivoire electric company, and the Gabonese railway lead the list. According to the 1988 rankings, they each lost more than $US 30 million.

Fifth, and contrary to the previous conclusion, public enterprises are also the biggest money-makers. Six of the seven most profitable firms are wholly or majority government-owned, while the seventh has a 49 per cent government share. Each had profits exceeding $US 25 million. One factor may explain their dominance of the profit ranking: five of the seven are natural-resource-linked to bauxite mining, petroleum, or petrochemicals, and they may have benefited from rising terms of trade since 1985.

For financial firms, however, definite clusters appear in the rankings. First, public banks have the most assets, accounting for nine of the top ten and fourteen of the top twenty-five positions. However, six of the top ten are Algerian, and represent a phenomenon more closely linked to Algeria’s industrial organization than to the state of public enterprises in Africa. Second, public banks, including six in Algeria, have high profit levels, holding the top ten positions. Third, a different cluster appears for the rate-of-return data; multinationals occupy eight of the top ten and thirteen of the top twenty-five positions. Their apparent lead disappears.
when looking at more than the top fifty, where public enterprises outnumber them.

**Financial indicators**

The financial performance of public enterprises in francophone Africa appears to have improved during the mid-1980s.\(^9\) The data in Table 8.1 indicate that, in 1987, profit ratios of large public or large private local firms averaged above 16 per cent, although they were, undoubtedly, operating in different markets and trying to meet different goals.\(^10\) In marked contrast, the multinational firms’ ratio was less than 8 per cent.\(^11\) The ratio of profits to sales was also highest for public firms (6.3 per cent) and lowest for the multinationals (0.1 per cent). The startling figures are supported by other indicators; there were fewer large public enterprises with losses (both in absolute and in relative terms) than similar multinationals, and there were fewer public enterprises with negative net worth: five compared to seven multinationals.\(^12\)

The opposite ranking for 1982 supports the conventional wisdom, when both multinationals and private local firms did substantially better than the public enterprises’ dismal average of 4.6 per cent of net worth and less than 1 per cent of sales. Also, more public enterprises showed losses than did either private national firms or multinationals.

The comparison of financial data between 1982 and 1987 indicates an initial, tentative hypothesis that the institution of reform measures may have had beneficial effects on portfolio performance. The hypothesis bears further attention, since Wilson indicates that about 80 per cent of the World Bank’s work on public enterprise reform in West Africa is done in francophone countries (Wilson 1988b:196, n. 8).

Public financial firms also did well in 1987, as also shown in Table 8.1, with profit ratios above 18 per cent, better than both private national firms and multinationals.\(^13\) However, their rate of return to assets, 1.2 per cent, lagged behind. Joint ventures outperformed all other categories of financial firms.

**Transfers to government**

Francophone Africa’s public enterprises consistently transfer funds to government budgets. Table 8.2 shows the revenue from public enterprises as a percentage of central government consolidated current revenue from 1977 to 1984. The figures show that, on average, in francophone nations they account for a greater and improving share of government revenue than they do in anglophone ones: 6 and 4.7 per cent respectively.\(^14\)
Alfred H. Saulniers

Table 8.1 Financial indicators for francophone Africa, 1982 and 1987

<table>
<thead>
<tr>
<th></th>
<th>Rate of return (%) to net worth (n)</th>
<th>n with negative losses</th>
<th>sales (n)</th>
<th>net worth (n)</th>
</tr>
</thead>
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<tr>
<td></td>
<td>n</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1. Non financial firms</td>
<td>1987</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>GT 50% Public</td>
<td>136</td>
<td>16.4 (111)</td>
<td>6.3 (133)</td>
<td>29</td>
</tr>
<tr>
<td>GT 50% Private national</td>
<td>174</td>
<td>16.8 (163)</td>
<td>4.8 (172)</td>
<td>11</td>
</tr>
<tr>
<td>GT 50% MNC</td>
<td>138</td>
<td>7.7 (120)</td>
<td>0.1 (138)</td>
<td>36</td>
</tr>
<tr>
<td>JV (50% Public-50% MNC)</td>
<td>15</td>
<td>4.8 (13)</td>
<td>–0.9 (15)</td>
<td>4</td>
</tr>
<tr>
<td>JV (50% Private-50% MNC)</td>
<td>20</td>
<td>18.1 (19)</td>
<td>4.2 (20)</td>
<td>3</td>
</tr>
<tr>
<td>JV (50% Public-50% Priv.)</td>
<td>0</td>
<td>+</td>
<td>+</td>
<td>+</td>
</tr>
<tr>
<td>No majority ownership</td>
<td>49</td>
<td>15.9 (42)</td>
<td>4.2 (48)</td>
<td>7</td>
</tr>
<tr>
<td></td>
<td>1982</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>GT 50% Public</td>
<td>112</td>
<td>4.6 (106)</td>
<td>0.9 (109)</td>
<td>29</td>
</tr>
<tr>
<td>GT 50% Private national</td>
<td>125</td>
<td>12.9 (121)</td>
<td>3.1 (124)</td>
<td>15</td>
</tr>
<tr>
<td>GT 50% MNC</td>
<td>127</td>
<td>15.5 (117)</td>
<td>1.9 (127)</td>
<td>23</td>
</tr>
<tr>
<td>JV (50% Public-50% MNC)</td>
<td>8</td>
<td>14.4 (7)</td>
<td>6.9 (8)</td>
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</tr>
<tr>
<td>JV (50% Private-50% MNC)</td>
<td>22</td>
<td>12.4 (22)</td>
<td>1.2 (22)</td>
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<tr>
<td>JV (50% Public-50% Priv.)</td>
<td>2</td>
<td>19.4 (2)</td>
<td>3.7 (2)</td>
<td>0</td>
</tr>
<tr>
<td>No majority ownership</td>
<td>11</td>
<td>9.7 (11)</td>
<td>3.6 (11)</td>
<td>1</td>
</tr>
<tr>
<td>2. Financial firms</td>
<td>1987</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>GT 50% Public</td>
<td>52</td>
<td>18.3 (49)</td>
<td>1.2* (50)</td>
<td>5</td>
</tr>
<tr>
<td>GT 50% Private national</td>
<td>19</td>
<td>13.7 (19)</td>
<td>1.6* (19)</td>
<td>1</td>
</tr>
<tr>
<td>GT 50% MNC</td>
<td>48</td>
<td>17.0 (41)</td>
<td>2.1* (44)</td>
<td>3</td>
</tr>
<tr>
<td>JV (50% Public-50% MNC)</td>
<td>6</td>
<td>11.4 (6)</td>
<td>3.8* (6)</td>
<td>0</td>
</tr>
<tr>
<td>JV (50% Private-50% MNC)</td>
<td>7</td>
<td>32.1 (7)</td>
<td>1.2* (2)</td>
<td>0</td>
</tr>
<tr>
<td>JV (50% Public-50% Priv.)</td>
<td>0</td>
<td>+</td>
<td>+</td>
<td>+</td>
</tr>
<tr>
<td>No majority ownership</td>
<td>15</td>
<td>15.1 (15)</td>
<td>0.9* (15)</td>
<td>0</td>
</tr>
</tbody>
</table>

Sources: Data from ‘Entreprises’ 1983; ‘262 leaders’ 1988; ‘Les leaders’ 1988
Notes: + not applicable; rate of return to assets; GT greater than; JV joint venture.
Table 8.2 Revenue from francophone African public enterprises as a percentage of current revenue of consolidated central government, 1977–84

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Benin</td>
<td>4.1</td>
<td>3.9</td>
<td>7.1</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
</tr>
<tr>
<td>Burkina Faso</td>
<td>7.5</td>
<td>7.4</td>
<td>8.7</td>
<td>3.5</td>
<td>7.5</td>
<td>5.5</td>
<td>4.6</td>
<td>–</td>
</tr>
<tr>
<td>Burundi</td>
<td>0.6</td>
<td>6.6</td>
<td>0.0</td>
<td>3.8</td>
<td>7.6</td>
<td>–</td>
<td>–</td>
<td>–</td>
</tr>
<tr>
<td>Cameroon</td>
<td>0.0</td>
<td>1.7</td>
<td>0.0</td>
<td>1.1</td>
<td>1.2</td>
<td>0.0</td>
<td>0.3</td>
<td>0.9</td>
</tr>
<tr>
<td>Central African Rep.</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>0.6</td>
<td>–</td>
<td>–</td>
<td>–</td>
</tr>
<tr>
<td>Congo</td>
<td>–</td>
<td>–</td>
<td>0.1</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
</tr>
<tr>
<td>Côte d’Ivoire</td>
<td>–</td>
<td>–</td>
<td>0.1</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
</tr>
<tr>
<td>Guinea</td>
<td>29.7</td>
<td>2.4</td>
<td>21.4</td>
<td>–</td>
<td>–</td>
<td>27.5</td>
<td>25.1</td>
<td>–</td>
</tr>
<tr>
<td>Madagascar</td>
<td>–</td>
<td>4.0</td>
<td>5.6</td>
<td>7.0</td>
<td>10.3</td>
<td>6.8</td>
<td>–</td>
<td>–</td>
</tr>
<tr>
<td>Mali</td>
<td>0.3</td>
<td>0.5</td>
<td>0.4</td>
<td>0.0</td>
<td>0.0</td>
<td>1.1</td>
<td>1.6</td>
<td>–</td>
</tr>
<tr>
<td>Mauritania</td>
<td>1.0</td>
<td>2.1</td>
<td>2.9</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
</tr>
<tr>
<td>Morocco</td>
<td>6.6</td>
<td>5.5</td>
<td>4.8</td>
<td>4.9</td>
<td>8.4</td>
<td>7.6</td>
<td>7.9</td>
<td>6.8</td>
</tr>
<tr>
<td>Niger</td>
<td>1.7</td>
<td>2.2</td>
<td>0.7</td>
<td>1.7</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
</tr>
<tr>
<td>Rwanda</td>
<td>0.4</td>
<td>0.7</td>
<td>1.7</td>
<td>2.5</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
</tr>
<tr>
<td>Senegal</td>
<td>0.3</td>
<td>0.3</td>
<td>0.5</td>
<td>0.3</td>
<td>0.7</td>
<td>0.2</td>
<td>0.2</td>
<td>–</td>
</tr>
<tr>
<td>Togo</td>
<td>1.4</td>
<td>1.2</td>
<td>17.2</td>
<td>10.2</td>
<td>6.0</td>
<td>6.5</td>
<td>6.7</td>
<td>9.9</td>
</tr>
<tr>
<td>Tunisia</td>
<td>17.4</td>
<td>16.3</td>
<td>21.9</td>
<td>22.2</td>
<td>24.7</td>
<td>24.1</td>
<td>19.1</td>
<td>23.3</td>
</tr>
<tr>
<td>Zaire</td>
<td>0.1</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>Francophone average</td>
<td>5.1</td>
<td>3.7</td>
<td>6.2</td>
<td>4.1</td>
<td>6.1</td>
<td>8.1</td>
<td>7.4</td>
<td>7.6</td>
</tr>
<tr>
<td>less Guinea and Tunisia</td>
<td>2.0</td>
<td>2.8</td>
<td>3.8</td>
<td>2.7</td>
<td>4.2</td>
<td>3.0</td>
<td>3.1</td>
<td>4.4</td>
</tr>
<tr>
<td>Anglophone average</td>
<td>5.4</td>
<td>5.6</td>
<td>4.7</td>
<td>4.2</td>
<td>4.2</td>
<td>2.8</td>
<td>5.5</td>
<td>5.3</td>
</tr>
<tr>
<td>less Somalia and Sudan</td>
<td>3.3</td>
<td>4.1</td>
<td>3.5</td>
<td>3.5</td>
<td>3.9</td>
<td>2.8</td>
<td>5.5</td>
<td>4.9</td>
</tr>
</tbody>
</table>

Source: International Monetary Fund 1986a
Notes: aRevenue defined as the sum of net profits or interest transferred from nonfinancial public enterprises and public financial institutions, cash operating surpluses of departmental enterprise sales to the public with a surplus, profits of fiscal monopolies, profits of entities engaged in the monopoly purchase and sale of foreign exchange at different rates, and the profit of export or import monopolies (International Monetary Fund 1986b:127–8)
bBotswana, Ethiopia, The Gambia, Ghana, Kenya, Lesotho, Liberia, Malawi, Mauritius, Nigeria, Sierra Leone, Somalia, South Africa, Sudan, Swaziland, Tanzania, Uganda, Zambia, and Zimbabwe
As a percentage of current revenue of budgetary central government.
A thorough study of Zaïre showed that public enterprises transferred ten times as much to the government as they received from it (Gray 1985). From 1981 to 1983, they transferred a net of 4.1 per cent of GDP. The estimate is low since, while the study considered tax arrears as transfers from government, except for a few isolated cases, it neither estimated government arrears in paying for goods and services or losses arising from below-market price sales to government, nor did it track down all taxes paid.

Published IMF accounts provide inadequate detail to permit the calculation of gross or net transfers to public enterprises. In particular, they do not always distinguish subsidies paid to public enterprises from those paid to private ones, or from transfers to other levels of national government, to nonprofit institutions, to households and transfers abroad. Moreover, even if published in detail, the IMF definitional anomaly that does not separate government transfers to publicly owned financial firms from transfers to private ones would mask the net flows.

Even if correctly defined and published, the true picture still would not be revealed, because many countries force hidden profits transfers from non-financial firms to financial ones or to the government (Saulniers 1988b:167). In Morocco, for example, firms with the legal status of ‘public establishments’ have to deposit their available funds in special accounts in the national treasury. The treasury pays a paltry 1 per cent interest on funds, compared to an average of 10 per cent paid by the commercial banks. The difference constitutes a hidden profits transfer to government.

The IMF-reported figures cover only part of public enterprise transfers to governments. For instance, they do not include taxes they pay on their own income, imports, exports, sales, or other operations. Taxes paid by public enterprises are combined with those paid by the private sector under the appropriate tax revenue category. The legal basis for taxation is important where public enterprise prices may act as taxes; tobacco monopolies illustrate the point. Government revenues from tobacco taken as profits of a fiscal monopoly figure separately in the IMF classification as, for example, in Burkina Faso; but excise taxes collected by a tobacco monopoly, as in Morocco, show up as revenue with no public enterprise link.

Another unreported transfer consists of the increase in arrears when government delays payment for the purchase of goods and services. Since accounts receivable are rarely disaggregated by type of debtor, data on arrears are difficult to obtain. One indication of arrears’ importance was that in Senegal they were the major cause of non-compliance with several contract plans (Nellis 1988:34). An increase in tax arrears constitutes the analogous current account transfer to public enterprises. Capital account arrears arise when governments fail to deliver budgeted capital grants.
Country experiences

Data problems plague the issue of trying to determine the nature and magnitude of transfers between public enterprises and governments. Only a generalized acceptance of the need for greater transparency in accounting—and its implementation—can enable the analyst to shed more light on the question.

Privatizations

Privatization has sparked intense debate in Africa. The arguments touch on the issues of microeconomic efficiency, macroeconomic stabilization through reduced government subsidies, economic nationalism, the role of multilateral or bilateral aid agencies, employment policy, and shifts in

Table 8.3 Francophone African privatizations by type

<table>
<thead>
<tr>
<th>Portfolio size</th>
<th>Privatizations carried out</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Sale of equity or assets</td>
</tr>
<tr>
<td>Benin</td>
<td>59</td>
</tr>
<tr>
<td>Cameroon</td>
<td>67</td>
</tr>
<tr>
<td>Central African Rep.</td>
<td>20</td>
</tr>
<tr>
<td>Côte d’Ivoire</td>
<td>63</td>
</tr>
<tr>
<td>Gabon</td>
<td>40</td>
</tr>
<tr>
<td>Guinea</td>
<td>193</td>
</tr>
<tr>
<td>Mali</td>
<td>35</td>
</tr>
<tr>
<td>Mauritania</td>
<td>41</td>
</tr>
<tr>
<td>Morocco</td>
<td>84</td>
</tr>
<tr>
<td>Niger</td>
<td>33</td>
</tr>
<tr>
<td>Rwanda</td>
<td>37</td>
</tr>
<tr>
<td>Senegal</td>
<td>57</td>
</tr>
<tr>
<td>Togo</td>
<td>56</td>
</tr>
<tr>
<td>Tunisia</td>
<td>123</td>
</tr>
<tr>
<td>Zaire</td>
<td>45</td>
</tr>
<tr>
<td><strong>Francophone Africa Total</strong></td>
<td><strong>894</strong></td>
</tr>
<tr>
<td><strong>Anglophone Africa Total</strong></td>
<td><strong>829</strong></td>
</tr>
</tbody>
</table>


Note: *The Gambia, Kenya, Liberia, Malawi, Nigeria, Sierra Leone, Somalia, Sudan, Uganda, and Zambia.*
domestic economic or ethnic power bases (Wilson 1988a). However, apart from the debate and irrespective of ideology, experiments with privatization clearly set the francophone nations apart. Table 8.3 shows that with similar portfolio sizes, they have sold assets or equity in eight times as many firms, placed management contracts in twice as many, and liquidated four-and-a-half times as many as have anglophone nations. Placing Table 8.3’s figures on a per-country basis, francophone nations averaged nine equity or asset sales, three management contracts or leases, and ten liquidations or closures each; anglophone countries averaged two per category.

Most privatizations have occurred through sales of equity and assets. Three countries led the category: Guinea, Niger, and Côte d’Ivoire. Typically, small- or medium-sized firms in manufacturing or services have been sold. A less common technique was to close down a firm or, in a limited number of instances, to liquidate it (Nellis 1986:45–6). Closure avoids the thorny political problems that can materialize around price or purchaser when a firm is sold, by keeping open the option that the firm could reopen. Liquidation closes even that option. Senegal led the list with twenty-five closures or liquidations, followed by sixteen in Guinea, fifteen in Côte d’Ivoire, and eleven in Zaïre. Leasing or management contracts form the third major category. Togo’s eleven firms accounted for a fourth of those reported. Leasing has been most common for service firms.

Leasing, closure, and liquidation avoid recourse to Africa’s thin or missing domestic capital markets, as do private sales to local or foreign investors. Another way of avoiding the capital market constraint is abolishing government-granted monopolies and opening the possibility of competition. This constitutes a non-divestiture privatization that has been subject to little systematic analysis. Indeed, many writers call it something else: change in ‘the regulatory environment’ (Berg 1987: 30); ‘economic policy reforms such as demonopolizing certain activities’ (Vuylstekte 1988:8); or the ‘reassignment of property rights from the public to the private sector’ (Berg and Shirley 1987:2). Others, however, refer to it as ‘partial’ privatization, because, while it transfers operating rights, it has the advantage of a low political profile (Glade 1986:13). In contrast to divestiture, it does not involve the asset transfers that may lead to questions about buyers and prices.

Morocco has tried partial privatization. Monopolies were lifted for municipal bus services in Rabat and Casablanca and private firms received franchises, resulting in the rapid alleviation of urban transport bottlenecks, and giving passengers more transport options with less waiting time. Morocco’s most striking use of this policy was in demonopolizing the large export service firm, OCE, ranked third nationally in sales in 1982. Within a few months after demonopolization in 1984, producers, co-
Country experiences

operatives, and new private firms made up of former OCE staff had captured most of OCE’s business—at a lower cost to exporters. Now, OCE maintains a paper existence, kept alive by its holdings in agro-processing subsidiaries. Its withering away attracted negative political attention, with questions raised in parliament and editorials in the opposition newspapers. Nevertheless, the decision appears irreversible.

Many francophone African countries have prepared privatization programmes, some with external assistance, as part of broader public enterprise reforms.20 With World Bank funding, Morocco has drawn up an ambitious privatization plan that, according to a draft law submitted to parliament, makes all but six of the more than 680 state holdings ‘privatizable,’ with the exceptions made largely for perceived national

Table 8.4 African contract plans by country

<table>
<thead>
<tr>
<th></th>
<th>Number</th>
<th>Required by IBRD* or in progress</th>
<th>Number completed</th>
<th>Of which required by IBRD</th>
</tr>
</thead>
<tbody>
<tr>
<td>Benin</td>
<td>7</td>
<td>5</td>
<td>2</td>
<td>1</td>
</tr>
<tr>
<td>Burundi</td>
<td>5</td>
<td>5</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Congo</td>
<td>18</td>
<td>8</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Côte d’Ivoire</td>
<td>5</td>
<td>4</td>
<td>3</td>
<td>3</td>
</tr>
<tr>
<td>Gabon</td>
<td>1</td>
<td>0</td>
<td>1</td>
<td>0</td>
</tr>
<tr>
<td>Gambia</td>
<td>6</td>
<td>3</td>
<td>6</td>
<td>6</td>
</tr>
<tr>
<td>Guinea</td>
<td>1</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Kenya</td>
<td>1</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Madagascar</td>
<td>1</td>
<td>1</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Mali</td>
<td>1</td>
<td>1</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Morocco</td>
<td>10</td>
<td>6</td>
<td>2</td>
<td>0</td>
</tr>
<tr>
<td>Niger</td>
<td>2</td>
<td>1</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>Senegal</td>
<td>30</td>
<td>0</td>
<td>22</td>
<td>*</td>
</tr>
<tr>
<td>Togo</td>
<td>2</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Tunisia</td>
<td>6</td>
<td>3</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Total</td>
<td>96</td>
<td>37</td>
<td>37</td>
<td>11*</td>
</tr>
</tbody>
</table>

Sources: Shahrokh 1987:15, 20, 28–45
Note: *Requirement status of twenty-nine contracts unavailable, twenty-two of them in Senegal. No IBRD requirement among the first ten Senegalese contracts completed.
security interests.\textsuperscript{21} While the version that emerges from parliament may be more lax in restructuring the portfolio, the Moroccan administration has opened a dialogue on the need for a drastic overhaul.

\section*{Contract plans}

The contract plan consists of a signed statement of the mutual rights and obligations of government and the public enterprise that are agreed for a fixed term, usually for three to five years. Usually it results from a long negotiation process between both parties to define or clarify company goals, clearly demarcating strictly entrepreneurial or managerial goals from the political. It often sets performance criteria to be monitored against the strictly commercial goals, while stating that politically inspired deviations from them are subject to reimbursement. It spells out government commitments which may have an impact on management, notably those concerning the institutional environment in which the firm operates, government-allowed price or tariff schedules, and resources for the firm, including payment of government arrears.

The use of contract plans sets francophone Africa apart. A census of ninety-six African contract plans from 1973 to 1988 found only seven in anglophone nations (Shahrokh 1987:15). Of the ninety-six, forty-four were in the drafting or planning stages, while fourteen had been completed, ten of them in francophone countries. Table 8.4 lists the plans: Senegal leads with thirty, followed by the Congo’s eighteen, and Morocco’s ten.

One reason francophone African countries use contract plans may be the plans’ country of origin: France. The Nora Report of 1967 suggested using contract plans to increase autonomy and responsibility for French firms and to provide ‘mastery of their own decisions’.\textsuperscript{22} In Senegal, that link to Africa is clear, since French government advisers helped set up the process (Shirley 1983:80). Another reason has been conditionally of some World Bank loans; of the thirty-seven IBRD-required contract plans, thirty-three were in francophone countries.

Plans have been used in many sectors, most notably in public utilities, water, electricity, communications, and transportation. They have helped improve strategic planning at the company level. In Senegal, companies have been forced to identify the sources of their operating deficits and to define their medium-term operating and investment goals and to calculate the cost of loss-making, government-imposed services (Shirley 1983:80–7). In Morocco’s recently negotiated electric utility plan, the principle of government payment for its imposed loss-making services was accepted (Royaume du Maroc 1988: art. 5, para. 5).
Country experiences

Some problems have marred the contract plan experience. Plans have proved unable to resolve complex company problems since the negotiation process precludes deep restructuring (Côte d’Ivoire). Governments have also overcommitted resources that they were later unable to provide (Morocco, Senegal). These problems point out the need for high-level political commitment to the process and for good-faith negotiations on attainable issues.

Exogenous factors have overtaken some plans. In the Côte d’Ivoire, a bus company plan was abandoned as increased competition forced efficiency to exceed performance targets. In Senegal, government arrears were responsible for failures to meet targets, as world prices for primary products exceeded the assumptions which underlay the financial commitments. These problems provide the lesson that although plans cannot account for all the uncertainty in a firm’s operating environment, periodic contract revisions or rolling contracts may incorporate changes in underlying assumptions.

Performance monitoring has often fallen short of expectations, as in the Congo’s complex contracts exceeding fifty pages that did not clearly define responsibilities, complicating efforts to link incentives or sanctions to results. Short, simple plans are easier to monitor.

In general, the francophone African experience shows that contract plans provide a useful counterpoint to the often heavy-handed government interference in public enterprises. Although their implementation still poses some problems, they help to clarify goals and may lead to increased autonomy and greater efficiency in the use of a nation’s scarce resources.

Conclusions

Francophone Africa’s public enterprises dominate neither the commanding heights of the economy nor the list of losers. Instead, for the set of countries, they share rankings with private local forms and multinationals.

The analysis of company-level financial indicators shows that public enterprises in francophone Africa have apparently improved in the mid-1980s, when compared with private national firms or multinationals. The findings are tentative, however, and merit further exploration. One hypothesis which deserves study concerns the possible link between the apparent company-level improvement and structural adjustment-induced changes in the public enterprises’ policy environments.

The link is corroborated by the finding that francophone African countries have tried more reforms through privatization or contract plans than have anglophone ones. While problems remain with both elements, the prognosis for continued improvement through reform is favourable.
Notes

1. I am indebted to Jamal Echiguer, Clive Gray, and Richard Mallon for comments on an early draft, but take responsibility for any remaining errors.
2. Similar motives impelled the colonial powers in Latin America over a century and a half earlier (Saulniers 1985).
3. Belgium conceded much of natural resource development to the private sector.
4. Table 8.3’s total, plus 343 firms from Burkina Faso, Burundi, Chad, Congo, Djibouti, and Madagascar (International Monetary Fund 1988); fifteen from Comoros; twenty-two local government firms from Gabon (International Monetary Fund 1986a); 128 more majority-owned firms from Morocco (Ouassini 1988:171); 500 from Algeria (Les 500 1987); fifty from rankings (‘Les leaders’ 1988 and ‘269 leaders’ 1988).
5. Based on Short 1984:116–22. The latest data are used to calculate the nonweighted average. Francophone countries are: Algeria, Benin, Côte d’Ivoire, Guinea, Mali, Mauritania, Senegal, Togo, and Tunisia. Anglophone countries are: Botswana, Ethiopia, Gambia, Kenya, Liberia, Malawi, Mauritius, Sierra Leone, Tanzania, and Zambia. See also Nellis 1986:9.
6. International Financial Statistics 52, 1 (January 1989) provides data for four francophone countries: Burundi, Djibouti, Rwanda, and Zaire, and fourteen anglophone ones. The selection suggests that the extremely low figures may result from inherited national accounts systems, since three of the four had been under Belgian control. Data are unavailable for most French ex-colonies. The anglophone average may be higher by including ‘other official entities’, however, state and local governments rarely account for more than a negligible share of national credit, so the figures primarily refer to public enterprises.
7. ‘Les leaders’ 1988:65–100. Data are compiled for an annual survey of large African firms, but provide better coverage of francophone countries, except for Algeria, than of anglophone ones. A questionnaire is sent to preselected large firms and information received by press deadline is published. Ownership is missing for the top Burundian firm. For information on Algerian public enterprises, see Les 500 1987.
8. ‘269 leaders’ 1988. A methodology similar to that described in note 6 is employed. Coverage of anglophone countries is more complete for financial firms than for non-financial ones.
9. Comparative analysis of financial data requires special care. Intercountry differences in accounting systems plus variations in taxation, depreciation, revaluation, and inflation may distort the meaning of standard financial indicators. Further, the caveat that profits may not be a good estimator of public enterprise performance bears repeating, since monopoly public enterprises may have used their economic power to keep prices up while governments may have used their monopoly over coercive power to keep them down.
10. In Table 8.1, profit ratios are reported for fewer firms than the leftmost total. The average ratios do not include (a) firms where either the numerator or the denominator was missing; (b) outliers, fixed arbitrarily as firms with rates exceeding ± 100 per cent; and (c) firms with negative net worth (return to net worth only).
11. Multinationals may have adopted strategies to lower profits and taxes in Africa; for a review see Susungi 1988:17–19.
12. The negative net worth figures fall far short of the 36 per cent of firms reported for West Africa (Nellis 1986:17; Nellis and Kiteri 1988:8). However, careful study of the original source on which their claim is based shows that (a)
Madagascar, Sudan, and Tanzania are included as West African nations; and
(b) only thirty-four firms are reported with negative net worth, or 9 per cent
of the 371 firms analysed (Bovet 1985: Exhibit 2).

13 Less than strict application of banking regulations may be responsible for
some of the high profit ratios.

14 For the revenue categories considered in the determination of transfers to the
government, see the notes to Table 8.3. The figures reported there may not be
strictly comparable to those reported by Short, who apparently omitted four
categories: cash operating surpluses of departmental enterprise sales to the
public with a surplus, profits of fiscal monopolies, profits of entities engaged
in the monopoly purchase and sale of foreign exchange at different rates, and
the profit of export or import monopolies (Short 1984:174, n. 1).

15 A thorough accounting treatment of the monetary flows between government
and public enterprises may be found in International Monetary Fund
1986b:274–319. For an excellent economic analysis of those flows, see Gray

16 Dahir No. 1–63–012 of 12 Ramadham 1382 [6 February 1963] and Arrêté du
Ministre de Finances no. 641–66 [16 February 1967], reprinted in Alaoui

17 Some authors hold that, because of exemptions or low rates, public enterprises
pay minimal taxes (Short 1984:166). The issue requires more empirical work.
In Morocco, most public firms exempt from income taxes are in agriculture,
where a sector-wide policy prevails (Royama du Maroc 1980:89).

18 Development during the past thirty years of a local private sector capable of
investing in industry may favour privatization (Saulniers 1988a).

19 ‘500 Leaders’ 1983:83. The Office de Commercialisation et d’Exportation
had monopolies on exports and marketing abroad of citrus fruits, fresh fruit
and vegetables, preserves, canned meat and fish, wines, fruit juices, and cotton

20 For a review of World Bank assistance for privatization, see Nellis and Kikeri

21 ‘Projet’ 1988. Under the draft law, the only firms not ‘privatizable’ are the
large water and electric utilities, the telephone company, the railway, the
phosphate mine, and the national airline.

22 There is an extensive French-language literature on French contract-plans;
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Alfred H. Saulniers


Country experiences


We trained hard, but it seemed that every time we were beginning to form into teams, we would be reorganized. I was to learn later in life that we tend to meet any new situation by reorganizing, and a wonderful method it can be for creating the illusion of progress while producing confusion, inefficiency, and demoralization.

Gaius Petronius, AD 66

This chapter presents some relevant features of the Argentinian public enterprise scenario, and provides an overview of the changes that took place during the Radical Party’s administration 1983–9. The subjects discussed are first, organizational structure; second, public enterprise financing; and third, privatization policies. Although the attempts to change have been largely unsuccessful, they offer some suggestions that might have validity in other situations. These will be reviewed summarily in the final section.

**Organizational reshuffling**

*The initial situation*

In the early 1980s public enterprises in Argentina were ascribed to sector secretariats, which were themselves grouped under ministries. Thus most secretariats responsible for public utilities came under the Ministry of Public Works, and most industrial enterprises under the Ministry of Defence.¹

But this hierarchical dependence did not imply a concentration of power in either the secretariats or the ministries. They could define goals for the enterprises but, lacking adequate control mechanisms, as well as incentives and/or sanctions related to goal fulfilment, such power was a mere formality. In theory at least, they could appoint and dismiss top management, but in practice this has been traditionally a presidential decision, at least in the case of the larger enterprises. Effective power was
concentrated in two different types of organizations. First, it was in those which controlled financial variables, like prices, indebtedness, investment financing, or which defined the amount of subsidies. Second, it was in those units which specified, interpreted, or oversaw the rules or regulations to which the enterprises were subjected, conditioning decisions ranging from salaries to the purchase of office equipment.

The enforcement power of these central government organizations (hereinafter CGOs) was limited by understaffing and by the dearth of technical and organizational information that the selection of alternatives required. These transformed their apparent ability to steer and guide public enterprises to a sort of veto power on decisions which were defined at the enterprise level. In short, the situation can be characterized as one of ‘multiple owners with limited influence’.

Initial strategies: minor adjustments to the traditional approach

This was the situation faced by the Radical Party when it assumed power in December 1983. In the first months there were no changes, although the power equation was modified through the personal circumstances of the persons who assumed responsibility for the sector. The first Minister of Public Works was Dr Roque Carranza, a well-known and respected technocrat of the Radical Party. Carranza had the confidence of the President, as well as a long friendship with Dr Grinspun, Minister for the Economy. These circumstances allowed Carranza to place in key positions technicians who had worked with him during the electoral campaign. This permitted informal solutions to the co-ordination problems, through the operation of a network of personal relations and contacts.

The situation was stable while Carranza was Minister. In 1984 he was appointed Minister of Defence, and a period of confusion ensued. He was replaced in Public Works by a member of his team who could not match his leadership. In the meantime, the economy was running out of control, with an inflation rate of 30 per cent per month. In March 1985, Dr Sourrouille was appointed Minister for the Economy. A few weeks later comes the first reorganization in the relationship between public enterprises and the administration. President Alfonsín appointed Norberto Bertaina, who had been Secretary of Finance under Grinspun, as presidential advisor with the rank of Secretary of State. His ill-defined terms of reference alluded to financial supervision of the public enterprise sector. The effective outcome was just the inclusion of a new ‘owner’ in the unclear maze of relationships between enterprises and CGOs.
In the meantime, President Alfonsín contacted a businessman unrelated to the Radical Party, with a background in the rehabilitation of firms in trouble. A new and almost ad hoc secretariat was created: the Secretariat of State for the Promotion of Growth. The policies of the new Secretary were announced loud and clear: growth should come from the private sector; the expansion of public enterprises should be done with private sector involvement; there should be a ‘redefinition’ of the roles of public and private enterprises. He soon clashed with the ruling party, with the Secretaries of State related to public enterprises, and with the enterprises themselves. There were no developments other than some verbal skirmishes which made news for a while, but effected no change in the administrative chaos.

The first significant change: the creation of the Secretariat of Control

During its first year in government, the Radical Party maintained the confusing multiple-owner structure, relying on informal co-ordination networks. By the second year, unwarranted hopes were placed on individual persons, who were given wide responsibilities, but without real power. By the end of 1985, President Alfonsín made a new and more significant move: he created a Secretariat of State for the Control of the Public Enterprises, on the model of the Brazilian SEST. Once again, this was an addition to the complicated network of CGOs supervising public enterprises. All others were maintained without change in functions, but now there was a conscious attempt to confer some real power to the new Secretariat. Once again, there were high expectations in relation to the appointed Secretary, Marcelo Kiguel, a young technocrat close to the Secretary of Finance. The tasks assigned to the new Secretary were ample, and the President publicly announced his support for his appointee, reserving a weekly meeting in which he would be briefed on problems requiring his intervention. The new Secretariat was also provided with technical resources. The SIGEP (Sindicatura General de Empresas Públicas, in charge of audit and control of public enterprises), one of the few public organizations that had managed to keep a certain level of technical capability, was placed under his authority.

From the start, Kiguel had to address some short-run problems. He had to explain to Congress the role of public enterprises in the external debt. He became involved in tough wage negotiations with the unions of the main enterprises. He insisted on obtaining wages for the staff of the new Secretariat that were much higher than those for the rest of central administration. The resentment that
these demands aroused delayed the approval of the new Secretariat’s organizational chart, authorization for appointments, and the release of funds. This was not an excuse for the failures in delivery: the available personnel from SIGEP were not utilized and continued with their traditional duties. Nothing really happened: some drastic measures were announced relating to the excessive price paid by public enterprises for their inputs. There was talk of studies being undertaken towards the formation of a holding company. But no major measures were taken during the year of life of the Secretariat, and even the studies that were publicly announced were not initiated.

The second significant change: the Directorate of Public Enterprises

In July 1986 Kiguel resigned and was named Vice-President of the Central Bank. There was a brief transition during which nothing happened, and the period ended in September 1986 with another significant change: the creation of a Directorate of Public Enterprises (DEP) and an Inter-Ministerial Commission for Public Enterprises, comprising the Ministers of Economy and Public Works and the President of the DEP.

There is clear evidence that this decision was a compromise between two extreme positions. On the one hand, a group wanted to create a holding company with broad powers, such as financial control and the authority to appoint and dismiss top management. On the other hand there was a group interested in maintaining the status quo, reinforcing the power of the Secretary of Control. A holding company was created for all the enterprises which came under the Ministry of Public Works—about three-quarters of the total—but with a number of factors which diminished its leverage. In particular was the imposition of a supervising ministerial commission which retained the crucial power, and the transfer of SIGEP (the audit and control body) to the Presidency’s General Secretariat. And, as happened before (for the same reasons), it suffered long delays in the approval of its organization chart, staff salaries, and budget.

The President of the DEP, Enrique Olivera, managed to handle some of these difficulties. He organized a Board of Counsellors, composed of prominent private industrialists. Each of them was given the task of diagnosing and proposing changes in policies for individual enterprises. Most of the appointed entrepreneurs assumed the challenge, and obtained the human and material resources necessary for the diagnosis from their own private industries. This imaginative approach brought new ideas to the public enterprises,
and gave a clear picture to the private industrialists about their problems. Support personnel were hired by some enterprises and then loaned to the DEP.

The strategy adopted by the DEP took into consideration its limited power. The basic idea was to use ‘programme agreements’ established between the government and individual public enterprises, each lasting more than a year, following the French tradition. Such programme agreements would have been based on the diagnoses and proposals prepared by DEP counsellors, discussed by all interested parties and then approved by the Inter-Ministerial Committee. In the year in which the DEP existed in its initial structure several diagnoses were carried out, and the Programme Agreement with Aerolíneas Argentinas was about to be signed.

**The third significant change: the reorganization of the Directorate**

In September 1987 the Radical Party was seriously defeated in local elections. The Peronist Party won by a large majority, and obtained all but two of the provincial governments. This led to important changes in the central government. Dr Terragno—a newcomer to the government—was appointed Minister of Public Works. Significant changes were introduced in structure and strategy. More than ever before, emphasis was placed on concentration of power. At the structural level, the Interministerial Committee was dissolved, and the DEP was transferred to the jurisdiction of the Ministry of Public Works. Although the performance of the DEP was quite satisfactory, its President was replaced with a personal acquaintance of Terragno who, like him, had lived out of the country for a great number of years. Changes in the legislation contributed to increase the power of the DEP and (indirectly) the Ministry of Public Works. There were also power-concentrating modifications in the financial structure (these will be addressed in the next section).

Although not explicitly, the critical prerogative of appointing and dismissing the top management of public enterprises was transferred to the DEP. The new power could be clearly noticed in Terragno’s clashes with the chief executives of some public enterprises with long political careers. In all cases Terragno obtained the resignations he required. The same happened at secretary of state level. Gradually, the Minister replaced all the heads of the secretariats with people from his own circle.

The idea of programme agreements was dropped, and emphasis was now placed on privatization at any cost. For the first time large enterprises were included in privatization rhetoric. A second key issue was
deregulation, clearly addressed to the elimination of the monopoly markets of some public enterprises. However, there was no explicit coherent policy for this reform. The key points in the policies were evidently the concentration of power within the Board and the Ministry by way of replacing the top managers of the enterprises and reinforcing financial controls. Reform was to follow power concentration. Apparently, some priority was given to the reconstruction of information systems within the enterprises.

The triumph of the Peronist Party in May 1989 and the collapse of the Argentinian economy in the first part of this year played havoc with Terragno’s attempts at reform, and he resigned after the elections. His was the first case in which most of whatever power remaining in the hands of central government was transferred to a single group. The experience was too recent to be adequately evaluated here, but some preliminary comments can be made. There was a basic flaw in the strategy followed by the ‘second’ DEP. As suggested above, central government was essentially reduced to veto power, on account of its limited administrative capability and the unavailability of information. The power to act and to introduce real change remained in the hands of the enterprises and its permanent management. In order to modify this situation, it would be necessary to build up administrative capability and adequate managerial information networks. Then it would be possible to concentrate and to use power, if so required. To proceed in the reverse order is self-defeating, for power tends to erode rapidly, at least as compared with the time required for building administrative capability and information networks. The ‘first’ DEP policy was much more sensible, for the sequence: diagnosis ? proposals ? programme agreements used less power and had a built-in bias for information retrieval.

Financial muddling-through

A heavy inheritance

The inadequacy of financial management in the Argentinian public sector has been and continues to be a crucial problem. First, transfers to public enterprises constitute a large proportion of budget deficits, representing a significant proportion of the GNP. Second, the magnitude of enterprise operations creates side effects on the financial markets.

These considerations at the macro level have been used to justify a detailed network of regulations and constraints on the financial management of public enterprises. Access to most external sources
of funding is controlled by central government units. Issues of shares or bonds are almost non-existent, and the use of bank credits is rather limited (except during 1978–80, as mentioned below). This means that, when funds are not generated internally by the enterprises, most needs are covered by the Treasury or by special funds created to finance certain types of investment. Although comparisons between benefits and costs could and should be made, this is not normally the case. The way the system works is that funds required to cover operating losses are provided *ex post facto*. Funding for investment projects is supposedly subjected to more efficient controls and to a rigorous comparison between benefit and cost. But in most cases central government’s administrative capability is of such low quality that projects only undergo superficial analysis. Last, but not least, we must add that finance secretariats rarely expect normal returns on capital invested in public enterprises, and act as if capital were cost free.

With most sources of funding prohibited or controlled by one or other organization in central government, the main potential alternative left is working capital, a rather costly source of funding. In such conditions, enterprise financial management is reduced to two main activities. The first is the preparation of the kind of short-term cash flows that are generally used when requiring money from the Finance Secretariat. Second, if there is not enough money to cover all financial requirements—which seems usually to be the case—then the job is to decide which payments are to be postponed. As the most likely candidates are other organizations in the public sector, a network of interlocking debts builds up, further complicating the financial situation throughout the system. Even worse, what evolves in this situation is a general lack of understanding of the cost of capital, which is reflected in poor management decisions throughout all enterprises.³

In the recent past, during the military regime that preceded the Radical Party in government, there was an attempt to change the rules of the financial game. Public enterprises were forced to resort to the money market for their financial needs, and they were to pay taxes from which they had been previously exempted. The new rules made it impossible for enterprises to avoid considering the cost of capital in their decisions—and resulted in a substantial reduction in budgetary contributions. Nevertheless, the rules were implemented carelessly and with disregard for individual enterprises. Some were forced to cover indebtedness with structural operating deficits; in others long-run investment was financed through revolving short-term credit. They were used as an instrument of monetary policy: when the private sector was indebted in dollars, public enterprises were forced to take loans in *pesos*. In 1980, with clear evidences of a forthcoming devaluation, the private sector was using *pesos* to pay
its debts in dollars, and public enterprises were forced into dollar indebtedness.

Policies 1983–9

Therefore when the Radical Party took possession of government they found a public sector with an enormous debt, a large financial imbalance, and with all the behavioural traits depicted above. As a reaction to the inherited situation, the management of the financial variables was centralized. Operating under the assumption that there was a lot of hidden inefficiency within the enterprises, most sources of funds were rationed, so as to create illiquidity in the enterprises. It was hoped that such a situation would force them to find funds in ‘virtuous’ ways: improved marketing, reduction of unnecessary expenses, etc. But, since the extremely poor accounting systems made it impossible to control the variations of working capital, enterprises resorted to unorthodox measures: delaying payments to other public sector units, to social security organizations and to suppliers.

The persistent deficits also resulted in the establishment of advance approval for a large number of items of expenditure: hiring new employees, salary increases, buildings, cars, furniture, computers, etc. These kinds of restrictions can perhaps be useful in the very short run, but when practised for several years, as in the case of Argentina, they produce all kinds of dysfunctional effects. First, enterprises maintained large out-of-date inventories and stocks of anything which might have a use in the future—even in a context of financial pressures. Goods that are unwanted today might become scarce tomorrow. Scarcity has a worse impact on efficiency than redundancy, and therefore even first-rate managers pursued a hoarding policy. Second, enterprises circumvented restrictions by utilizing more expensive ways of solving problems. For instance, if typists could not be hired regularly, but were indispensible, enterprises used labour from temporary personnel agencies on a permanent basis, although this was much more expensive. Or, as automobile purchases were forbidden, maintenance costs were incurred which exceeded the market-value of the cars. Third, when the enterprises negotiated authorizations to purchase some input or to hire an employee, they requested more than they needed, in order to provide for future shortages.4

Another pervasive problem of the system was the multiplication of ‘involved’ central government organizations, which resulted in an unnatural subdivision of the decision-making process. Enterprise problems were analysed by different groups with different criteria and with inadequate timing. This fractioning of decisions and the application of inherently different logic created innumerable incoherences. When Terragno took office, and as a part of his strategy of concentration of
power, he negotiated a complicated arrangement with the Finance Secretariat whose main features were as follows:

(a) the Finance Secretariat would absorb most of the external debt of public enterprises, thus eliminating one of the most distorting factors in their finances;
(b) the administration of some taxes and special funds related to public works, representing a substantial amount of money, was transferred to the Ministry of Public Works;
(c) the Ministry of Public Works and the sector secretariats would have the freedom to specify prices according to production costs;
(d) In exchange, the Ministry of Public Works assumed the compromise of not requiring additional budget support, covering the needs of the chronically indebted enterprises like the railways with special funds and with the support of other enterprises;
(e) The Ministry would adopt measures for reducing enterprise expenditures. It was decided that every enterprise should diminish its non-personnel expenditures by 4 per cent, depositing the amounts in a special account.

It is not possible to evaluate the results of this last attempt, taken when the government had a little more than a year left in power. The economy collapsed a few months after the agreement was reached, and inflation rates of the order of 30 per cent per month made it impossible to follow a pricing policy independent of the anti-inflationary efforts and reduced the value of the amounts collected by the special funds. After a short while, public enterprises were again requesting budgetary contributions. The situation at the end of the Radical era was about as bad as had been inherited at the outset.

Privatization: from optimistic policies to uncomfortable facts

The inherent difficulties

Privatizing is not an easy job. The best proof is the result obtained by the military regime that preceded the Radicals in the government. An economic team with a strong private sector-oriented ideology, which had considerable power during five consecutive years, was able to privatize only a few small and medium-sized enterprises.

Privatization efforts must surmount several problems. First, and paramount, is the ideology of the larger parties and social groups. Both the Radicals and the Peronists have in the past followed development strategies for which the public sector was the main determinant of growth.
Both have a strong component of nationalism, and share a certain mistrust for the foreign private sector. The same attitude is to be found in the armed forces, which were involved in the initial industrialization efforts. The opposition is even stronger in the area of labour, where some of the more powerful unions are those of public enterprises.

These traditional positions have been changing rapidly in the last few years, with the mounting crisis and the increasing evidence of poor enterprise performance. The candidates of the Radical Party in the last elections held a strong privatist position, and even the more statist Peronists advocated the possibilities of privatization. These trends are clearly related to drastic changes in public opinion, and to polls showing massive support for such policies.

With disintegrated accounting systems and in a context of unrealistic pricing, a second significant problem is the difficulty of establishing a fair value for the largest enterprises. After years of decreasing investments and irregular maintenance, certain types of estimates are almost impossible to make. Furthermore, these objective difficulties exist in a context where the general public—and even specialists—tend to assign considerable value to outdated enterprises with obsolete equipment and where the suspicions of corruption, or at least of too-easy bargains, are rampant. In the case of small and medium-sized enterprises it is quite easy to conceal real selling prices. This is usually done by Treasury absorption of existing liabilities and separate sale of ‘clean’ assets in public bidding. But this, of course, is out of the question in the case of large enterprises.

The fact that many of the public enterprises operate in monopoly or oligopoly markets, and in many cases are monopsonies or constitute a large part of the market for certain goods, does not simplify the matter. The potential buyers might be more interested in the exploitation of the monopoly situation than in the physical assets of the enterprise. Here also is the problem of the capability of the government as a future regulator. It is true that this problem can be solved through parallel deregulation efforts, but that is not always possible.

Lastly, the limited development of the capital market must be mentioned. This makes it difficult to implement strategies which attempt to achieve a wide distribution of shares and which might have a greater degree of political viability. Given the rather poor reputation of public enterprises, a public offering of shares would require prior reconstruction of the enterprises and at least a couple of quarters showing reasonable profits.

The privatization strategies of the Radical Party

Very little changed in six years of Radical government. As usual in Argentina, activity amounted to a crescendo of policy announcements that were never implemented. The initial step in
1984 was the creation of a Commission (the so-called Commission 414, from the number of the Decree that created it) that slowly privatized a group of the remaining medium and small-sized public enterprises. In 1984, when the Secretariat for the Promotion of Development was created, the idea of ‘privatizing the growth’ of enterprises through private investment appeared in the official discourse. But although the idea was suggested as a broad strategy, in practice it was related to a very specific proposal: the development of a private communication network in Buenos Aires’ financial district. This, of course, meant privatizing quasi-monopolistic access to one of the most lucrative markets of the telephone system. As it might be expected, it was strongly opposed by the public enterprise concerned. This initiative was not put into effect, and the whole idea of privatizing public enterprise growth disappeared a few months later when the Secretary resigned. In September 1985, in the wake of the Plan Austral, both the President and the powerful Minister of Economy disclosed intentions of selling the steel and chemical industries: but their announcement never went beyond this stage of declaration. There are, nevertheless, two areas in which significant advances were made: the achievement of significant private participation in oil exploration and production (the so-called Houston and Olivos Plans), and the financing by users of the expansion of the telephone system (the so-called Plan Megatel).

The strongest—and the best publicized—effort took place when Terragno was appointed Minister of Public Works. After a round of secret negotiations, he reached agreements with SAS for a 40 per cent participation in the national airline, and with Telefónica Española in relation to ENTEL (the telephone company), and sent them to the Senate for ratification. There were a few heated debates, in which the Minister participated, but nothing else happened. There were also parallel efforts aimed at demonopolization and deregulation. Terragno issued a Decree authorizing the submission of proposals for private-sector intervention in any of the areas previously reserved for public enterprise operation, and establishing a very short period for government analysis. If no reply ensued, the proposals were to be considered accepted. There were a number of proposals, but not much evidence of action. The results of the elections of May 1989 have put the subjects of privatization and deregulation on hold, and the whole discussion is left for the agenda of the future Menem government.

It is difficult to evaluate Terragno’s efforts. But it can be argued that from the beginning the chances of success were minimal, given the imminence of the presidential election. The unnecessary secrecy of the negotiations caused more damage than benefit, and threw a cloud of doubt on the privatization process. On the bright side, even if the attempt was
not successful, it was a bold move which had the virtue of breaking a taboo, opening up the subject of private intervention in large public enterprises for future discussion.

Some lessons from Argentina

Although efficiency problems are usually perceived at the enterprise level, they are far too often due to the ineptitude of central government units in their role as ‘enterprise owners’ and to inadequacies in the set of instruments they use to guide and control behaviour. Using the recent Argentinian experience as an example, the problems and advantages of several approaches will be discussed. The following three—co-ordination, concentration, and negotiation—emphasize improvement in the relations between the central government and public enterprises, while another—privatization—attempts to minimize such relations.

Co-ordination has been the traditional approach to improve relationships between government and enterprise. There is a basic assumption in this: that the essence of the problem is the multiplicity of objectives. Enterprises are not only required to be efficient and to produce financial returns but also, it is suggested, they reproduce on a lesser scale the objectives of governments: more employment, regional development, etc.

The essential problem then is to consolidate these sometimes inconsistent goals into a single preference function (or into a coherent set of goals) which is then given to the enterprise. Usually, the problem is perceived in functional rather than institutional terms, and as technical rather than deriving from conflicts of power.

Two types of solutions have been attempted in Argentina. In the 1960s the focus was on planning institutions and techniques, and these attempts generally failed. Co-ordination may also be sought through the building of networks based on informal relationships. That was the initial implicit approach in 1983, and elements of it were strongly present in the successive strategies. But unless these informal networks are somehow crystallized, by the creation of a tradition or through institutional support, they provide a very weak basis for the improvement of relations, as the Argentinian case clearly suggests.

Concentration is the approach adopted when the problem is not perceived as inconsistency of objectives but rather as a power conflict between several components of government—the ‘multiple owner’ situation described earlier. If such is the problem, then one possible solution is to concentrate the power in one institution, thus converting the situation into one of ‘single’ ownership. This is very appealing. It was gradually
approached after 1985 and fully adopted when Terragno was appointed Minister of Public Works.

One common problem however, present in Terragno’s case, is that the resulting power accumulation becomes too large and requires administrative capabilities and information systems that, at least in the Argentinian case, do not exist. Another problem, also apparent in previous attempts, is that power should be acquired step by step. If administrative authority (which is not the same as power) is transferred by a presidential ukase to a just-created institution, with new personnel and without previous experience, the government units formerly in charge will successfully resist, and the apparently powerful institution will soon become the fifth wheel on the cart. Such was the case, for instance, with the Secretariat of Control.

Negotiation is based on one central assumption: that effective power is derived from the ability to design alternatives of action. Otherwise, what government institutions do are essentially veto-type interventions. Obviously, effective power (which requires technical and organizational information and the ability to use it) mostly resides in the enterprise. Therefore, it might be necessary to negotiate with the enterprise in fair quid pro quo exchanges. This is an excellent way of clarifying goals and requirements of the ‘government owners’: the Finance Secretariat might define its goals very diffusely (the guardians of the nation’s purse or a similar general statement), but they will be very clear and precise when discussing future funding compromises.

Negotiation might also solve another problem in government-enterprise relationships. One of the most negative characteristics of government interventions and restrictions is that they tend to take place following central government rhythms and needs. The consequence is that interrelated issues are discussed on different occasions between different people and using different criteria. Investments are considered within a planning agency, using planning criteria, in a discussion which lumps together the enterprise’s investment with those of other agencies. Prices are discussed at a different session, in another ministry, with an eye on the impact of the rise on the cost-of-living indices. The framework of the so-called programme agreements or contracts might result in a much more consistent discussion of the problems, even if the actors are the same. A second fringe benefit could be obtained if the formulation of the agreement is preceded by a jointly prepared diagnosis of the enterprise and of the requirements of government organizations: an improved knowledge of the problems of the enterprise, which is presently missing.

The short experiences of the first quarter of 1986 did not provide enough experience of programme agreements, although they showed clear promise. But they were enough to introduce a few caveats. The main
danger, of course, is that whatever agreements are reached they will not be respected afterwards by one of the parties. This can be countervailed by making realistic agreements, and involving in the discussion the people who might give stability to them. Ministers and board members are here today and gone tomorrow—there can be no better examples of that than in Argentina! —and, unless the permanent bureaucracy and the managerial cadres at the enterprise have been effectively involved in the negotiations, the programme agreements will not be worth the paper on which they are written. It is also necessary to remember that it is a long and complicated process which involves a large number of persons, and that a careful evaluation of future possible courses is required if it is to be an effectively strategic agreement. It cannot be conceived as an over-the-table set of negotiations between ministers’ advisers and enterprise board members. Last, there are, of course, a number of technical considerations related to the design of an agreement that allow flexible adaptations to changing circumstances. But this is not the place to enter into such discussions. Suffice it to say, programme and contract agreements constitute one of the most promising ways of solving the problems discussed.

The above approaches emphasize improvements and/or changes in the relations between public enterprises and the government. Privatization is a much more drastic solution, since it can be thought of as the complete elimination of such relations, which perhaps explains its growing popularity. The only exception is the case of public utilities, in which some degree of regulatory relations should be maintained. There is very little that can be learnt from the short and frustrating Argentinian experience, except that more of it should have been tried, and at an earlier stage.

A successful public enterprise policy is a combination of these elements, and the right combination varies from situation to situation and from country to country. It is true that in Argentina, as in many other countries, more emphasis should be placed on privatization. But the rest of the picture should not be forgotten. Unless reforms are introduced at central government level, unless the relationships between enterprises and the government are redefined, the overall problems will remain, as in Argentina, which is even worse off after six years of attempted reform.

Notes
2. Dr Sourrouille had been previously Secretary of Planning, a rather powerless position. Grinspun took this job, in a sort of castling.
3. Examples of this can be found everywhere in enterprises in such conditions: excessive stocks, inefficient cash management, etc.
Horacio Boneo and Enrique Waterhouse

4 Even under the assumption of perfect adjustment of the enterprise to the spirit of the restrictions, the required amounts will be always greater due to the additional time that the authorization requires. The optimal size of the orders increase.

5 One of the privatized enterprises was a producer of pipeline steel tubes. A few months after it was sold, the construction of a large gas pipeline was announced. The firm was then resold to the pipeline constructors for more than three times the original amount. The increase in production and employment was attributed to privatization, rather than to the obvious fact of the pipeline construction.

6 This allows negative sale prices, if the amount obtained through the sale of the assets does not cover the liabilities absorbed by the Treasury.

7 This was not really privatization, since the control of the public enterprise remained in the public sector: it was a rather interesting way of financing the expansion of the system.
Chapter ten

Privatization in Chile

William P. Glade

There is no need for another general recapitulation of the Chilean privatization experience. Several good accounts are now available. Hence, instead of taking stock of what has been accomplished and the associated problems, we may find it more useful to take a different tack, and pursue three interpretive aims.1

The first is to examine how the strong public policy commitment to privatization materialized in the first place. The question is especially pertinent inasmuch as it has been the notable absence of such a commitment that has been a major stumbling block to the successful implementation of such programmes elsewhere.

The second aim is to indicate how the implementation of privatization in Chile reveals a learning-by-doing experience that highlights the advantages of policy continuity.

The third and final objective, which serves as a sort of subtext to the others, is to show why it can be argued, somewhat paradoxically, that privatization, despite its ostensible aim, can properly be conceptualized as a public good.

To cover this territory, we shall first look briefly at the general context in which privatization began and then move on to three case examples of the way the process has worked in practice.

The context of privatization

Before the peculiar spectacle that took place in the early 1970s, the Chilean economy was not one of the stellar performers of Latin America. Neither was it in the shambles of, say, the Argentinian economy in the sixty years of mostly disappointing performances that ensued after 1929. On the political front, before the 1970s the country was decidedly ahead of most of the rest of the region in the general stability and orderliness of its democratic processes. The dismal record of many of its sister republics with their on-off attachment to constitutional government made Chile exceptional, though there too—perhaps less than elsewhere—successive
governments had dispensed favours and privileges to reward supporters and buy off opponents.

While rent-seeking had not reached the extremes it had in some of the larger economies, it was nevertheless most likely a contributing factor to the low productivity of much of the Chilean economy. Likewise, although the Chilean state became over-extended through politically inspired economic and social concessions, before 1970 the extent to which the public and parastatal sectors exceeded the administrative capability of the government was certainly less than elsewhere in Latin America.

The general effect of this institutional growth was not altogether salutary. For a while it was reasonable to argue that the web of commitments that had been projected into policy was productive in the long run, on account of its politically stabilizing effect, but the intensity of the revanchist nature of the regime that came to power after Frei’s accelerated reformism reveals this reading of the policy cost-benefit calculus was very much in error. A generally low rate of capital formation, the maldistribution of resources, and the complicated patch-work of the social insurance system, along with an endemic inflation of exceptionally long duration, though of modest intensity, were among the consequences of this politicized economy.

The Chilean economy was not very competitive internationally, except in copper and a few minor products. The sluggishness of domestic investment set in bold relief the dependence on foreign investment in the copper industry and elsewhere. Both circumstances undoubtedly fed into the gradual Chileanization policies that were applied to the copper industry in the moderate economic nationalism that characterized the country’s policy stance prior to 1970. They became the basis for part of the radical reorientation of policy that followed the coming to power of the Unidad Popular government.

**Case example: self-privatization**

**Political background**

Of special interest is a case in which the initiative for privatization came from the response of technically trained workers to a threatened loss of employment. The threat originated in a need to cut back the size of government agencies as part of the programme to bring public spending in line with public resources. The ultimate source of the retrenchment measure, however, sheds light on why privatization came to occupy such a high priority on the policy agenda of the government that came to office in 1973.
To put the matter in perspective, following the gradual enlargement of the public and parastatal sectors that characterized the half-century of development up to 1970, the Allende episode brought with it a wildly aberrant expansion of the state that enlarged the scope of public management far beyond the capacity of the administrative machinery to handle its new responsibilities. The process was, moreover, as disorderly from a legal point of view as it was in terms of its practical consequences for investment and production. The payrolls of almost all agencies of the government came to be bloated, as did the employee rolls of the firms brought into the public sector in a rash of nationalizations, with contending political factions evidently dedicating a large portion of their time to settling old scores and manoeuvring for advantage. Predictably, public policy lost its accustomed stability, and in a relatively short time the implementation of policy began to break down as well.

By the time the Unidad Popular government was thrown out, the expanded state sector encompassed a large number of hastily nationalized companies, while the functions of several old-line parastatals had been rapidly augmented. In particular CORFO, the Chilean Development Corporation, had been made to serve as the spearhead of a substantially stepped up, though ill conceived, programme of public investment. Under the circumstances, the task of getting on with the everyday business of mobilizing factors of production and deploying them efficiently suffered from a replication of the same set of circumstances that impaired the management of government agencies. Overstaffing, politicized and inexperienced management that engaged in sectarian bickering, and a deterioration in labour discipline, were rife among the parastatal companies.

The debacle was even more widespread than the foregoing might suggest. During the first year of the Allende administration, aggressive Keynesianism quickly brought the economy to full employment, but thereafter an equally aggressive Marxian adventurism no less quickly drove the economy into ruin. Neither the agricultural sector nor the industrial sector—nor, for that matter, the financial sector—was spared the ministrations of doctrinal enthusiasts, who were almost inquisitorial in their zealotry. A negative interaction ensued. The deteriorating public administration contributed to economic decline, and this in turn added to the difficult situation which the government had to confront. With production capacity severely damaged and government spending spinning out of control, the rate of inflation shot upwards: saving and investment, which had not been high for
years, dwindled to negligible levels. A prime task for the post-
Allende government was, therefore, that of paring back the public
sector through scaling down or eliminating various public agencies
and restoring the management of much of the production system
to the private sector.

One further background factor is relevant. Before 1970–3 the Chilean
public sector, especially in state-owned enterprises, had attained a relatively
high degree of professionalism. Although it was not solid enough to
withstand the assault of the Unidad Popular’s revolutionary programme,
the public service was nevertheless able to survive this period with some
portion of its human capital intact. Consequently, even after the political
cadres of the Allende coalition were dismissed and the payrolls padded
with hangers-on reduced, the number of reasonably well-qualified people
who remained in the bureaucracy was still larger than the state could
support as it moved deliberately to make ends meet.

Two policy imperatives thus emerged directly from the Allende episode.
The first was the unavoidable necessity of re-privatization simply in the
interest of getting production started up again. There was no way for the
state to handle its inflated portfolio successfully, at least not without years
of management development. In three years almost every mistake a
centrally planned economy could make, save that of actually installing
central planning, had been made, and when Allende left the scene, things
seemed to be getting worse rather than better. The economic situation,
therefore, called for immediate rescue and the only way to do this was to
turn to the only experienced management available, i.e., those who had
been driven out of, or rendered inoperative in, the erstwhile private sector.
At the same time, the commitment to privatization, for which there seemed
no practical alternative at the time, implied devising a macroeconomic
environment that would sustain and foster the effective functioning of the
private sector.

Economic requirement

The second policy imperative, therefore, was rectification of the economic
environment. This implied, in turn, halting the runaway inflation through
appropriate fiscal and monetary policies. What could be done through
monetary policy was limited, for although credit was greatly tightened it
was still necessary not to choke the production sector entirely if output
was to be revived. Much therefore turned on the possibility of cutting
back public-sector spending since an immediate increase in real tax
revenues did not seem possible.

Reduction in government spending, then, led ineluctably to paring back
the public payroll wherever possible, and to dealing with the deficits of
the remaining parastatal firms. For the latter, this meant lowering and the
eventual removal of subsidies, reform of pricing policies, a strengthening
Country experiences

of managerial authority, and in a growing number of instances, the sale of public enterprises, in whole or in part, to private investors. That their sale could even be contemplated, however, tells us much that is important about these firms. Behind the excesses of the Unidad Popular period, when even minimal discipline slipped badly, the historic record of these firms was reasonably positive and, hence, their recuperative power was not impaired irreversibly. The case of the Empresa Nacional de Computacion e Informatica, SA (ECOM), a relatively straightforward example, is a compelling testimony to this underlying strength in that it involved privatization in an especially competitive field.

Computer privatization

ECOM had been established in 1968 as a subsidiary of CORFO, to serve as the computer service centre for large parts of the public sector. Among its intended customers were the retirement funds, the public health service, and government ministries. Some of the large parastatals however, such as the telephones, steel, electric power generation, and petroleum, were not clients as they had in-house computer capabilities. ECOM was not intended to compete with national private firms, though in essence it did so by pre-empting major public sector users in what amounted to a captive market.

From its foundation until 1985 ECOM remained an affiliate of CORFO, whence it played a leading role in the development of computer services in Chile. During this time ECOM worked out extensive training courses with the collaboration of the University of Chile, where most of the country’s R&D in computer science had been done. Through these courses, which began in the mid-1970s and ran until the early 1980s, the company helped develop many of the technicians who are employed throughout the computer field in Chile today.

In effect, this pioneering developmental work gave ECOM an extensive network of alumni—friendly contacts in many companies, both public and private. This was to stand the firm in good stead when it became a private-sector company.

By 1985 the government had decided that with the growth of private-sector computer firms, ECOM was no longer needed. CORFO then proposed to shut down the company and let the public sector buy computer services from private businesses. Members of the ECOM union, however, wanted to keep the organization going, not so much to make profits as to salvage their jobs. They negotiated with CORFO to forestall liquidating ECOM, and instead to sell it to its employees, who were mostly technicians. Although the union was not allowed to use the severance pay reserves (indemnizaciones) to buy the assets, it was able to negotiate favourable terms from
CORFO, which was consistently helpful. The new owners were given eight years to buy the firm, after they had used their own savings and bank credits to make the down-payment. The union determined at the outset that all technical and other employees of ECOM, including those who were not union members, would be eligible to purchase shares in the new enterprise. The initial subscribing group numbered approximately 250, but workers hired later were also allowed to buy shares.

ECOM was able to keep most of its public-sector clientele, while it broke into the private-sector market. Moreover, although the company itself was not authorized to sell computer hardware, SAICOM, the shareholding company that was set up by CORFO to own ECOM, was authorized to do so. Today the company is able to sell to both public and private customers a number of hardware items from the IBM and EPSON lines it handles. To aid in its penetration of the private-sector market, SAICOM hired private business entrepreneurs as consultants, and private businessmen have also been appointed to the board of directors. The company is continuing to develop new software applications, adapting its packages to new uses, and was in 1988 exploring the possibility of exports to Bolivia and Argentina. Not only has the company operated at a profit, but it has also been able to expand its employment to some 600 workers by mid-1988.

**Case example: energizing the energy sector**

While it might appear that only recently did the Chilean state turn its attention to divestiture in the electric power industry, the preparatory process for this major step stretches back to around 1976. Price reform was begun that aimed at relating electricity prices to the real costs of power production. This was done to staunch the large subsidies that constituted such a drain on the Treasury, to lead to a more rational allocation of resources, and so to enable the power industry to resume paying its way. There were at the time two major companies which engaged in both generation and distribution: ENDESA, which had operated as a public enterprise since its establishment in 1944, and Chilectra, a once privately owned company serving the Santiago area that had been nationalized in 1970.

**Background: periods of privatization**

The first wave of privatization consisted mainly of the return to the private sector of 360 firms that had been expropriated by the Allende government. None of these were in the electric power field, which
remained in the government’s hands. Given the disarray in the economy generally, to say nothing of the capital market, there was no likelihood of raising the sums that would have been necessary to put the electricity industry back on its feet at that time. The paramount objective of policy was the recovery of production capacity.

Nor did electric power figure importantly in the second wave of privatizations in 1975–82, during which period the state’s fiscal objectives were seen as overriding. Instead, the state’s shareholdings were reduced or sold completely, mainly at the highest price, in 135 more companies, including CORFO affiliates, other companies owned directly by the government, and sixteen commercial banks.

Although some of the transactions were criticized for their lack of transparency, whether or not this charge is justified the single-minded aim of maximizing sales returns in order to bring down the deficit and restore macroeconomic stability meant neglecting other objectives that might have been a legitimate part of public policy in a wider view. Little thought appears to have been given, for example, to technological upgrading, it having been assumed evidently that this would follow automatically from the return of management to the private sector.

A more fatal flaw was to disregard the effects of privatization on industrial organization. The result of the programme was to concentrate ownership and strengthen oligopoly in many sectors of the economy. Worse yet, this was done in an inherently unstable manner. Quite a few firms were sold on a highly leveraged basis to corporate speculators who were able to use their banking connections to build conglomerate empires on the basis of borrowed capital. Since much of this loan capital had been raised abroad, thanks to the double incentive of a sharp interest rate differential in favour of foreign credits, and an exchange rate that was becoming progressively overvalued, the recession that hit the country in the early 1980s plunged these large holdings into bankruptcy. The banks involved, together with their industrial portfolios, had to be returned to the public sector.

The third wave of privatization, which started in 1985, was notably better in design than the previous efforts had been, as much had been learnt from the policy experience of the preceding years. By this time exchange rate policy, which had proved so detrimental in every respect except that of bringing down inflation, had been corrected. And, as the government had seen the error of permitting an extensive concentration and interpenetration of financial and industrial ownership to develop, an explicit goal in the third
privatization episode was to broaden the distribution of corporate shareholding. ‘Popular capitalism’ was now the objective, in connection with which the purchase of shares on credit was strictly regulated.

Worker shares

At the same time workers were given preferential treatment for some stock purchases. Later both the newly privatized pension trust funds and the managers of corporate severance pay reserves were authorized, within strict guidelines, to acquire shares in the companies being privatized. Towards the end of 1985, for example, CORFO offered the pension funds and other small investors a 30 per cent stock share in its most profitable companies, including the CTC (Chilean Telephone Company), Chilectra, ENDESA, ENTEL (National Telecommunications Company), CAP (Pacific Steel Company), Laboratorios Chile (pharmaceuticals), and SOQUIMICH (Chilean Chemical and Mining Company). The permission to use severance pay reserves was a means of enabling workers to acquire shares in employee stock ownership plans while also enabling them to tap the indemnization accumulations to which they were entitled without having to leave their jobs. Further, the fact that these companies were eligible for such investments in 1985 was testimony to the success of CORFO management, for to qualify as such they had to attain a specified level of profitability for the previous three years, which at this time covered the recession of the early 1980s.

This was not the first time that employee stock ownership had been considered. During the very first stage, that of the re-privatizations, some effort had been made along this line, but without much success. Local funds for facilitating worker purchases were extremely limited, owing to the enfeebled state of the banking system in the aftermath of the Unidad Popular expropriations. Suitable foreign backers for the purpose were also scarce. Some who might have done so, at least on a small scale, had withdrawn their backing to show displeasure with the military regime. Further, the prospect that the programmes, had they been implemented, would have worked out well was scant to begin with. The overvalued exchange rate that came into play after mid-1979 on the recommendation of the ‘Chicago Boys’ who were advising the government, would most probably have driven many of the firms under eventually. (The government opted for a fixed exchange rate while inflation was still 40 per cent a year.) As it was, the measure prompted a massive flood of imports, financed largely on foreign credit, and brought ruin to many local producers.
Moreover, the second phase of privatization, as indicated, was given over to the excesses of corporate speculation, made worse by the foreign funds ploughed into the process.

**Policy improvements**

By the time the third phase of privatization was under way, however, a number of policy improvements had been made. Direct subsidies to public enterprises were phased out after 1975, redundant staff were discharged, and unprofitable operations trimmed. This meant that a number of parastatals were in a position to achieve a modest profitability once the economic recovery of the mid-1980s began. After 1980, only five state-owned enterprises were regularly receiving subsidies, the four most important being ENACAR (the state coal company), LAN-Chile (the national airline), and two military-related firms.

More stringent regulations had been developed to govern the capital market, with public disclosure and certified auditing requirements for corporate information that were, effectively, very probably well in advance of anything required elsewhere in Latin America. Given the economic ruin to which the feverish speculation of the late 1970s had led, there was also a far greater appreciation in government circles of the need for transparency in privatization transactions. The socialization of information was, in other words, recognized to be prerequisite to authentic privatization—a key aspect of a successfully functioning market-driven economy.

**Privatizing electricity**

It was in this greatly altered context, then, that the electric power industry was inducted into the privatization process. Another significant preparatory step was the creation in 1978 of the Executive Secretariat of the National Energy Commission. Organized to report directly to the presidency of the republic, this body moved quickly to put the pricing policies of the power industry on a more economic basis, and more methodically to elaborate a systematic plan for decentralizing and divesting the electric power industry once conditions were propitious for doing so.

As an industry characterized by relatively stable and well-known technology (subject however to some up-grading), by stable management procedures, and with a virtually assured growth in demand, the industry seemed ideal as a blue-chip option with which to anchor investment portfolios in general. It was also especially suitable for the employee stock ownership programme, and for the privatized pension trust funds, where security of principal and reasonably steady growth in income had to be counted on to meet future claims. The small investors the government hoped to cultivate for its scheme of popular capitalism were likewise apt to find the electricity industry an attractive opportunity. Thus conditions were such that the third privatization episode could have more subtleties and be more diversified in its public policy objectives than the first two had been.
Two further factors made the time ripe for a privatization of the electric power generating and distribution industry. The institutional infrastructure of a functioning capital market had been rebuilt and improved so that stock brokerage firms and investment banking houses were operating in the market. They were ready to work with CORFO, the agency to which the privatization of the industry was entrusted on account of its decades-long experience in the management of corporate affairs.

Second, the foreigners who had lent so much to Chile during the widespread Latin American borrowing spree of the pre-1982 period were beginning to cast about for new options to recover their investments, including those made to private industrial and financial entities for which the government had assumed, probably not very wisely, the responsibility in the course of debt renegotiations. Thus, foreign commercial and investment banking interests also entered the privatization market in search of ways to recoup (through debt-equity swaps) some of their outlays. For a variety of reasons, in short, the capital market was ready to handle the privatization of the energy industry, although the prices at which the electricity companies were subsequently sold does seem to have reflected some investor uncertainty regarding the future course of the new public utility regulatory framework.

De-concentration of the electric power industry, in order to remove the vertical integration that had characterized it from the beginning, was seen as an important way to increase transparency in the economy and disperse economic power (and access to opportunity). Thus, the two large state-owned firms that controlled the industry in the 1970s, ENDESA (Empresa Nacional de Electricidad) and Chilectra (Compania Chilena de Electricidad), were broken up into distinct sets of generating and distribution companies, the multiple new companies being organized, logically, as regional and local electric power companies. Chilectra was divided into three new companies: Chilgener, the power generating company, and Chilquinta, the distribution company for the Valparaiso area, and Chilmetro, the distribution company serving the Santiago market. A number of small hydroelectric installations belonging to Chilectra were sold off separately. For its part, ENDESA was divided into an even larger number of new companies. Five new generating firms were carved out of its assets—Pilmaiquen, Pullinque, Colbun, Peheunche, and Edelaysen—though ENDESA itself (now more than 50 per cent privately owned) remained by far the largest source of power and, with privatization, the largest publicly traded company in Chile.

On the distribution side, seven firms took the place of the three subsystems into which ENDESA was organized prior to privatization: SAESA, FRONTEL, EMEC, EMEL, EMELAT, EDELMAG, and EDELNOR. To add to the competitive character of the energy sector,
generating companies were authorized to sell to any distribution company and the latter, in turn, were authorized to turn to any source of power.

Owing to the size of the total capital involved, the privatization process was gradual. In general, blocks of shares were tendered for bidding on the market through financial intermediaries that served as underwriters. In some sales portions of the issue were reserved for purchase by workers and small local investors on especially favourable terms, and limits were placed on the amounts that could be purchased by other investors. Worker stock purchases were part of the privatization of Colbun, Chilgener, Chilmetro, Chilquinta, EDELNOR, and EDELMAG, in the first four of which the pension funds were also allowed to invest. In two cases, those of EMELAT and EMEL, the companies were sold in their entirety to their workers.

Although the total package, the largest privatization carried out by CORFO, was not without its critics, the most striking characteristic of the process—at least to the outside observer—was its transparency. Moreover, as the results seem to have been so salutary, there can be little doubt that the privatization of the electric power industry has been the culminating achievement of the whole privatization programme. At least two foreign banks came in as buyers. Bankers Trust, for example, acquired the Pilmaiquen hydroelectric plant for $20.8 million, contributing thereby to the country’s debt reduction programme. No less significantly, many local investors came into the market.

Whereas the number of shareholders (in all firms, not just electric power companies) stood at 26,604 in December, 1985, by April 1988, their number had increased to 110,000. No separate figures are available on the portion of these that was attributable to the electric power privatizations, but it appears that, directly and indirectly, it may have been considerable. (Workers who had bought 3 per cent of the shares in the Schwager Coal Company purchased 6 per cent in Chilgener, 9 per cent in Chilquinta, and 31 per cent in Chilmetro.) Altogether, 26,897 workers acquired shares in the privatized enterprises in which they worked. The pension trust funds were also significant investors, acquiring 7.2 per cent of Schwager, 14 per cent of Chilgener, 17 per cent of Chilquinta, and 24 per cent of Chilmetro. (The figures on the ENDESA spin-offs are less clear, save for the two purchased entirely by their workers.)

Some other privatizations

This said, not every aspect of the third privatization phase went as smoothly as the divestiture of electric power. Particularly controversial was the divestiture of the very profitable CTC, the Compania de Telefonos de Chile, in which CORFO sold 30 per cent of its 83 per cent holding to the Bond group of Australia. Although the buyer who submitted the highest
bid was committed to raising the capitalization of the company by 15 per cent to continue its programme of modernization and expansion, and although 7.5 per cent of the company’s shares were sold to pension funds and 12 per cent to some 4,500 of the firm’s workers, the partial sale was much criticized.

The second bidder, a French-Spanish joint venture with links to Ericsson, had much stronger experience and better access to advanced technology in the telecommunications field. The Bond offer was also believed to be highly leveraged.

A further objection was that, subsequently, the Bond interests were allowed to increase their share of the outstanding stock by contributing additional capital, to 50.2 per cent of the total, thereby gaining control of the company. Notwithstanding the illegality of this, as company statutes limited a single owner to 45 per cent of the stock, Bond was given to mid-1992 to reduce its share to the permitted maximum, on the grounds that the additional funds provided were very much needed for technology upgrading and expansion of the system. The additional capital injection made it possible for the CTC to double the number of telephone lines, automate 100 per cent of its lines, install some 14,000 additional public telephones, and convert nearly three-quarters of its switching equipment to a digital system.

The privatization of CAP, the Compania de Acero del Pacifico (the state steel company), also ignited some controversy as the state reduced its interest from 87 per cent to 51 per cent by paying itself off with the large accumulated surplus of the company. Even though this measure left the workers of the firm with a 33 per cent stake therein, the transactions were called into question because the largest single private interest, which became a controlling interest with subsequent divestitures, was in the hands of a Swiss consortium. It held 20 per cent of the shares outstanding, and through recapitalization the share of the workers had been somewhat reduced. There was some objection, too, that the profits of the steel company were financing not only a modernization of its technology, but also a diversification into non-related lines of production.

These cases aside, and allowing for the arguable points in each, it would seem fairly clear that the third stage of privatization, led as it were by the privatization of the electric power industry, did much to fortify the general functioning of the capital market in addition to what it did for the industry itself.

Case example: the role of financial intermediaries

Central to the success of the privatization effort in Chile has been the effectiveness of CORFO, the government’s industrial development corporation, which chalked up an enviable record of investment
banking and effective industrial management before the Unidad Popular episode, and which was able, in an impressively short interval after this hiatus, to reconstitute itself as the spearhead of industrial policy. Through its Gerencia de Normalizacion office, as well as the other parts of the organization, CORFO was able to recover its reputation as a leading institution in economic management. Nevertheless, in the way that it has managed its tasks it has also been able more generally to contribute much to rebuilding the institutional infrastructure of the economy.

Five different methods of privatization have been employed by CORFO in its operations since 1985: (1) direct sales of stock to the public in general or to private companies in particular; (2) public tenders; (3) sales through the stock exchange; (4) sales of shares to employees; and (5) sales to the pension funds. Various combinations have been employed, depending on circumstances and the nature and size of the subsidiary being privatized, and equally pragmatic has been the decision whether to privatize in whole or in part.

In organizing the privatization process, CORFO has often used financial advisors, such as BICE Chileconsult, a Chilean firm working in affiliation with N.M.Rothschild and Sons, Ltd, in calling for a public bid. Selection of the firms enlisted for this purpose has been made on the basis of the service offered and price, through a competitive process of negotiation that covers the privatization strategy to be employed. The relation negotiated has typically involved a variable mixture of functions, ranging from presentation, marketing, and supervising the privatization to prequalifying the bidders. Table 10.1 indicates the investment banking houses that have worked with CORFO on some of its major privatizations in recent years.

Of other major transactions in this period, EMEC, EMEL, and EMELAT were sold directly to the purchasers by ENDESA; Laboratorios Chile was sold directly to the purchasers by CORFO; and ENAEX, an explosives manufacturer, was sold directly to Austin Powders (76.6 per cent) and FAMAE (33.4 per cent), the latter being a company owned by the Chilean army.

Of twenty more-or-less typical cases, all of the shares were sold through a public bidding process in five of them. In two they were all sold directly to the workers. In the other thirteen cases, the shares were placed by a mixture of methods, some to pension funds, some by public bid, some through the stock exchange, and in a few instances through other means. The stock exchange was used to move the majority of shares in three cases and a substantial portion of the shares sold off in seven others.
Generally speaking, where financial advisors have been used, shares have been sold by public bid and to workers, as well as pension funds when the company was deemed eligible for their portfolios. This has enabled the shares to be marketed to particular groups of investors: for example, a group of related investment interests for whom the company being privatized might present some complementarities. The expectation has been that by allowing targeted purchasers to internalize the externalities, the sale would fetch a higher price than if the shares were to be sold to the public at large. In many cases, however, CORFO has specified that at least a portion of the shares be offered through the stock exchange in the interest of making it immediately available to the investing public. The ENDESA related companies, for the most part, were channelled through the stock exchange, attracting individual investors before the institutional ones.

The actual pricing of issues has followed conventional lines, with share price being determined by calculating the present value of future cash flows, discounted at the existing market rate. This has been the usual reference price for offering the shares to the private sector, though CORFO has on occasion adjusted the offer price upwards or downwards depending on the level of activity in and the direction of the stock market. In fact, on some occasions the existing exchange environment has been used to determine the channel for marketing shares. For example, public bidding has been used with a reservation price determined by the present value of future cash flows, rather than placement through the exchange when the

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**Table 10.1** Banking houses which have worked with CORFO

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<th>Company privatized</th>
<th>Investment bankers</th>
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<td>Chilener</td>
<td>Inversiones Boston and Inver Chile</td>
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<tr>
<td>Chilquinta</td>
<td>BICE Chileconsult</td>
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<td>Chilmetro</td>
<td>Inver Chile and Tanner</td>
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<tr>
<td>Colbun</td>
<td>Banco Santiago and Shearson Lehman Hutton</td>
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<tr>
<td>CTC</td>
<td>Larrain Vidal and Paine Webber</td>
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<tr>
<td>ENDESA</td>
<td>BICE Chileconsult and N.M. Rothschild</td>
</tr>
<tr>
<td>ENTEL</td>
<td>Ban Chile</td>
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<tr>
<td>IANSA</td>
<td>Raimundo Serrano Stock Brokers</td>
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<tr>
<td>LAN Chile</td>
<td>Chase Manhattan Bank</td>
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<td>Pehuenche</td>
<td>BICE Chileconsult and N.M. Rothschild</td>
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<td>Pilmaiquen</td>
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<td>Pulingue</td>
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<td>SOQUIMICH</td>
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trading environment of the exchange was judged to be apathetic. The financial advisors, however, have normally acted only as agents, not as underwriters, providing advice on strategy and handling the marketing through a wide variety of media.

**Conclusions**

The history of Chilean privatization, as illustrated in these three cases, shows unmistakably how intimately the programme has been linked to broader public purposes. In every case, even the small instance represented by the computer company, significant externalities have been either the objective or the by-product of public policy. In the computer case, the aim was that of protecting employment, and the by-products were those of generating employment, promoting capital accumulation (including human capital) and production capability in a strategic industrial sector, and releasing entrepreneurial ability. Although only one company was discussed, the example stands for a broad category of cases in which market-disciplined management has demonstrably led to an expansion of output, employment, and income. In this there is a sense in which the notion of scale economies seems to apply.

In the case of the electric power industry, privatization served to rationalize the use of resources, strengthen the capital market, broaden the distribution of wealth, and generate the capital for further expansion of a basic industry. The accomplishments show, moreover, the benefit of learning from experience, and represent therefore a sort of capitalized social learning. In the case of the financial intermediaries, the methods employed by CORFO for privatization have contributed to building up the institutional underpinnings of the stock exchange in particular and the capital market in general, thereby encouraging a higher rate of capital formation.

Indeed, the very first phase of privatization, that focused on reconstituting the production system, and the second as well, when fiscal objectives were the driving force, show a public purpose to have been the key consideration, even when substantial errors of implementation were also revealed to be part of the policy design. For this reason, it may make sense to conceptualize a privatization programme as a public good, even when the particular instances of privatization may seem to fall into the category of private goods.

*Tout ensemble,* the implementation of privatization policy is intended clearly to confer benefits that are shared by all members of the system and for which consumption is, in a sense, non-rival. Though it could be argued that the system as a whole is objectionable, it has never been the case that the valuation of a public good is unassailable by all concerned, even in the classic textbook examples. National defence, for instance,
may be judged negatively by pacifists. Flood prevention, no less negatively by sellers of flood insurance. Thus, whatever the ultimate merits of the market system as such, the privatization of production can properly be treated as a public good, provided the scope of privatization is sufficiently wide to generate effects felt, in greater or lesser measure, by the other components of the system.

### Regulation

Among the public goods produced with privatization, ironically, was a considerable body of new regulation. This was not only the new regulations that were required for a satisfactory functioning of the capital market or, indeed, a socially adequate privatization procedure itself. It also entailed, as mentioned, the passage of a new framework of regulation in the public utility field, for the natural gas industry, electricity, and telecommunications.

For natural gas, a new law was promulgated in February 1979 setting up a register of firms authorized to operate in the different branches of the industry, and new reglamentos were issued in 1983, 1985, and 1986, modifying the basic legislation that had been issued in 1931.

For electric power, a new general law regulating the industry was passed in 1982 and a supervisory agency was established in 1984, along with a large number of reglamentos in 1983 and 1984. (Decrees on new technical norms for natural gas and electricity were also issued in the 1970s and 1980s.)

In the case of telecommunications, the basic regulatory step came in 1977 with the creation of the Subsecretariat of Telecommunications in the Ministry of Transport and Telecommunications, followed by a general law in 1982 and several sets of new reglamentos and decrees on new technical norms.

It would be a grave mistake, in other words, to associate privatization solely with deregulation and laissez-faire. In key respects the Chilean experience shows that privatization also brings the need for a substantial body of re-regulation—a marked expansion and alteration of the regulatory regime to ensure that new arrangements in industrial structure and business organization conform to socially acceptable norms.

### Managing the privatization process

This much said, however, it must also be recognized that the general efficiency with which privatization was achieved in Chile also tells us something about its cost-benefit ratio. Part of the reason that the policy could be implemented so comprehensively has to do with the managerial competence of CORFO, the presiding institution in the process, as it were. Had this entity been less adept in managing the process there is no doubt
but that a number of serious problems would have crept in to throw the programme off course.

But the contribution of CORFO does not stop here. Thanks also to the general supervisory ability of CORFO over the years in its capacity as the lead institution of the parastatal sector, that sector as a whole, save for the aberrant 1970–3 interval, has been relatively well managed. Thus, the ease with which privatization could be carried out bespeaks the substantial human and organizational capital that had been accumulated in the parastatal sector over the course of many years. When due credit is given to this institutional base, the net benefits of privatization, at least in terms of short-run X-efficiency gains, would appear to be somewhat less impressive than the scope of the process might suggest.3

Notes

1 The research on which this chapter is based was conducted in Chile during the summer of 1988. Extensive use was made of field interviews and a review of documentary sources at CORFO and the Superintendencia de Valores y Seguro. Also helpful were then unpublished studies by Jorge Marshall, Rolf Luder, and Dominique Hachette.

2 SAESA and FRONTEL were actually cases of reprivatization.

3 For support that made the research possible, I am indebted to the Tinker Foundation, the Woodrow Wilson International Center for Scholars, the Hewlett Foundation through a grant to the L.B.Johnson School of Public Affairs of the University of Texas, and the Commission on International Migration and Cooperative Economic Development.
Chapter eleven

The effectiveness of public enterprises in Greece

Spyros K. Lioukas and Demetrios B. Papoulias

As in many countries, there is a critical public debate in Greece on the performance of state enterprises, with media reports of incidents or impressions of malfunction and inefficiency. Criticism is usually levelled at:

1. the low productivity of public enterprises, in particular that of their employees, who are perceived to return less than the privileges they assume;
2. the lack of innovation and management initiative;
3. the deficits in ‘problem’ firms and in some utilities.

State bureaucracy and tight controls, political interventionism, and outdated management systems and structures are assumed the main causes of low performance. Much of this criticism, however, is based on selective experience and partial case study, rather than on systematic research and analysis of performance, and the factors which affect it.

The present study provides evidence on the issue of public enterprise performance in Greece. It focuses on certain indicators of performance and attempts to highlight their relationship with certain key environmental and organizational factors. The study draws upon statistical analysis of a sample of about 110 Greek public enterprises.

For the purpose of the present paper, public enterprises are defined as those enterprises whose majority capital is owned by the state at large, and which are engaged in ‘business-type’ activity, having their own balance sheet and profit-and-loss account. This population in Greece includes about 250–300 enterprises.

Public enterprises in Greece occupy a significant part of the economy. Their total investment in 1985 accounted for more than 25 per cent of gross fixed capital formation in the economy as a whole. Public enterprises dominate in the banking, energy, transport, and
Country experiences

tele communications sectors. Their presence in manufacturing is moderate in numbers, but considerable in assets. A smaller participation appears in commerce. The sample used in the present study includes business-type enterprises from all these sectors. It resulted from a survey based on a questionnaire which was dispatched to most of these enterprises by the Ministry of National Economy (Secretariat of Public Enterprises).

Effectiveness and its ‘determinants’

Assessing the performance of public enterprises is a theoretical challenge in itself, and has been far from resolved in the literature. In the context of a typical public enterprise, one finds both political and social considerations intertwined with economic or business-oriented criteria. Because of its proximity to the governmental and political arenas, it faces multiple goals with fuzzy, often unstable, priorities, reflecting the constantly changing equilibrium in the ‘political markets’.

It is well known that traditional profitability criteria, such as surplus or deficit and return on capital employed, are of limited value as indicators of performance. The information they provide is heavily distorted by government regulation and controls on strategic, managerial, and operational matters. Protected markets, subsidies, and pricing controls are important determinants of profit or loss. Social goals and policies are often imposed by government without compensation for the extra costs incurred and for the divergence from commercial and economic principles of operation.

The classical criteria of goal achievement in evaluating performance are not easily applicable in the case of public enterprises. Goals range from formal official objectives to those actually pursued by the enterprise, or implied from its decisions and actions. In most public enterprises the official objectives laid down by statute are too general to guide decision-making. Actual goals, on the other hand, are multiple, partly conflicting, with unclear priorities and trade-offs. Problems stem from both the multiplicity of controlling bodies, which have different views and perceptions on what the goals should be, and the politicization of many enterprise decisions. Trade-offs between conflicting views and values are affected by the wider political process. This often results in intensive political interventions in enterprise decisions and actions. In this political process, distinctions between ‘good’ and ‘bad’ performance cannot be based solely on profitability and efficiency criteria.

Under these conditions it would be useful to use multiple indicators, in line with the models advanced in the wider literature on organizational effectiveness. These include criteria such as goal achievement, ability to
acquire resources, flexibility/adaptability to a changing environment, participants’ or constituency satisfaction, and social justice.5

Measures of effectiveness

The present study uses two sets of effectiveness indicators, related to ‘efficiency’ and to ‘innovation’. The first set includes three commonly used efficiency indicators:

1. **profitability** is measured by the ratio of profits or losses to the capital employed (return-on-capital [ROC]); despite its shortcoming, profitability is a focal point of the public debate on the performance of public enterprises;

2. **total factor productivity** is measured by the ratio $VA/(K+L)$, where $VA$ is valued added and $K,L$ are monetary values of capital and labour inputs respectively; in the case of public enterprises, this indicator appears to be more reliable than profitability, in the sense that it is less sensitive to accounting conventions and distortions;

3. **capacity utilization ($u$)**, which because it depends on the particular production process and technology used, a relative measure was employed: this shows how average utilization compares with that of similar industries in domestic markets or abroad; it is however, a subjective measure based on managers’ perceptions.

The second set has three indicators of ‘innovation’:

4. **acceptance of new ideas**, a subjective measure showing the degree to which adoption of new methods and ideas is relatively easy, or meets strong reactions;

5. **organized support to new ideas** measures the extent of systematic, organized support to new ideas and innovation, as perceived by the managers themselves;

6. **modernization investments** is a composite measure showing the existence of investment initiatives and programmes—in the design of new products or services, the developments of materials technology, the introduction of information technology, in the production and administrative systems, and the modernization of production facilities.

‘Determining’ variables

With respect to the factors that may potentially have an impact on enterprise effectiveness, the following are included:
1. *intensity of state control* is a composite measure which gives the average of perceived intensity of control over resources (manpower, finance, contracts, and supplies), pricing, and strategic decisions which shift substantially the boundaries of enterprise activity (e.g., diversification, large investments, or divestments);

2. *competition*, which is represented by two measures:
   (i) perceived intensity of competition in domestic markets;
   (ii) exposure of the enterprise to international competitive markets through exports and operations abroad;

3. *internal decentralization* within the enterprise is a composite measure which is the average of the perceived degree of influence that subunits and departments exert on budget allocations, investment and purchasing decisions, personnel recruitment, and production planning;

4. *internal management systems*, where the following composite variables were used, as assessed by the managers themselves:
   (i) sophistication of corporate plans, measured by the depth of analyses performed in the five-year plan (examination of scenarios, parameters affecting demand and cost, risk analysis, organizational analysis);
   (ii) development of computerized information systems (CIS) in accounting and finance, personnel, materials and purchasing, sales, production, administrative support, and top management;
   (iii) existence of formal personnel evaluation systems (dummy variable);

These variables provide an indication of the development of the internal management systems and processes. Planning, CIS, and personnel evaluation systems are areas where much of the modernization effort is focused in Greek public enterprises.

**Results**

A cross-section analysis of the effects of these factors was undertaken, based on alternative multiple regression equations for each performance indicator. The significant effects which are supported by the regression results are outlined in Table 11.1. It appears from this table that across the spectrum of publicly owned enterprises, the following broad relationships obtain:

1. the intensity of state control is negatively associated with the innovation and capacity utilization indicators;
2. domestic competition is negatively associated with profitability and total factor productivity, suggesting that monopolies and protected industries are more profitable; by contrast, exposure to international
competition is positively related to three performance indicators: ROC; capacity utilization; and receptability to new ideas;
3. decentralization of decision-making is positively associated with all ‘innovation’ indicators.
4. development of internal systems is generally positively associated with effectiveness, which appears both in the ‘efficiency’ and ‘innovation’ indicators.

Table 11.1 Indicative relationships between effectiveness and selected explanatory factors for the population of public enterprises

<table>
<thead>
<tr>
<th>Explanatory factors</th>
<th>Efficiency indicators</th>
<th>Innovation indicators</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>VA</td>
<td></td>
</tr>
<tr>
<td></td>
<td>ROC (1)</td>
<td>K + L (2)</td>
</tr>
<tr>
<td></td>
<td>u (3)</td>
<td>Accept. (4)</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Org. (5)</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Modern. Inv. (6)</td>
</tr>
<tr>
<td>(1) Intensity of state control</td>
<td>–</td>
<td>–</td>
</tr>
<tr>
<td>(2) Competition</td>
<td></td>
<td></td>
</tr>
<tr>
<td>• domestic</td>
<td>–</td>
<td>–</td>
</tr>
<tr>
<td>• exports</td>
<td>+</td>
<td>+</td>
</tr>
<tr>
<td>(3) Internal decentralization</td>
<td>+</td>
<td>+</td>
</tr>
<tr>
<td>(4) Development of internal systems</td>
<td></td>
<td></td>
</tr>
<tr>
<td>• planning</td>
<td>+</td>
<td>+</td>
</tr>
<tr>
<td>• CIS</td>
<td>+</td>
<td>+</td>
</tr>
<tr>
<td>• personnel evaluation</td>
<td>+</td>
<td>+</td>
</tr>
</tbody>
</table>

Note: All + and - denote statistically significant relationships, positive and negative respectively, at a 0.10 level. Blanks indicate that no significant relationships were found. Results were derived from multiple regressions of each effectiveness indicator on explanatory variables (Lioukas et al. 1989).

Overall, a conjecture which emerges from these relationships is that the effectiveness of public enterprises is increasing with less government control, exposure to international competitive markets, decentralization of decision-making inside the enterprises, and development of internal management systems by the enterprise. Policy interventions can be proposed along the lines suggested by these factors. These may have a positive effect on effectiveness, at least with respect to the efficiency and innovation dimensions outlined above.

A discussion of the above relationships in the context of Greek public enterprises follows. This discussion is extended beyond strict statistical
### Table 11.2 Intensity of control applied by ministries and holding organizations

<table>
<thead>
<tr>
<th>Areas of control*</th>
<th>Ministries</th>
<th>Energy</th>
<th>Agricult. bank</th>
<th>Indust. devel. bank</th>
<th>Commercial bank</th>
<th>National bank</th>
<th>Holdings for 'problem' firms</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Transport</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1. Strategic decisions</td>
<td>7.8</td>
<td>6.5</td>
<td>6.6</td>
<td>6.0</td>
<td>5.0</td>
<td>4.5</td>
<td>6.7</td>
</tr>
<tr>
<td>(expansion etc.)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2. Pricing</td>
<td>8.3</td>
<td>5.3</td>
<td>4.1</td>
<td>3.5</td>
<td>3.6</td>
<td>4.7</td>
<td>2.7</td>
</tr>
<tr>
<td>3. Human resources</td>
<td>6.5</td>
<td>5.5</td>
<td>5.9</td>
<td>4.7</td>
<td>5.0</td>
<td>4.2</td>
<td>4.9</td>
</tr>
<tr>
<td>4. Financial resources</td>
<td>9.8</td>
<td>7.3</td>
<td>6.4</td>
<td>6.9</td>
<td>6.0</td>
<td>5.6</td>
<td>5.8</td>
</tr>
<tr>
<td>5. Purchasing</td>
<td>8.8</td>
<td>7.3</td>
<td>4.4</td>
<td>4.0</td>
<td>4.4</td>
<td>6.2</td>
<td>4.0</td>
</tr>
<tr>
<td>Total control</td>
<td>7.5</td>
<td>6.0</td>
<td>5.3</td>
<td>5.3</td>
<td>4.8</td>
<td>4.7</td>
<td>4.9</td>
</tr>
<tr>
<td>(Number of enterprises**)</td>
<td>(8)</td>
<td>(8)</td>
<td>(25)</td>
<td>(11)</td>
<td>(10)</td>
<td>(11)</td>
<td>(9)</td>
</tr>
</tbody>
</table>

* In a scale from 1 (no control) to 10 (very tight control). Measurement was based on enterprises’ perceived degree of control in 13 separate dimensions. Questionnaire scales were from 1 to 5, but were transformed here to a scale from 1 to 10

**This refers to the most important enterprises in the sample for each controlling organization.
results, and encompasses our reflections on personal experience. Suggestions are also provided for policy directions that seem promising in improving enterprise effectiveness.

**Discussion of results and policy directions**

**Control framework**

The major characteristics of the control framework in Greece are;

1. it is *tight*, in all sectors of the economy for most types of publicly owned enterprises;
2. it focuses on *a priori* approvals;
3. it includes many controls which cover all enterprise activities (multiplicity of controls);
4. it allows intensive informal interventionism by government and politicization.

First, state control on public enterprise appears to be intense throughout. The controls exercised cover all major enterprise decisions: major investments, differentiation and expansion in new products and markets, pricing, acquisition and mobilization of human and financial resources, top management appointments, purchasing and contracts, and various other day-to-day operational decisions. In general, enterprises in the sample which completed the questionnaire state that they have little autonomy.

Table 11.2 provides an indication of the average intensity of controls in certain groups of enterprises controlled by ministries and by ‘holding’ organizations. It appears that:

1. perceived control is intense under all supervision regimes;
2. enterprises directly controlled by the Ministries are subject to more intensive control than enterprises supervised by holdings;
3. there are differences among ministries and holding organizations. The Ministry of Transport appears to exercise the closest control. The commercial banks (National, Commercial) seem on average to allow more autonomy to their enterprises than investment banks (Agricultural Bank, Industrial Development Bank).

The specific control averages suggest that there are important differences in control regimes across the population of public enterprises.

The second major feature of control practice is that it is orientated to *ex ante* controls, based on a plethora of *a priori* approvals. In fact this is a wider characteristic of public administration in Greece. Supervising
bodies generally require the approval of decisions before they are implemented. This is partly enforced by regulations, and also by established practice. Sometimes, however, it may reflect the inability of state managers to assume responsibility and take initiatives. Thus it may conceal managerial inefficiency.

Established control practice results in issues and decisions being taken to many different supervisory bodies in search of approval. The process is focused on individual decisions and *ad hoc* approvals, rather than a consideration of total programmes, plans, and targets.

A striking absence of clear policies and objectives aggravates the problems with this piecemeal system of approvals. To an extent, government’s will and interventions may be internalized at the stage of initiating decisions inside an enterprise. This is helped by government’s power to appoint the majority of the board of directors and the top management, which is extensively exercised in practice. Nevertheless there have been occasions when ministries have withheld approval of decisions already taken by an appointed board of directors. As a result the attention of most enterprises is directed to the government. Problems of overloading at the top and delays in decision-making are endemic.

A third characteristic of the control framework is the multiplicity of individual controls applied. As explained earlier, controls cover all major activities of the enterprise: strategic, managerial, and operational. They range from important decisions on large investments and pricing, to trivial decisions on software purchasing, vehicle utilization, and foreign travel approvals. Multiple supervising bodies are also involved in certain of these approvals. A problem therefore arises with respect to the different views of those involved, and the asymmetry in information and specialized knowledge which is concentrated in the larger enterprises.

Much inconsistency arises between these multiple controls. For instance a major investment project receives a series of approvals: first, indirectly as a component of the five-year plan which is submitted in the sponsoring ministry; second, as a separate investment scheme; third, further approvals are received with respect to implementation contracts and supplies, both through the submission by the enterprise of an annual purchasing plan to the Ministry of Commerce and through controls on individual contracts; fourth, approvals are sought for human resources required for the new project etc. All these take place in different points of time, involve different controlling organs, and cover various aspects of the project. There is no guarantee that smaller partial controls and restrictions are in line with grand project approvals or that they will follow smoothly.

Fourth, informal ‘behind-the-scenes’ interventionism abounds, often for private or partly political reasons. Political survival and maximization of political capital, or minimization of political cost, are also widely used criteria in decision-making, in addition to technical and economic
criteria. Political interventionism often takes place through the government-appointed directors. Survival for top management is related to the degree to which they are able to understand the motives of ministers, politicians, or simply officials in key positions, and to achieving the balance of ‘political’ and ‘economic’ effectiveness which would satisfy these controllers in power. Disagreement and criticism of government are seldom a recipe for survival. Management can affect the outcome of this process by political mobilization and lobbying, not by technocratic arguments alone.

Examples of political interventionism can be found in many enterprises, particularly with personnel recruitment. Overmanning of many public enterprises in administrative personnel is a striking example. For instance during the period 1984–5 Olympic Catering appointed over a thousand people, who, as was widely admitted, were not necessary. Most of them were merely a result of political intervention, an outlet of the pressures exercised on politicians by voters seeking a public post. This is a well-known phenomenon in Greece whose intensity peaks commonly before elections.

This tight control framework, in conjunction with dependence on the state for resources, subsidies or other favours, brings intensive informal interventions. Politicians acknowledge in theory the need for top management autonomy, but in practice find it difficult to resist the temptation to intervene at will. Public enterprises provide them with an opportunity to control the allocation of considerable amounts of resources away from the very visible and highly politicized process of public budgeting. Moreover, this informal interventionism allows politicians to distance themselves from enterprise decisions when these prove unpopular.

The above underlying factors produce the negative association between intensity of control and effectiveness which was found in the sample (see Table 11.1). Some plausible directions for improvement follow from this discussion.

1. Granting public enterprises more autonomy is likely to lead to improvement of their effectiveness, at least for the efficiency and innovation dimensions tested in this study. However, this has to be considered in the wider context of social and market-type controls. What would happen if enterprises are given much autonomy without strengthening other types of control?

2. Shifting the emphasis to *ex post* and *a posteriori* controls, for example through auditing and performance evaluation against agreed plans and targets, is expected to have positive effects on performance. This would entail a radical transformation of the existing public management philosophy and may therefore impose special difficulties in implementation.
3. Reduction of multiple controls to a few, more comprehensive ones should also be considered. For example, introducing total cost targets, external financial limits, or approval of total plans, may render some of the existing partial controls unnecessary. Such a rationalization of controls would relieve many enterprises from dysfunctional overload at the top and heavy bureaucracy associated with it.

4. Measures which limit some unwanted political interventionism should be introduced. For example, a system of *ex ante* compensation for interventions, together with a publication by the enterprise of interventions received and their costs, would be helpful. Extending the stability of top management, through guarantee of a minimum office period, restrictions in recall procedures, openness in the selection of top managers (perhaps use of parliamentary committees) are other measures which should be considered.

It is obvious, however, that all these directions for reform touch the wider political and administrative system of the country. Some recent examples, with participation of interest group and employee representatives on the boards of directors (‘socialization’ measures), introduced into several enterprises, have shown that devolution of the state’s power is not easy to implement.

*Competition*

The population of publicly owned enterprises includes those which operate in competitive environments, both in domestic markets and internationally. Table 11.3 gives the proportions of enterprises in our sample, classified according to whether they are exposed to competition in domestic markets and in export markets. It appears that 19 per cent of the enterprises face weak competition or no competition at all, while 28 per cent face considerable competition, both at home and abroad.

Figures in parenthesis in Table 11.3 suggest that average return-on-capital is negative in three cells (about -6 per cent or -7 per cent) and zero in one. This shows that the state enterprises sector was running at a loss, in the period 1983–5.

One of the interesting findings is the positive effect of exposure to international competition. Greek public enterprises involved in competitive export markets have better profit performance than those not involved in export markets, or involved only through bilateral trade agreements (virtually no competition). The benefits of exposure to international competition are clearly evident. Table 11.3 shows that profit performance of enterprises which are involved in export markets but face no competition in domestic markets is particularly superior. Are profits in this case due to exploitation of domestic monopoly positions or to benefits arising from exposure to international competition? This
Table 11.3 Classification of public enterprises according to competition in domestic and export markets

<table>
<thead>
<tr>
<th>Competition in domestic markets</th>
<th>Competition in export markets</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>No (%)</td>
</tr>
<tr>
<td>Weak or none</td>
<td>19</td>
</tr>
<tr>
<td></td>
<td>(−6.1)</td>
</tr>
<tr>
<td>Considerable</td>
<td>43</td>
</tr>
<tr>
<td></td>
<td>(−6.8)</td>
</tr>
<tr>
<td>Totals (%)</td>
<td>62</td>
</tr>
</tbody>
</table>

Notes: 1 Figures in parentheses are average rates-of-return for years 1983, 1984 and 1985.
2 'No' competition in export markets means enterprises not involved in exports or involved only through bilateral trade agreements ('non-competitive').

is a question which cannot be answered on the basis of the information available.

Table 11.1 suggests that capacity utilization and receptability to new ideas is also positively associated with exposure to international competition. So a positive relationship between openness to international competition and performance is confirmed for both efficiency and innovativeness measures.

Results for domestic competition, however, are opposite. Table 11.3 suggests that enterprises facing no competition or weak competition in domestic markets have, on average, slightly better profit performance. Table 11.1 confirms this result when all factors are included together in the analysis. It also suggests that a similar negative effect exists between the productivity indicator and intensity of domestic competition. So monopolistic enterprises facing no competition or weak competition in domestic markets seem to have a superior profit and productivity performance. It may be that in a period when most industry sectors in Greece were facing profitability problems, monopolies were able to secure better profits, or rather smaller losses. The negative result for the productivity indicator runs against common expectations.

Overall the benefits of competition are confirmed across the sample of public enterprises only with respect to export markets. This becomes particularly important in view of developments towards open EC markets. The overly regulated markets, however, and the state's permeative presence in all sectors of the economy may reduce the reliability of this cross-section statistical evidence.
There are various ways to increase competition and reap its assumed benefits. Specific measures can be taken to restructure the external and internal environment of public enterprises:

1. **external environment**

   - encouraging or promoting the development of competitors in sectors dominated by monopolies, if this is feasible, for example in telecoms and transport;
   - dismantling protectionist measures and barriers to entry;
   - challenging the markets of monopolies by threatening to reduce the scope of their activities or allowing competition for the monopoly (through tendering);
   - exposing public enterprises to international markets, for example by removing restrictions to imports and promoting international cooperation.

2. **internal environment**

   - introducing ‘internal markets’ in large enterprises, for example by dividing their activities into smaller semi-autonomous units possibly competing among themselves, or simply by promoting internal comparisons and ‘leagues’;
   - increasing subcontracting and open bidding processes for parts of enterprise activities that can be undertaken by external firms, for example some administrative services, maintenance, and construction;
   - controlling ‘creeping nationalization’ by establishing economic criteria for enterprise expansion and comparisons with alternatives provided by the market.

All the above measures, however, have to be tailored to the specific conditions and structures in each enterprise.

Public opinion in Greece, though critical of the subsidies and protectionism enjoyed by some enterprises, has not yet turned to competition. There are vested interests and social groups which would raise considerable opposition to efforts to increase the exposure of public enterprises to competitive pressures—in particular the unions, which equate competition with private ownership, and the industries themselves. It should be noted here that similar reactions were experienced in other western countries which attempted to introduce liberalization measures. Quite relevant is the preference of regulation which some enterprises have shown during their fierce objection to deregulation programmes, and the pressure exercised by some nationalized
industries in the UK to be privatized as single undertakings, for example, British Gas, British Airports Authority, and British Telecom. In Greece the strength of such reactions has not yet been tested.

**Internal decentralization**

Research findings show that internal decentralization is positively associated with enterprise innovation (see Table 11.1). This is also indicated in Table 11.4, which gives the averages of the return-on-capital and of the innovation indicators in four cells: low-high state control and low-high decentralization. A measure of decentralization was obtained by considering the degree of influence which subunit

or departmental managers have on important decisions (see above). Results suggest that decentralization is associated with better performance, even when state control is high (Tables 11.4 and 11.1).

It is often argued that tight state control is the main cause of centralization within an enterprise. At first this seems to be supported by the negative correlation obtained between the intensity of state control and decentralization. Such arguments, however, may often conceal management’s unwillingness or inability to decentralize. Results suggest that internal decentralization alone can make a positive contribution to effectiveness (results in Table 11.1 for the intensity of state control and other factors), so it would be pursued on its own merits.
Management’s difficulties in decentralizing may come from pressures or reactions of pressure groups, mainly unions, top managers themselves, or the controlling authorities. A polycentric decentralized model of organization, with many enterprises partly overlapping in their activities and competing among themselves, has been rather suppressed in public debate. For some people this model would amount to a lack of co-ordination, duplication of effort, and ultimately a waste of resources.

Instead, co-ordination through a tightly organized hierarchy, of the Weber or Taylor type, more often has been supported. Similar phenomena were also observed internally in some enterprises which contemplated decentralization schemes (for example electricity, Olympic Airways).

Implementation of decentralization schemes would also require the development of mechanisms for controlling semi-autonomous units or departments within an organization. For example, establishing mutual commitments through planning and budgeting processes, monitoring and control mechanisms and procedures, all require managerial knowhow and effort. Skilled managers who would implement such systems are a scarce resource in a developing country with limited industrial experience. Confusion about the design of such internal mechanisms were evident in the modernization plans of several public enterprises.6

Internal systems

The internal management systems and processes considered in the analysis were: sophistication of the corporate plan, development of computerized informations system (CIS), and the use of formal personnel evaluation systems. These systems or processes constitute focal points for reform in enterprises and those in control.

Results show that a positive relationship exists between the development of such systems and most measures of effectiveness. The consistently positive relations with all indicators and measures is striking (see Table 11.1). Such results are in line with arguments advanced in other contexts. For instance, the positive association between certain performance indicators and formal planning is well documented in the literature. Although such processes and systems may be associated with more formalization and perhaps bureaucracy, their effect is likely to be positive.

This result is particularly significant for Greek public enterprises, whose systems are rather underdeveloped. For instance more than 50 per cent have no formal personnel evaluation system. About 30 per cent of the enterprises in the sample do not formulate a five-year plan, or an equivalent. Those operating under competitive conditions have more sophisticated planning both in terms of existence of corporate plans and also depth of analyses performed in the context of corporate plans. More developed systems can be found in enterprises which co-operate with multinationals or are involved in similar operations. This phenomenon of
relative underdevelopment seems to extend to most Greek firms, private and public. So any lag in management technology which may exist would perhaps be better described by the distinction ‘traditional Greek vs multinational’ enterprise rather than the distinction ‘public vs private’ enterprise. Thus systems developed by multinationals and tested in the international league should be considered for introduction in Greek public enterprises.

**Conclusion**

The present study was based on two working assumptions. First, organizational effectiveness is multidimensional and so, especially in public enterprise, multiple effectiveness measures are required. Secondly, effectiveness depends on certain environmental and internal organizational factors.

Using this analytical framework some main ‘determining’ factors were considered which focused on the effects of state control, competition, internal decentralization, and development of internal management systems. Their relationships with selected performance indicators were tested using a cross-section sample of about 110 Greek public enterprises.

The results broadly support certain policy directions which are at the heart of public debate on the modernization of state industries. The major directions are:

1. loosening of state control: measures can be taken such as reduction and rationalization of existing controls and approval procedures, with emphasis on *ex post* rather than *ex ante* control, and depoliticization of management;
2. exposure of public enterprises to competition, particularly in international markets;
3. organizational and managerial modernization of public enterprises through internal decentralization and development of internal systems and processes.

To some extent these policy directions and related measures can be implemented internally by enterprise management. Certain measures, however, require considerable support from government. All these reforms have to pass not only the test of technical, economic, and operational feasibility, but also the test of political acceptability. Certain long-established traditions and trends in administrative and socio-political systems have to be considered, such as the long-standing emphasis on *a priori* approvals of individual decisions, protectionist structures, and centralization. Overall, our personal evaluation is that gradual, incremental
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introduction of measures along these dimensions would be more feasible
than drastic, over-ambitious changes.

Notes

1 An earlier version of this paper was presented at the CIRIEC Conference on
Public Enterprises, held in Athens in February 1989.
2 On the definition aspects of public enterprises or ‘publicness’ see, for example,
Ramanadham 1984; and Bozeman 1988.
3 Enterprises owned by local authorities, co-operatives, purely regulatory bodies
as well as organizations engaged in ‘non business-type’ activities such as
social and community services including health, education and cultural, and
research organizations have been excluded from the present research.
4 See CEEP Review 1984, section for Greece.
6 These plans were initiated by the Secretariat of Public Enterprises, Ministry
of National Economy.

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Part four

Specialist topics
Chapter twelve

Reflections on the role of the World Bank in public enterprises and privatization in Africa

Myrna Alexander

The World Bank, as one of the principal development finance institutions in sub-Saharan Africa, has helped a large number of governments in shaping their policies and practices toward public enterprises. At the end of 1988, the Bank was supporting programmes of public enterprise reform in over thirty-four countries in the Africa Region. In no other region are the Bank’s activities on public enterprises as extensive and pervasive. This chapter looks back at the evolution of the Bank’s public enterprise reform activities since the late 1970s, with particular emphasis on sub-Saharan Africa, and then examines the Bank’s approach and experiences in such reforms including privatization.

The nature and character of the world bank

The Bank’s main goal is economic development of its member countries. Through its financing, the Bank supports investments that contribute ultimately to increased economic and social welfare. While much of this support was originally focused on building up the base of physical infrastructure, the scope of the Bank’s activities has expanded over time so that financing is now provided for investments in a wide range of sectors, including education, health, nutrition, and population, in addition to productive activities in agriculture and industry. Total Bank group lending in the fiscal year ending 30 June 1988 amounted to US$19.2 billion equivalent, with US$2.9 billion or 15 per cent for Africa. The Bank and the European Economic Community (EC) rank as the largest multilateral doners for Africa. In the last two years, 1986/7 and 1987/8, the Bank’s net transfers have averaged over US$900 million equivalent annually, as compared about US$800 million for the EC.

In support of its lending activities, the Bank studies economic performance and structures of its member countries. This ‘country economic and sector work’, as it is called, formulates lending
strategies and increases understanding of effective development policies. Armed with these studies, the Bank provides technical advice on investments, expenditure plans, and policies at both macroeconomic and sectoral levels. Through its publications, donor co-ordination meetings, and other means of information dissemination, the Bank’s work reaches a large audience in developing countries and the donor community. In its role as a development agency, the Bank acts as a catalyst to mobilize other donor financing, and helps governments in the formulation and implementation of particular development strategies.

Support for public enterprises

As a public institution, owned by its member-country governments, the Bank is mandated to provide financing for the benefit of eligible member governments. As a result, the primary focus of the Bank’s lending has been, both by nature and by statute, the public sector, and much lending has been to public enterprises which provide transport, water, power, port and telecommunication services, or produce goods in agriculture and industry. While it is not possible to estimate accurately the amount of the Bank’s financing for public enterprises, a safe assumption is that almost all of the lending in the areas of industry, ports, rail transport, water, and electricity have been in support of public enterprises. A significant portion of agricultural lending would also have been directed towards public enterprises. Since its inception in 1948, the Bank has, therefore, been one of the major sources of investment capital for governments to channel into public enterprises in developing countries.

In the years leading up to the international economic crisis of the 1980s, the Bank’s approach in lending to these enterprises was based on the assumption that they would perform as commercial entities, subject to an appropriate legal framework, balancing the interests of users and enterprises, typically monopolies that offer public services. That meant that enterprises were expected to be financially viable. The Bank’s policies were thus aimed at ensuring that enterprises met certain financial targets, consistent with the viability objective, and enjoyed a large degree of managerial autonomy. Essentially, the investments supported by the Bank were to be both economically and financially sound; enterprises were to be professionally managed and pursue their activities along ‘rational’ (i.e., profit-maximizing) economic and financial lines. The conditions typically included as part of lending agreements with governments specified rates of return on assets, debt-equity limits, and liquidity ratios, for example. Emphasis was on individual enterprises and performance at the level of the firm.
The need for change

Throughout the 1970s, the expansion of public enterprise sectors in most parts of the world, but especially in sub-Saharan Africa, was rapid. More than half of existing public enterprises in Africa were created between 1967 and 1980. As shown in Table 12.1, public enterprises occupy a dominant role in Africa, as compared to Asia and Latin America: they typically account for about 25 per cent of total public investment, and a sizeable share of formal sector employment. They also account for as much as one-third of domestic credit and, in some extreme cases, 50 per cent of external public debt.

As debt crisis of the 1980s affected most developing countries, it was quickly recognized that public enterprises were a major part of the problem. The link between public enterprises and public sector deficits has been studied in detail (Nair and Filippides 1988). The conclusions are that public enterprises have contributed little to national savings, and are a major source of savings-investment gaps, which in turn are closely correlated with current account imbalances. Thus, in many countries in sub-Saharan Africa, where public enterprises play a dominant role, poor

Table 12.1 Public enterprise share of output, investment, and employment

<table>
<thead>
<tr>
<th>Indicator^</th>
<th>Share (%)</th>
<th>Range of percentage shares</th>
<th>Number of countries</th>
</tr>
</thead>
<tbody>
<tr>
<td>Output (GDP)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sub-Saharan Africa</td>
<td>15</td>
<td>4–48</td>
<td>18</td>
</tr>
<tr>
<td>Asia</td>
<td>3</td>
<td>1–7</td>
<td>6</td>
</tr>
<tr>
<td>Latin America</td>
<td>12</td>
<td>2–28</td>
<td>8</td>
</tr>
<tr>
<td>Investment^c</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sub-Saharan Africa</td>
<td>25</td>
<td>8–54</td>
<td>12</td>
</tr>
<tr>
<td>Asia</td>
<td>17</td>
<td>10–56</td>
<td>9</td>
</tr>
<tr>
<td>Latin American</td>
<td>19</td>
<td>7–47</td>
<td>17</td>
</tr>
<tr>
<td>Employment (formal sector)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sub-Saharan Africa</td>
<td>14d</td>
<td>2–37</td>
<td>8</td>
</tr>
<tr>
<td>Asia</td>
<td>15</td>
<td>3–29</td>
<td>4</td>
</tr>
<tr>
<td>Latin America</td>
<td>5</td>
<td>1–10</td>
<td>5</td>
</tr>
</tbody>
</table>

Sources: Heller and Tait 1983, Nair and Filippides 1988, Swanson and Wolde-Semait 1988
Notes: ^Output and investment data for 1980–6; employment data for 1976–82
^Regional figures are median estimates of sample country data
^Either gross domestic investment or gross fixed capital formation
^A more recent figure is 25–30 per cent according to the data for 1980–6
enterprise performance has contributed to overall macroeconomic imbalances.

Much past investment proved to be of little worth. Donors lent large sums of money to enterprises, even though many of these investments were overly ambitious and ill suited to the realities of developing economies. Some lending, particularly by commercial banks, was entered on the grounds of country risk rather than an explicit appreciation of enterprise performance. Other investments were motivated by less noble objectives—commercial interests on the part of suppliers and personal gain on the part of public figures who were in positions to gain from the transactions. In extreme cases, public enterprises performed so poorly that they could not continue to function without direct government subsidy. Much support to enterprises, moreover, was hidden as governments gave monopoly privileges to enterprises, protected them from competition, and forgave payment of taxes. The costs to consumers through higher prices, and to economic development in terms of the opportunities lost by the diversion of resources to inefficient public enterprises, were undoubtedly high, though they have seldom been adequately quantified.

While experience varied and showed strong regional tendencies—performance in Asia has been consistently better than in Latin America, and that in Africa the worst of all—overall disenchantment with public enterprises soon emerged. As performance deteriorated, so did the interest of governments and many donors, including the Bank, to continue to provide financing to expand public enterprises or create new ones.

**Evolution of a new approach**

In response to the acute economic crisis facing Africa in the early 1980s, it was obvious that governments and the Bank had to reformulate their policies. It was not feasible for the Bank, which maintains strict standards of financial and economic viability for its operations, to finance new investments in public enterprises which were technically bankrupt. A prerequisite was a dramatic change in performance. The Bank was among the first donors to articulate a new policy regarding public enterprises. It has since become a strong advocate of public enterprise reform and closely associated with specific measures, such as privatization.

Changes took place both in the kinds of instruments the Bank used and its approach: the new focus was on broad macroeconomic and sector-wide policies, and a new form of lending called ‘adjustment lending’. Because of the importance of public enterprises in African economies, public enterprise reform became
an integral part of these adjustment operations, either as part of structural adjustment programmes or specific public enterprise programmes. Thus, the Bank now attempted to facilitate the process of policy reform, going much beyond its earlier role in financing investments directly.

This approach did not supplant the Bank’s earlier policies, but added new dimensions. Essentially, the change was to assess public enterprises from a global perspective, and to analyse the policy and financial issues facing governments in managing investments, across sectors, and in aggregate, not only enterprise-by-enterprise. While recognizing that enterprise performance improvements were vital and would continue to be the mainstay of the Bank’s activities, the shift permitted the Bank to deal with the underlying, systemic policies that have an impact on overall performance. Underlying this new approach to public enterprises, and unifying it with broader reforms of the macroeconomic policy framework, was the reliance on competitive forces, especially in those cases where there was no natural monopoly, to set prices, determine resource allocation decisions, and enforce discipline in the marketplace. Governments and the Bank began to shift their concerns from market failures—which had justified the creation of public enterprises—to bureaucratic failures—which resulted in poor enterprise performances. The reform of public enterprises, therefore, went hand in hand with reforms aimed at liberalizing and deregulating economies.

The first Bank-sponsored attempt to reform public enterprises in this systemic, cross-sectoral manner was in Senegal. A project to provide technical assistance to government and enterprises to improve performance was approved in 1978. Since then, efforts have become much more widespread, particularly in Africa. More than half of the sixty-four structural adjustment operations, approved by the Bank in the period 1980–8, were in Africa, and all included public enterprise reforms. In addition, four countries in Africa, plus Jamaica and the Philippines, have received adjustment programmes specifically and uniquely devoted to public enterprise reform.

At the end of 1988, about thirty countries in sub-Saharan Africa were actively undertaking some form of macroeconomic policy reform programme. This is in addition to a steady stream of investment lending which, as noted above, continues to benefit a significant number of public enterprises. The geographical distribution is wide. Bank-supported activities range from Mauritania to Madagascar, the Gambia to Nigeria, and Senegal to Somalia. Out of the forty-four countries that make up the African region, the Bank has been involved—through its economic and
sector work, project lending, and adjustment operations—in public enterprise reform in thirty-four of these.

**Common elements**

According to a recent review of the Bank’s adjustment operations, conducted by the Policy, Planning, and Research Division, the types of enterprise reforms supported under these programmes fall into three general categories: changes to the policy framework governing enterprise operations; changes to the institutional framework; and changes to the size and nature of governments’ holdings in enterprises (World Bank 1988). In addition, another important element, occurring in about half of the adjustment operations, was reform aimed at restructuring and improving performance of specific enterprises. These enterprises were normally a major fiscal burden and of significant socio-political importance. Most were in very poor condition and needed specific action in the short term to curb sizeable financial drains on the budget. The main features found in most of the public enterprise reform programmes supported by the Bank of Africa are summarized below.

**Rationalization of the sector**

The first step in these reform programmes supported by the Bank is typically to rationalize government holdings, in order to reduce the scope of government intervention in the economy, and concentrate scarce resources on activities that warrant public involvement. This is being done, for example, in Cameroon, Congo, Mauritania, Rwanda, Madagascar, Burundi, Uganda, and Guinea. Classification exercises help to sort out (1) those enterprises that are viable but no longer serve a strategic public purpose and hence could be divested; (2) those that have failed at achieving their purpose, are non-viable, and ought to be liquidated; (3) those that are no longer seen to require special status or independence from the rest of the public sector, and could be merged into another public agency or ministry; and (4) those that, because of an overriding public interest, would be retained in the public sector.

**Increasing competition**

For all enterprises—the retained and those to be privatized—an important element of reform is to increase competition where feasible, typically through the reduction of special privileges and protection either specially granted to public enterprises or more generally to all enterprises. One important and demonstrably effective feature is to eliminate monopoly status, through the abolition of quantitative restrictions and other trade restrictions, thereby exposing the public sector to competition from imports, such as in Mauritania and Niger, or by reducing barriers to entry,
allowing domestic competitors. Another approach, tried in Algeria and debated in Nigeria, is to create competition by breaking up large parastatal units into component parts or regional units. Other measures to liberalize price controls or equalize access to foreign exchange also work to increase the level of competition faced by public enterprises.

Privatization

Certain enterprises will be targeted for some form of divestiture, privatization, or liquidation. As experience has demonstrated in recent reviews (Berg and Shirley 1987, Vuylsteke et al. 1988), privatization is easier said than done, with many problems encountered in trying to sell moribund enterprises, especially in countries with investment climates that are not yet conducive to private interests. Moreover, there have been considerable difficulties encountered in making the process transparent, preventing abuse, and reducing conflict of interest between governments and potential buyers. Privatization has, nevertheless, advanced in several countries—notably Guinea, Togo, and Niger, which have sold a relatively large number of companies. Other countries—such as Ghana, Kenya, Malawi, Central African Republic, Congo, Mali, Mauritania, Senegal, and Côte d’Ivoire—have taken limited actions. A major programme of privatizations has recently been approved in Nigeria, involving some 100 enterprises.

So far, experience has shown that it is easier to sell small, profitable enterprises, especially those that do not demand much technological or managerial sophistication. These enterprises are also most likely to attract local investors. Since public enterprise sectors in Africa tend to include forestry, fishing companies, trucking companies, hotels, construction companies, and breweries, there is obviously considerable potential for such privatization. Where more capital is required and high demands place on management, foreign partners/joint ventures may be an alternative. However, in many countries, foreign ownership can pose political problems, and few countries are indifferent to the nationality of the purchaser. Even within local ownership, difficulties can arise due to the potential concentration of ownership among elites, selected ethnic or regional groups, and the lack of capital markets to distribute shares more widely. Experience has been most positive if there is wide participation by local investors, groups of employees, and management partners, with governments perhaps retaining non-controlling shares. The main success factor, however, seems to be the commitment of governments to pursue privatization aggressively, combined with high profile and politically important advocacy for the process.

In addition to outright sale of enterprises, a large and untapped scope for privatization exists through partial divestiture of selected activities that are no longer essential. This can be done by the contracting-out of
activities amenable to private involvement, such as repairs, canteen services, transport, and even accounting, billing, and collection services. This is particularly true of the very large enterprises and public utilities which can rarely be privatized fully. So far, interesting cases exist in infrastructure: for example, the contracting-out of road maintenance in Mali, the privatization of river transport in Congo, and the involvement of non-governmental organizations in the provision of water services in Rwanda. Other examples include the sale of public housing in Côte d’Ivoire, Botswana, and Lesotho, and the shifting of construction financing for housing to the private sector in Zimbabwe, Botswana, Swaziland, and Nigeria.

Restructuring and rehabilitation

Realistically, the Bank recognizes that many public enterprises can neither be privatized nor left to ‘wither on the vine’ because of their strategic interest. Most of these offer basic public services, or are involved in major exports. Efforts for these enterprises therefore mainly concentrate on restructuring, including rationalizing production, increasing prices, improving productivity through staff reductions, tightening up controls, better management of stocks and inputs, reconstitution of working capital, recapitalization and debt refinancing, improvements to billing and collection systems and procedures, plus internal and external audits. Examples of restructuring abound in Africa, ranging from transport in Zaïre, sugar factories in Côte d’Ivoire, rail services in Sudan, water supply in Guinea Bissau, iron ore in Mauritania, rice milling in Niger, cotton marketing in Chad, and banking institutions in Madagascar. In addition to helping to rehabilitate viable enterprises, through its investment lending, the Bank also provides assistance for management training, audits, and other improvements throughout the parastatal sector.

Specific issues of restructuring arise in the case of those enterprises that may be destined for privatization but are not yet attractive to private investors. Such enterprises may be ‘white elephants’ that never should have been built in the first place. In these cases, it may be best to leave these enterprises to ‘wither away’, since they can neither be sold as a going concern nor operated profitably, even on the basis of marginal cost pricing, without considerable protection. Experience in Guinea, for example, does not support rehabilitation prior to divestiture—even for those cases where the enterprises may eventually be economic—on the grounds that future buyers will rarely give full credit for what has been done. There could be cases where restructuring and rehabilitation does make sense prior to sale, especially if there was to be a public
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offering; however, such cases would be rare in Africa. Since a solid track record of profitability is needed, rehabilitation and restructuring prior to public offering implies a very long time of continued government ownership. Efforts would, therefore, have to be combined with privatization of management, through leasing or management contract agreements, until the enterprise can be sold to the general public.

Government-enterprise relations

In addition to reforms at the enterprise level, a large part of the Bank’s efforts is directed at altering the institutional framework for government supervision of enterprises. The dual objective is to increase the level of autonomy enjoyed by parastatals, and the level of their accountability. The underlying rationale is that enterprise management will perform better if it has a clear idea of what is expected and is then given sufficient autonomy to perform, yet held accountable for results. This entails, at the outset, clarification of goals and objectives, agreement on means and level of autonomy, and a process of monitoring and performance evaluation to assess whether or not objectives were met. This would then be followed up by appropriate rewards and sanctions to managers and staff. Changes to the legal framework for parastatals are frequently required to reflect these greater levels of autonomy and accountability. Also needed are revisions to the level of autonomy on contracting, procurement, wage setting, and prices, changes in the composition and responsibilities of the board of directors, and hiring and firing practices. Other aspects deal with the number and kind of controls imposed by governments on parastatals. The general approach is to reduce \textit{ex ante} controls, especially on prior authorizations of expenditures, and to strengthen \textit{ex post} checks and balances, via external audits.

One of the main tools to improve autonomy and accountability has been performance contracts. Building upon France’s experience in the use of ‘\textit{contrat-plan}’ and the system of performance evaluation in Korea and Pakistan, there is now relatively wide-spread use of similar tools, called performance contracts. Through these contracts, the process of mutual specification of obligations and responsibilities is being applied in selected enterprises in Gambia, Ghana, Gabon, Nigeria, Mali, Niger, Chad, Guinea-Bissau, and Congo. Senegal was the first country, outside of France, to adopt the use of performance contracts and has now about ten years of experience in their application. A review by the Bank on experience so far in the use of performance contracts has shown them to be an effective tool for bringing issues to the fore and increasing communication between enterprises and government; however, they have
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not—on their own—had a marked effect on improving performance (Nellis 1988).

Financial discipline and restructuring

In redefining relationships between governments and parastatals, considerable attention has been paid by the Bank to the financial transactions between the two groups. Since governments act as managers, investors, consumers of public enterprise goods and services, and as regulators, it is common that distinctions among these various roles become blurred. Governments do not pay, or pay only partially and very late, for water and electricity bills; enterprises do not pay taxes; governments compel enterprises to make certain investments; and enterprises refuse to service ensuing debts. Debts accumulate and liquidity/working capital declines to the point that enterprises no longer function. A break in this vicious circle and the restoration of normal commercial transactions are therefore vital. This can start with the settlement of interlocking or cross-debts, among enterprises and between enterprises and governments, plus adequate budgetary allocations for the consumption of public enterprise goods and services, and measures to cut off services if bills are not paid.

For those enterprises that are to be divested, the problems posed by the accumulation of arrears and excessive debts may be particularly severe. It is governments which must frequently bear responsibility for settling these debts. In most cases, amounts outstanding far outstrip their means to settle these debts quickly. Added to the total are amounts due to employee pension funds and severance payments to laid off employees. So far, progress in many African countries in coming to grips with the problems of enterprise debts has been limited, mainly because of the amounts are extremely large.

Creation of a parastatal focal point

An essential feature of reform, and often one of the first steps taken, is the creation of a focal point to provide guidance and orientation in parastatal issues. This has been the case in Mali, Mauritania, Senegal, Guinea, Burundi, Togo, Zaïre, Sudan, and Madagascar. Alternatively, measures can be taken to improve the effectiveness of existing parastatal agencies—such as in Gambia, Niger, Ghana, and Uganda. The objective is to provide a central point to implement the reform process and to act as arbitrator between competing interests. This body, ideally at a high level, can present policy options and trade-offs in an impartial way as compared to the technical or line ministries which have a vested interest in creating and expanding enterprises under their control. Since many issues concern
funding, such an entity could be located in the finance ministry. On the other hand, the finance ministry cannot always arbitrate among diverse interests, and there may be other locations, such as the president’s or prime minister’s office, that can take the required long-term, strategic view of parastatals. Most structures have been relatively small organizations without executive powers, but with the means of quickly attracting the attention of senior policy makers; one such example is in the Gambia.

Lessons from experience

Based on the above-mentioned reviews and studies of public enterprise performance, as part of a larger review to monitor economic performance in sub-Saharan Africa with financing from the UNDP (World Bank/UNDP 1989), the Bank has been able to examine what has been happening in Africa. However, it should be highlighted that such evaluation is very difficult due to the continuing lack of reliable data on public enterprises compounded by the weak causal relationships and general difficulties in measuring effects of specific actions, especially on institutional matters. Moreover, in many cases it is too early to assess the results conclusively. Although the Bank’s efforts were initiated about a decade ago, it is only in the last four to five years that activities have become widespread. In many countries, these efforts are just beginning to scratch the surface of what needs to be done.

From these reviews, a number of lessons have emerged. One of the most important is that public enterprise reform is not quick. Even though some actions and policy decisions can be taken rapidly, many reforms are contentious and can conflict with other development and political objectives. Reforms require a long period of reflection in order to build internal consensus and to gauge the necessary political trade-offs. This has been the case particularly with efforts to divest enterprises: the choice of to whom to sell to can present serious constraints. Moreover, the outcomes are never assured and no one can predict definitively the outcome of privatization transactions. Other actions, for example price increases, are similarly difficult. Governments typically want to keep prices low to consumers, or high for selected producers, but cannot afford to continue to pay subsidies. As losses by public enterprises mount and credit from the banking system is no longer available, difficult choices must be made. Labour questions, especially if it becomes necessary to lay off staff from enterprises that are to be restructured, closed down, or sold, present persistent difficulties in economies that suffer from high unemployment and rapidly expanding labour forces.
Overall, the Bank’s experience in the implementation of public enterprise reforms under adjustment operations seems to be about the same as that generally observed under such operations. According to the aforementioned review, public enterprise reforms have been fully implemented about 60 per cent of the time and substantial progress on implementation achieved about 87 per cent of the time. This indicated that most of the agreed actions have been taken, although little can be said on the ultimate effects. The review noted that pricing, staffing, and financial improvements seem to achieve high rates of compliance, with management improvements implemented more slowly and the slowest of all being divestiture. Divestiture related measures frequently took longer than originally anticipated, and it has generally been concluded that simple, time-bound conditionality on divestiture is counter-productive, given the uncertainty of the whole process. More generally, it was found that those reforms entailing institutional change typically were the least successful in terms of their timely implementation. A summary of the reforms being implemented in Africa is presented in Table 12.2.

There is evidence that these reforms are taking hold in Africa. In one recent study of public enterprise performance (Swanson and Wolde-Semait 1989), it has been observed that, as compared to the 1970s, sub-Saharan Africa’s public enterprise sector is no longer growing as rapidly. The

<table>
<thead>
<tr>
<th>Type of reform</th>
<th>Number of countries with reforms implemented</th>
<th>Number of enterprises affected</th>
</tr>
</thead>
<tbody>
<tr>
<td>Privatizationa</td>
<td>19</td>
<td>80</td>
</tr>
<tr>
<td>Liquidationb</td>
<td>13</td>
<td>78</td>
</tr>
<tr>
<td>Rehabilitation</td>
<td>15</td>
<td>56</td>
</tr>
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<td>Management contracts</td>
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<td>54</td>
</tr>
<tr>
<td>Performance contracts</td>
<td>15</td>
<td>16</td>
</tr>
<tr>
<td>Autonomy to public enterprise managers</td>
<td>13</td>
<td>n.a.</td>
</tr>
<tr>
<td>Autonomy to governing boards</td>
<td>7</td>
<td>n.a.</td>
</tr>
<tr>
<td>Price setting</td>
<td>14</td>
<td>n.a.</td>
</tr>
<tr>
<td>Adoption of accounting and auditing systems</td>
<td>12</td>
<td>n.a.</td>
</tr>
</tbody>
</table>

Source: Reconstructed from tables 21–23 in Swanson and Wolde-Semait 1988
Notes: aSales of shares; sixty more are open for bids in eleven countries
bSales of assets; fifty-two more are underway in nine countries.
number of enterprises remains at about 3,000 in total, over the 1980–6 period. About half of the thirty countries included in the review have reduced the number of enterprises, and at least 100 enterprises were scheduled for privatization or liquidation. Financial losses, though still greater than profits, are declining in most countries. However, the burden of public enterprises on the public treasury remains large. In Senegal, subsidies to public enterprises are equivalent to over 90 per cent of the total public sector deficit. In Togo, government has taken over more than 90 per cent of public enterprise foreign debt. In many countries, costs of transforming public enterprise sectors are likely to outstrip available financing.

Future directions

There is still a long way to go in reforming public enterprises in Africa. Several new directions have emerged within the Bank. More careful and systematic examination of the performance of privatized firms and the impact of other reform measures is called for. In addition, as the policy environment improves, it is anticipated that restructuring and rehabilitation of public enterprises, typically utilities, will be a growing part of the Bank’s activities. Part of this will, no doubt, emphasize measures to contract-out public services and reorganize service delivery programmes into more manageable units. Techniques of monitoring performance and providing incentives to reward good performance will have to become more widespread and sophisticated. Measures to stimulate competition, whether from private producers, imports or other public enterprises, need to be pursued. In the cases of natural monopolies, in either the public or private sectors, effective regulation must be put into place.

There continue to be major challenges—the resource limitations of the nascent private sectors in many developing economies, the lack of actively contested markets to ensure competition, the fragmentation of regional markets, the inadequate regulatory framework and weak capacities in the public sector to design and enforce regulations, and the structural deficiencies of past investments in terms of technology and markets. Privatization, on its own, is obviously not the entire answer. From the Bank’s perspective, the main thrust of public enterprise reform remains improving enterprise efficiency. This can be achieved, as advocated by the Bank, by more clearly defining and separating the role of governments, establishing precise and measurable objectives for enterprises, granting them freedom of action and managerial autonomy, yet reinforcing systems of accountability. At the same time, it is important to stress concomitant moves towards creating more competitive and open economies and overcoming bureaucratic failings in the management of public resources. In Africa, this remains a large agenda.
Notes

1 The author is grateful to colleagues at the World Bank, especially Mary Shirley and John Nellis in the Country Economics Department, who have contributed significantly to the Bank’s knowledge and approach on public enterprise reform. The views expressed are those of the author and do not necessarily represent those of the World Bank.

2 Formally the World Bank is called the International Bank for Reconstruction and Development (IBRD). Throughout this paper, the term ‘the Bank’ covers both IBRD and its concessional lending arm, the International Development Agency (IDA).

3 While IBRD can lend to private entities with government guarantee, this is highly exceptional. For IDA, lending must be to governments, although the funds can be on-lent to private entities.

4 This study does not, however, cover financial institutions owned by governments and other agencies, such as regulatory, health, educational, and promotional bodies.

References


Chapter thirteen

Performance contracts and public enterprise performance

A.H.M. Bennett

Starting with France in 1969, the governments of a number of countries have launched systems of controlling their public enterprises through periodic negotiated agreements, which are here collectively called ‘performance contracts’. These countries include Senegal, Gambia, Pakistan, Korea, Bangladesh, India, New Zealand, Venezuela, and Sri Lanka.

The objective here is to highlight some features of these contracts which appear to have been critical in improving public enterprise performance in developing countries, and features which may have reduced performance. This will be done partly by a review of secondary sources, and partly by the author’s own observations in Bangladesh and Sri Lanka.

The word ‘contract’ suggests a legal document which is enforceable in the law courts. This appears to have been the original intention in France. Though public enterprises set up as public corporations or as limited companies have legal autonomy and the capacity to contract with the government, relationships between public enterprises and the state in developing countries are not determined so much by written law as by unwritten custom, by power relationships, and by the personalities involved. It is inconceivable in most developing countries that a public enterprise should sue the state in the event of an agreement of any kind not being honoured by the latter. Nor would the state have recourse to the courts to enforce performance by a public enterprise; it has alternative means of enforcement, such as replacement of directors. However, this is not to say that agreements between governments and public enterprises cannot have any effect; even agreements between parents and their children may modify behaviour on both sides.

A performance contract may be defined as an agreed set of mutual commitments which the respective parties expect to be able to meet, to their mutual advantage, with regard to the management of a public enterprise for a given period. The contracting parties are the chairman or chief executive officer of the public enterprise (or of its holding company, if any) and the minister or administrative head of the ministry which has supervisory responsibility. Other agencies on which the public enterprise’s
performance depends are usually brought into the planning phase, and may also be parties to the contract.

Its purpose is to improve the contribution of the public enterprise to national goals through greater clarity on what constitutes performance towards those goals, greater management autonomy on the means used to achieve performance, and incentives for its achievement. It thereby addresses three of the key problems commonly facing public enterprises, viz., ill-defined and partially conflicting goals, political and bureaucratic interventions in operational decision-making, and management rewards which are fixed irrespective of effort or results.

In a few countries (e.g., Korea, Bangladesh, New Zealand), the system has been backed by legislation.1 Democratic legislatures can give greater moral force to performance contracts, and may enable the system to survive changes of government.2 In Korea, the strong support of the President and Deputy Prime Minister has ensured a high level of media coverage and public interest. In most countries, performance against the contract is subject to state audit. However, in most countries, performance contracts have been treated as an in-house affair between the government and its enterprises.

The following aspects of performance contracts are commented on below:

- goal specification;
- target specification;
- variation of contract;
- operational autonomy;
- incentives;
- period covered.

The final section reviews the results seen so far, and draws some tentative conclusions.

**Goal specification**

All public enterprises appear to have multiple goals, and these goals are different in each enterprise, though some (like remaining financially solvent) are common to all. Goals also differ in their relative importance, and their importance changes over time (Robson 1977).

If a contract is intended to be operational, it should be possible for the parties to the contract to agree, at the end of the contract period, whether or to what extent each goal has been achieved. This does not necessarily imply that goals are quantitative (they may be event goals, such as reaching a specified stage in development of a new project) or even that they are wholly objective (if both parties are willing to accept the judgement of an independent consultant). However they do have to be specific and unambiguous.
If it is accepted that public enterprises are set up with public funds as instruments of national development, it follows that their goals should be sub-goals of the national plan (if such exists), or at least congruent with national goals, and their importance should be rated accordingly. In most countries in which performance contracts have been developed, contracts have been based on corporate plans for a period of three or five years, drafted by the respective enterprises and approved, usually after considerable discussion and some modification, by the government exercising its role as equity owner and interpreter of the public interest.

In Bangladesh, for instance, a technical secretariat made an in-depth review, then proposed the goals of each enterprise and their relative weighting. These were discussed and amended by an inter-ministerial task force (which included a representative of the Planning Commission), and contracts were subject to ratification by a Council for Public Corporations chaired by the Deputy Prime Minister. By this means enterprise goals and their weighting were made to fit with national goals, even though the latter were not explicitly stated or weighted.

In France, most of the early contracts (those for which English translations are available) did not clearly specify the goals, nor were they weighted (Trivedi 1988:31). For instance, one goal of SNCF (the railway organization) was to adopt ‘a more decentralized command structure’. One goal of ORTF (TV and radio broadcasting organization) was ‘to apply a rate policy that is in the public interest’. There was no specification of ‘decentralized’ or the ‘public interest’, so such goals could not be operational. Similarly, EDF (the electricity organization) over achieved its profitability target, but failed to meet its gross internal funds generation target 1971–5; in the absence of weights, managers had no guidance or ‘signals’ for decisions in which goals pulled in different directions. Elements of performance could still be evaluated, but the planning of corrective actions would suffer from the same deficiency.

Target specification

For each goal (performance criterion), one or more targets (standards, criterion values) are fixed. For instance, if one goal is profitability (suitably defined), the target may be 15 per cent in 1990. If another goal is to progress a major new project (defined), the target may be to obtain Cabinet approval by the end of the 1990.3

This is far more difficult than specifying the goals. There is a strong inducement for enterprise management to set their targets low, particularly in contracts which allow bonus to managers on the relationship of actual performance to targets, as in Pakistan, Korea, and perhaps Bangladesh. In these countries, the targets were negotiated with the help of highly expert and independent secretariats or task forces, able to coopt industry
consultants and perform in-depth analyses of corporation operations and plans. This technical assistance compensates for the lack of commercial experience in government agencies, and to some extent rectifies the inequality of information on markets, technology, etc., between the negotiating parties. However, it is costly and time-consuming (Ramamurti 1986:29, 143).4

Another solution to the target-setting problem is the disclosure bonus device which originated in the USSR. Managers are induced by additional bonus to increase government-set targets where they believe it is possible to achieve them. This has been recommended for developing country public enterprises (Jones 1981: V27–V30), but does not appear to have been tried out yet.

A third solution is to use targets as a motivating device to focus on what needs to be done, but to decouple them from specific bonus by paying on the basis of the improvement of results over previous years, after allowing for factors outside the control of management. This is being tried in two industrial public corporations in Sri Lanka in 1989. Following agreement of goals with the government, and the method of calculating bonus, the management teams in these corporations set their own targets.

**Variation of contract**

Every performance contract rests on a number of key assumptions. The early French contracts did not provide for variation in targets following changes in these assumptions, and either collapsed (e.g., following the oil crises of 1973 and 1979) or had to be renegotiated. The distinction between factors which are under the control of management within the contract period (such as physical productivity, generally speaking) and factors which are outside the control of management (such as prices in competitive markets) has long been made in the design of management control systems (Horngren 1975: chap. 11) and was applied by Leroy Jones to public enterprise control systems (Jones 1981: V-18/19). This distinction was followed in the design of systems in Pakistan, Korea, Venezuela, Bangladesh, and Sri Lanka, so that contracts should be fair to the managers. For instance, after the Pakistan government stopped the supply of natural gas to a fertilizer plant because of an energy shortage, the targets of the plant were adjusted appropriately.

In Bangladesh, prices of all inputs and all outputs are deemed to be uncontrollable, and are therefore excluded. Comparisons of target and actual are made at constant prices. This is clear, operable by the technical secretariat, and was understood and accepted by the authorities. However, it excludes the possibility of negotiating better prices (e.g., on long term supply contracts) or of substituting cheaper inputs or more valuable outputs; these factors also contribute to efficiency and are under management control.
Unless all uncontrollable factors are agreed at the time the contract is negotiated, and unless ‘escalation clauses’ are written to allow for targets to be flexed appropriately, there is a danger that managers will attribute all failures to uncontrollable factors and all successes to controllable factors, and vice versa by the government. This may be the Achilles heel of performance contracts; experience will tell if performance is improved despite this potential weakness.

On the other side, the government undertakes to support the enterprise in its achievement of agreed targets by providing specified inputs (such as capital funds for approved projects) and approvals, e.g., to new projects, pricing policies, borrowing, recruitment. Thus the contract attempts to resolve outstanding issues and create a firm basis for performance outside and ahead of the standing procedures for project approval, price changes, recruitment, etc. It is understood that government commitments, like enterprise commitments, are subjects for force majeure. However it remains to be seen whether government agencies will honour their commitments, or whether they view contracts as merely another stick to beat the enterprises with if they fail to achieve their targets.

Operational autonomy

Performance contracts have generally tried to apply ‘management by results’ (Drucker 1954:121–36). Essentially this means that a government specifies the end goals of an enterprise, their weighting, and targets for a period, then stands back and leaves the management to choose its strategies, tactics, and operating decisions. Ex post evaluation is confined to comparison of achievements with targets, and conformity to applicable laws and regulations.

This neat division of duties contrasts with the messy position in many developing countries in which public enterprises vary their goals unilaterally (Aharoni 1982, Ghai 1983:218), while governments intervene continuously at all levels of control, introducing delays, discouraging entrepreneurial initiative, reducing enterprise flexibility of response, increasing costs, and dividing public accountability.

The means/ends dichotomy is difficult to apply, because (i) means, as well as end-goals, have political implications (e.g., local purchase, rather than import); (ii) some end-goals are covert; and (iii) the political and bureaucratic directorate cannot foresee all the situations in which they would want to intervene, nor prescribe policies in advance to cover those situations.

In France, most early contracts did provide for a reduction in a priori controls, but this did not always work as intended, as the government used loopholes in the contract to reapply controls (Trivedi 1988:32). In Bangladesh, managerial autonomy has been a controversial issue since
the country was founded. The initial performance contracts therefore did not propose any formal changes in autonomy, though holding companies were urged to give greater leeway to the respective enterprises, and enterprises were encouraged to draw government’s attention to adjustments in autonomy demanded by industry-specific factors (Ramamurti 1986:53, 88, 111).

In Pakistan, the intention was to separate the role of government as owner from day to day management (Mehdi 1988:71). How far this was achieved, particularly with regard to ministries other than the Ministry of Production, is in doubt. The literature is silent on this point.

In Korea there has been a clear and visible improvement in management autonomy. Article 3 of the Government-Invested Enterprises Management Act guaranteed autonomy over budgeting, procurement, and personnel. This was associated with a change in the direction of enterprises. Boards became policy boards, appointed by the relevant minister, on a non-permanent basis, and having no executive powers. All executive responsibility is given to the chief executive officer who has to be appointed from within the organization (outsiders are not eligible). This appears to have resulted in more professional and respected management, and de facto management autonomy.

**Incentives**

Whether public enterprise managers are negligent in their duties and wasteful and extravagant in their use of resources, or whether they are continuously searching for ways of cutting costs, improving revenues, and strengthening their enterprises, in many countries they are paid the same. Pay is usually based on civil service scales, which are lower than they could earn in the private sector. Non-pecuniary rewards do exist, but are small and uncertain.

The result is endemic management weakness, characterized by low morale, feelings of frustration, failure to apply known management skills and techniques, dysfunctional attitudes, and high management turnover, when compared with the private sector (United Nations 1974: chap. XI).

The importance of incentives should not be understated. They are the fuel which makes the contracting cycle work. Sustained effort is required to undertake the task of corporate planning, just as effort is needed to achieve the contract targets and even to comply with the reporting conditions. Financial incentive is a powerful driving force in every phase of the cycle.

Performance contracts in Pakistan, Korea, Bangladesh (as planned), and Sri Lanka (as planned) offer significant bonuses for good performance. ‘Significant’ means up to three months’ basic pay (per year) in Pakistan, and up to six months’ pay in Korea (where three months’ bonus had already
been built into the pay structure). For each goal, the possible range of achievement is divided over a scale of one to five (one representing poor performance, and five excellent performance) and the points achieved for each goal are weighted as agreed and added. The overall score is matched with a scale of bonus, from nil to the maximum allowed.

Initial contracts in Bangladesh skirted this sensitive problem, but provided a small fund for general managers to distribute selectively to superior performers (at some risk to the distributors) (Ramamurti 1986:45).

In Sri Lanka the planned basis for calculating bonus (as mentioned above) is improvement in performance over previous years (the mean of the last three years). Bonus is calculated as the residue of total allowed pay (see below), after subtracting actual pay given (salaries, wages, allowances, overtime, production incentive pay, attendance incentive pay, benefits in kind, etc.). These pay elements vary considerably in relative importance and in total per person from one enterprise to another, despite continuous efforts by supervising ministries to suppress pay differences between enterprises. Since bonus is calculated as a residue, there is an incentive for managers (and workers also since they share in the bonus) to ensure that overtime and incentive payments are given only where they do in fact add to corporate performance. Similarly there is an incentive to avoid unproductive overstaffing, as this results in smaller individual shares of the corporate bonus pool. Individual shares in corporate bonus are generally determined by the corporations themselves in accordance with internally negotiated agreements. Initially, it is expected that bonus will be distributed in proportion to basic pay.

The concept of total allowed pay is drawn from Scanlon- and Rucker-type productivity-sharing plans (Lesieur 1958), adapted to a value added basis. It is believed that the ratio of total pay to value added is quite stable over the medium and long term, subject to basic changes in products or processes. The pay ratio varies of course from year to year, going up with a salary increase and down with a selling price increase, but these changes tend to even out. The long-term historic pay ratio is used as a way of sharing current productivity gains where these are due both to the efforts of managers and workers, and to capital expenditure by the owners, and there is no objective way of dividing the gains and rewarding the factors of production on their separate contributions.

Value added (or conceivably a ratio of value added to capital employed provides a rational, objective, and auditable basis for the payment of bonus for achieving high productivity or operating surplus in a competitive environment. In monopoly conditions, some formula adjustment to constant prices would be necessary. However, the achievement of goals which are not reflected in increases in current value added is motivated separately. These include future-oriented goals such as technological modernization, introduction of corporate planning/monitoring systems,
computerization, new project or product developments and human resource development, and any social or redistributional goals, in so far as these are not fully compensated by the government. Achievement of these goals gives rise to additions to bonus in proportion to their weighting and the bonus on targeted operating surplus.\(^6\)

One desirable condition to be met by a bonus is that it should be self-financing. Bonus should be payable only out of real gains, preferably cash flow gains. In Pakistan, the rule of thumb principle is that bonus should be not more than one third of gains. In Sri Lanka, the proportion depends on the historic pay ratio, which is higher in labour-intensive enterprises and lower in capital-intensive enterprises. An obvious problem arises where a firm performs well on the agreed goals, but does not have the cash to pay bonus. This may arise: (i) where goals other than profit predominate;\(^7\) (ii) where the goal is to reduce loss;\(^8\) (iii) where profit is pre-empted into increases in inventories and receivables, or for repayment of loans, outstanding taxes, etc.; or (iv) where adjustment is made in favour of enterprise management for the adverse effect on profit of factors over which they had no control.

Part of the answer to this may lie in the assurance that management would certainly make the payment of bonus a first charge (like the payroll) on their available cash. Also, if bonus is paid for high achievement of developmental goals which may be expected to generate future cash flows, this is of a capital nature and it would be reasonable to borrow in order to pay the bonus. Similarly if the system reduces a loss which would have been met by subsidy or borrowing, the bonus should come from this inflow. However, these arguments are admittedly difficult for ministries of finance to accept.

**Period covered**

French contracts were based on corporate plans made to fit with the national plan period (mostly three to five years). Senegalese contracts were also multi-year. This may have been appropriate having regard to the long time they took to prepare, but it is intuitively easier to keep contracts relevant and effective if they can be redrawn at shorter intervals (Garner 1978).

Contracts prepared on the signalling system or performance contracting approach (Pakistan, Korea, Venezuela, Bangladesh, Sri Lanka) were also derived from medium-term corporate plans, but the contracts were based on the first financial year only. In Sri Lanka, industrial corporations selected for trial performance contracts have corporate plans covering a three-year or five-year period, with action plans for performance improvement. These are rolling plans, reviewed and redrafted each year. In India, where the contract is called a Memorandum of Understanding,
the holding company specifies its plan for a five-year period. The Memorandum is reviewed and updated each year. Similarly in New Zealand, the State-Owned Enterprise Act requires each SOE to draft each year a Statement of Corporate Intent (Bennett 1988:60).

Performance may be monitored by government during the contract period. An exception is Korea where there is no external monitoring during the year. In New Zealand, monitoring is limited to a half-yearly report on a pre-agreed format. Senegal also has six-monthly reviews. In Venezuela, Pakistan, Bangladesh, and Sri Lanka, monitoring is quarterly on pre-defined formats. The frequency of monitoring may reflect the level of trust between the parties or the monitoring capacity of the government rather than the optimum frequency which minimizes total costs.

Results

The justification for the time and trouble involved in setting up performance contracts, and for the cost of any bonus or other rewards given, can only be the improvement of enterprise performance according to agreed criteria.

Only a handful of countries have sufficient experience of contracts (say five years) for any reliable evaluation of results. These are France, Senegal, Pakistan, and Korea. Even with regard to these countries, it is difficult to disentangle the achievements of their performance contracts from the claims of system advocates, and there is a need for more evidence on the impact of the system on achievement of end-goals.

In France, for instance, the system works to both parties’ satisfaction according to a French observer who points to regular adjustment of tariffs, a trend to improved financial results, and more ‘relaxed’ government control (Belot 1985). A World Bank report also paints a generally favourable picture; enterprises achieved some internal improvements such as higher labour productivity, refined corporate planning and introduction of management audits, but did not always meet their financial targets, perhaps because the government did not allow the promised freedom of pricing (Shirley 1983). An advocate of the signalling system, on the other hand, points to the break down of initial contracts and the increase in subsidies to the public enterprise sector (as a whole) in 1983 (Trivedi 1988:29).

This may be compared with reports of the Senegalese experience which had French technical assistance. The negotiation was a learning process for both parties; enterprises prepared corporate plans for the first time, while the government compared costs and benefits of social objectives and proposed investments. Out of the first five contracts, only one is said to have failed, and most have produced measurable improvements in performance (Shirley 1983).
In Pakistan, there appears to have been a substantial increase in profitability, maintained over a number of years. This is longer and more widespread than could be attributed to the Hawthorne effect of singling out one or two enterprises for special treatment, so it may be claimed as a system benefit. Over the four years to 1986/7, there was an increasing proportion of enterprises getting above standard (A & B) grades (Mehdi 1988:78–9).

Korea is the biggest success story, from all indications. The system applies to all public enterprises. Operating profit increased by 50 per cent in 1984 over 1983, by 20 per cent in 1985, and 24 per cent in 1986, far outpacing growth in GDP. Cost saving was especially apparent in inventory management. This was achieved despite greater expenditure on research and development, improvements in management systems, and higher quality of services provided. Questionnaire surveys have shown that employees strongly favour the new system, especially executives (Song 1988:91, Lim: 44–9).

One of the advantages of performance contracting is that contracts can be used selectively, e.g., with enterprises not scheduled for privatization, or where boards of directors have been restructured or are more trusted. In Bangladesh and Sri Lanka, contracts have been drawn up on a trial basis with selected manufacturing enterprises, pending general application to all commercial parastatals. In Pakistan, the system is so far limited to enterprises under the Ministry of Production.

Performance contracts are flexible instruments. They can define performance in any desired dimensions and give whatever weight to each dimension the government feels is appropriate, provided it is prepared to do so explicitly. Thus, performance contracts are not devised so that (good) economic efficiency can replace (bad) political goals, but rather so that overt and predetermined political goals (including efficiency) can replace covert and ad hoc political and bureaucratic interventions.

A common argument against greater autonomy for public enterprise managers is that they would use this discretion to enrich themselves at the public expense. In theory, performance contracts deter corruption and side-payments since these reduce profit and bonus. Certainly, an individual may gain more from a secret commission than he would lose on reduced bonus, but under a performance contract system everyone is more vigilant and more inclined to expose corruption and protect the bonus pool. However, there do not appear to have been any empirical studies testing this proposition.

It is often asserted, with regard to the introduction of an administrative reform, that an absolute pre-condition is top political support, sponsorship or leadership. The assertion does appear to be particularly true of performance contracting, as the system involves a shift of power away from particular ministers and their civil servants,
who forego their usual powers of patronage over public enterprise employment, contracts, prices, etc. in favour of the senior management of public enterprises. In some cases labour unions lose influence. Technocrats who mediate between the contracting parties may gain. Such a significant change in relationships is not easily achieved, especially against the heavy weight of inertia and custom, even with leveraging by donor agencies such as the World Bank.

The difficulties of setting targets which are neither so high that they are ignored or even become counter-productive, nor so low that they fail to motivate, may be solved as planned in Sri Lanka, that is, by allowing managers to set their own targets, and linking bonuses not to targets but to improvements in management performance. The author attended planning sessions by enterprise managers and was surprised at the enthusiasm and potential for performance improvement generated by the prospect of improvement-linked bonuses.

A difficulty that is likely to continue is the adjustment of targets (or of actual results in the Sri Lankan model) for the impact of factors over which management had no control. The difficulty of specifying such ‘uncontrollables’ (particularly in the grey area where deviations from target imposed by the environment may be corrected within the year by additional effort in other directions) is matched by the difficulty of calculating their impact. Some factors are pervasive; how does one adjust for the impact of subversive activity in the country? The answers given are likely to reflect the culture, ethos, and management attitudes (tough or tender) of each country. This indicates that performance evaluation will never be a wholly mechanical exercise and that, despite the quantification and weighting of goals in contracts, there will continue to be arguments, subjective judgements, and compromises.

Notes

1 In Korea, the Government-Invested Enterprises Management Act of 1984; in Bangladesh, the Public Corporation (Management Co-ordination) Ordinance No. XLVIII, 1986; in New Zealand, the State-Owned Enterprises Act, No. 124, 1986.
2 Only a government can activate performance contracts and give them substance; a statutory requirement that they be prepared to do so is not sufficient in itself.
3 These goals are corporate-level surrogates for the national goal of economic growth.
4 In Korea, many of the quantitative targets are prepared by statistical projections from past data. However consultants are still needed to select which targets can be specified in this mechanical way.
5 Value added at current prices is an appropriate basis to ensure that bonus is not eroded by inflation.
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6 For instance, if an enterprise has three goals—say financial profit (which is weighted at 80 per cent), foreign exchange earnings (at 10 per cent), and human resource development (also at 10 per cent)—and the bonus for achieving the profit target is calculated at (say) Rs. 2.4 million, then the bonus for achieving each of the other two targets would be 10/80 x 2.4 = Rs. 0.3 million, and proportionately more or less for achievements above and below each target. This system has been fully documented by the author elsewhere.

7 In Pakistan, a sophisticated public profitability concept was brought in too fast, and was replaced by private profitability (Mehdi 1988:73–4).

8 As in the first two Bangladeshi contracts.

9 The Indian Memorandum of Understanding appears to differ from the UK concept, eg. the Memorandum of Understanding between the National Enterprise Board and Rolls-Royce (The Times, London, 27 February 1976). The latter clarified and formalized the relationship between a holding company and a public enterprise, but did not address possible conflicts between goals, nor specify targets or performance-related rewards.

10 Though the abnormal (U-shaped) distribution of grades suggests that the B, C, and D grades were not sufficiently widely differentiated.

References


Chapter fourteen

Public enterprise and planned development in Sudan

E.A.Musa

At the time of independence in 1956, there was virtually no private sector in Sudan. The few private enterprises that existed were owned by non-Sudanese, and were engaged in retailing. During the Ten-Year Plan, 1960–70, the onus of achieving economic and social development was placed on public enterprise.

However, the majority of public enterprises in Sudan—especially those in manufacturing—were established within the Five-Year Plan, 1970–5, and the Six-Year Plan, 1977–83. In 1972 the interim Action Programme made it clear that ‘the public sector shall remain the leading and pioneering sector in the process of economic development and the creation of new production relations and it is to be helped and complemented by the private and co-operative sector’.

But given the poor financial performance of public enterprises throughout the 1970s the government started to support the private sector more strongly. The Encouragement of Investment Act 1980 gave private national and foreign investors a variety of facilities and privileges, including guarantees against confiscation and nationalization, a five-year exemption from business profit tax, exemption from customs and import duties, allotment of land necessary to erect investment projects, reduction of electricity and transport costs, and full protection of locally produced consumer goods against foreign competition.

As a result, the size and scope of the private sector grew rapidly. It included manufacturing, transport, hotels, tourism, commerce, banking, insurance, and agriculture. Private enterprises engaged in many activities which used to be monopolized by the public sector. Many joint ventures came into being, including the Kenana Sugar Company, established in 1980 and owned by the Sudan government and other Arab countries. It is the largest in Africa and the Middle East, and the third largest worldwide.

Nevertheless, public enterprises still predominate. They are estimated to contribute about 60 per cent of Sudan’s GDP and to employ about 70 per cent of the workforce.
The role of public enterprise in Sudan

In the Five- and Six-Year Plans, 1970–83, public enterprises were all required to pursue and to achieve the following development targets:

1. to create jobs on a large scale to stop emigration from rural to urban areas;
2. to obtain balanced (even) development within and between regions, within a framework of regional specialization and complementarity; central development planning was based firmly on regional planning to ensure that development of programmes and projects would reflect the potentialities and needs of every region;
3. to ensure a good and balanced distribution of investment over the different regions of the country, so as to eliminate the sense of humiliation and backwardness felt in some Sudanese regions;
4. to develop industry as a complement to agriculture, giving priority to agro-based and import-substitution industries;
5. to achieve self-sufficiency in major consumer goods.

Alongside this role in regional and rural development, public enterprises in Sudan provide social services to their employees and to citizens of the rural areas. These include health, education, and housing. They are seen as necessary to achieve the government’s economic and social development goals.

The smooth flow of foreign aid, grants, and loans, from Arab and international financial agencies, and from other friendly countries during 1960–80, facilitated the growth of public enterprises in Sudan. Manufacturing investment in these enterprises grew from 7.5 per cent of total gross investment during the period 1960–70 to 13.2 per cent in 1970–5, and to 21.3 per cent by 1983. It now stands at over 13 per cent. Due to the encouragement of the private sector, and to the denationalization and privatization of some public manufacturing enterprises in the late 1980s, the share of the public enterprise manufacturing investment in the total of manufacturing investment now stands at little more than 25 per cent (Kapullo 1986). This indicates the growth of private sector manufacturing investment.

Performance of public enterprises

The financial performance of public enterprises has been very poor and unsatisfactory for many years. In all industries they almost all made huge losses (Musa 1987). The aggregate statistics in Table 14.1 illustrate the poor financial performance of seven manufacturing industries including
sugar and distillery, textile, food, cement, leather, mining, and building materials. Although there is no breakdown for losses per manufacturing industry, yet the message is clear: generally rising losses from 1971/2 until 1979/80. Then losses started to decrease, due to privatization and the restructuring of some enterprises.

The use of profitability as a sole measure of performance in the public sector poses a variety of problems. The obvious reason is that in developing countries, enterprises are sometimes used for basic development purposes. The view is therefore that their performance should be measured also by their contribution to development, an antithesis of the doctrine of commercial profitability. For this reason, it has been suggested that the profitability index has to be supplemented by other non-accounting indicators that take into consideration their development role and their multiple objectives.

But this developmental role needs closer scrutiny. Financial losses may occur because:

1. public enterprises are required to start or to run activities of a kind or in a location which on strict commercial grounds would not be undertaken;
2. they may conduct their development roles inefficiently and with overmanning for the tasks to be undertaken;
3. compensation for any development roles undertaken, including the social roles in constructing roads, schools, hospitals, etc., are inadequate to cover the extra costs;
4. public enterprises may have an employment creating role (it is possible, of course, to develop entrepreneurial activities which create employment, for example through diversification, without incurring financial losses).

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**Table 14.1 Financial performance of public enterprises in manufacturing**

<table>
<thead>
<tr>
<th>Years</th>
<th>Profit (loss) £</th>
<th>Year</th>
<th>Profit (loss) £</th>
</tr>
</thead>
<tbody>
<tr>
<td>1971/2</td>
<td>(0.4)</td>
<td>1977/8</td>
<td>(9.7)</td>
</tr>
<tr>
<td>1972/3</td>
<td>(0.3)</td>
<td>1978/9</td>
<td>(18.2)</td>
</tr>
<tr>
<td>1973/4</td>
<td>(1.4)</td>
<td>1979/80</td>
<td>(17.7)</td>
</tr>
<tr>
<td>1974/5</td>
<td>(0.9)</td>
<td>1980/1</td>
<td>(4.2)</td>
</tr>
<tr>
<td>1975/6</td>
<td>(1.6)</td>
<td>1981/2</td>
<td>(3.8)</td>
</tr>
<tr>
<td>1976/7</td>
<td>(2.0)</td>
<td>1982/3</td>
<td>(0.8)</td>
</tr>
<tr>
<td></td>
<td></td>
<td>1983/4</td>
<td>(0.3)</td>
</tr>
</tbody>
</table>

Source: Kapullo 1986
Note: *In the last few years £1 = approximately US$0.22.*
In addition the prices of goods in Sudan are held down for economic and social reasons—in an attempt to stem inflation, and to benefit the poorer sections of the community.

Even if none of the above applied, losses may occur if public enterprises are badly managed with failures in production or in market responsiveness.

There is a further problem. Public enterprises design their accounting and budgeting systems according to the provisions of the government’s detailed financial regulations, which do not suit commercial operations. Modern management accounting techniques are unknown in public enterprises in Sudan.

Public enterprises are also required to adhere to the purchasing statutes of government. These are very bureaucratic, and do not facilitate commercial operation. A recent study (Musa 1988) suggests that adherence to these purchasing statutes has also contributed to the poor efficiency and financial performance of public enterprises.

The result is that in Sudan we cannot use measures of performance along any of these social dimensions, and the true commercial position of public enterprises is also uncertain.

The fact that public enterprises are estimated to contribute about 60 per cent to the GDP and employ about 70 per cent of the workforce in the country (Abu Affan 1985), and that they create jobs on such a large scale that most of them have disguised unemployment (overstaffing) problems (Musa 1987) leaves the basic questions unanswered.

Managing the social services

Alongside their regional development role, public enterprises in Sudan provide social services to their employees and to citizens of the rural areas. They include health and education. Whenever an enterprise is established, the government has to allocate funds between equipment for production and for building schools and clinics. Although teachers and hospital staff are employed, paid, and controlled by the Ministries of Education and Health, which also provide books and drugs, nonetheless public enterprises have to contribute to other expenses such as furniture and the maintenance and provision of transportation facilities. They also provide other infrastructure services, e.g., building houses, roads, and electrification facilities.

Within public enterprises, these social and development activities are generally all mixed in with their commercial activities. There are for example no ‘social departments’, nor does there appear to be a separate part of the workforce designated for this work.

Expenditures on these social and infrastructure services are normally approved by the Ministry of Finance and Economic Planning as part of the annual development budgets of public enterprises. They are reported
separately in their profit and loss accounts as social and infrastructure costs but are deducted from revenues as are the usual operating costs. These infrastructure and social costs are considered by the government as necessary to extend welfare and social services to the rural areas in fulfilment of the government’s economic and social development plans.

Some consequences of conflicting roles

In pursuing their development role, public enterprises in Sudan have found it difficult to reconcile their social and political objectives with those which are commercial. The pricing of finished goods is a good example of this conflict. The government fixes prices which are in most cases below the actual costs of production, so as to reduce prices for the final consumer. The creation of jobs to the extent of overstaffing, and the provision of social and infrastructure services are other areas of conflict.

Another consequence of conflicting roles is that they have to deal with several ministries. The Ministry of Finance and Economic Planning, which owns public enterprises, maintains excessive controls through financial and purchasing statutes to protect public money against theft and embezzlement. This has resulted in a rigid bureaucracy and poor management information systems which do not suit commercial operations. The Ministry of Industry, on the other hand, is responsible for the technical administration of public enterprises and for making the production inputs (spare parts, energy, and raw materials) available. Poor co-ordination between these Ministries, and the shortage of hard currency, has led to an acute shortage of production inputs and to capacity underutilization. The Ministries of Education and Health are also closely involved.

The future

For more than three decades public enterprises have been a major institution and a vehicle for economic development in Sudan. By the 1980s, however, a host of exogenous and endogenous problems emerged to constrain the previous subsidization by the public exchequer. Fundamental reforms, including privatization, are being considered by the Sudanese government as part of a structural and rehabilitation programme. The privatization debate in Sudan started in 1982 for similar reasons as in other developing countries (Aylen 1987, Young 1986). By 1983 the government had taken pragmatic measures along the privatization road, when it sold off its oil refineries and two sweet factories. In July 1988 the government expressed intentions to sell off all the loss-making public enterprises. Despite the government’s intentions to privatize, it is evident that privatization in the strict sense of transfer of ownership is difficult for four reasons:
Specialist topics

1. the lack of efficient capital markets makes privatization by means of conventional equity sale difficult;
2. some enterprises have been located in rural areas with no or poor infrastructure, to pursue the development role; this makes them less attractive for potential investors;
3. as most enterprises made huge losses, they are less attractive to the private sector;
4. the strong trade union movement opposes privatization, as it involves massive compulsory redundancies.

In view of these problems, we believe that privatization in Sudan can only be pursued as a long-term objective. Improvement of public enterprises’ financial performance and efficiency is a prerequisite for a successful future privatization programme. In this respect, we share Aylen’s (1987) view that:

A programme for privatization in a developing country is really a programme for reform. State enterprises that are closely integrated into government bureaucracy need to be separated off. An independent board, financial autonomy, and operating freedom are first steps towards improved efficiency and eventual private ownership.

Improvement of public enterprises’ financial performance in Sudan is, however, not an easy process, and requires a long-term reform and restructuring measures. To this end, the following steps are suggested.

Commercialization of goals

Because the government has now decided that it is unable to continue to subsidize public enterprises, because of its huge budgetary deficit, a profit target in terms of return on investment should be set up by government in liaison with management. Enterprises should be held responsible for achieving this profit target, provided that the other problems are solved, and that their managerial autonomy is guaranteed. The pursuit of commercial goals does not mean elimination of the development role, but reflects a shift in emphasis.

Liberalization

This is the most challenging and controversial question in developing countries because of the desire to give managerial autonomy on one hand and to ensure public accountability on the other hand (Ramanadham 1984). In this respect we strongly recommend the abolition of the government financial and purchases statutes, and their replacement by more flexible internal policies and procedures. Moreover, management should
participate in making decisions that have a direct impact on their financial performance, such as fixing prices on a commercial basis.

Ensuring public accountability

Being established within the government’s economic and social development plans, ministerial control is inevitable to ensure public accountability. This ministerial control, however, should be confined to general supervision. Failure to do so may endanger managerial autonomy and accountability for financial performance (Ramanadham 1984). The Auditor General could take part in ensuring public accountability through the conduct of efficiency audits (Musa 1988).

Availability of production inputs

As the government maintains full control over hard currency and energy supplies, it has to accept responsibility for making production inputs available to enable enterprises to operate a full capacity and to make profits.

Improvement of management information systems

No one can deny the significant contribution of sophisticated management information systems to good financial performance and efficient operations (Boodho 1983, Musa 1987). The modern information systems such as management and cost accounting and computerization of accounting activities, have to be introduced in the public sector. The Industrial Research and Consultancy Centre, which was established by the UNIDO in 1965 to help apply modern information systems in enterprises, could play a vital role in this respect.

Management training and development

Advancement of management training and development is required to make this reform programme a success. Managers should be trained to acquaint themselves with the processes and objectives of the reform programme and the role of modern management information systems in efficient operations. Regular training programmes on these matters can be arranged by the government training institutes such as Management Development Centre, Sudan Academy For Administrative Sciences, and Business and Accounting Departments in Sudanese universities.

References


Comparisons, if not on all fours, are indeed odious. Comparing private and public sector enterprises is rather like comparing oranges and lemons: same genus but different species. For the purpose of this article, therefore, if any general conclusions are to be drawn, it is necessary to set a few boundaries.

First, the database: the best available information in India is the Survey of Industries published annually, the latest being 1985–6. Although this restricts us to the industrial sector, it is where the maximum investment is concentrated, and where managerial efficiency counts and is countable. We shall base our findings on the time-series 1981–2 to 1985–6. All data are in current prices.

We also choose to take the wholly privately owned and the wholly publicly owned groups, ignoring joint and co-operative sectors (which are only about 2 per cent of the total).

Second, the representativeness of the sample: there is a great diversity within both public and private sectors in regard to size, investment, products, and, of course, efficiency. The public sector has, for instance, very large units in basic and intermediate goods and in public utilities, like road transport and electricity corporations. Also it has picked up a number of failures of the private sector, such as textile and jute mills. The private sector has large corporate enterprises under the management of transnationals or family houses, as well as thousands of medium and small units, both public and private limited companies, again of varying degrees of efficiency.

For a two-sector comparison, therefore, it would be sensible to take the sectors in their totality as they exist in the economy today.

Third, a conceptual boundary is necessary to be set in regard to the term ‘managerial efficiency’. Managerial efficiency, in our opinion, ought to be measured only in terms of what the manager can control and be responsible for. These are workforce (numbers of men and women, wages, and salaries), materials (total inputs for production, inventory), and money (fixed and working capital). There is considerable difference in the degree of freedom and responsibility enjoyed by managers in the two sectors in relation to these factors.
Comparisons would be better understood in the context of the structure of the Indian industry and the relative shares of the two sectors. These are shown in Table 15.1.

The outstanding feature is the large share of fixed capital investment in the public sector—all postwar investments in the mining and metallurgical industries, power, transport, heavy engineering, and the like. This was a consequence of the industrialization strategy pursued after independence.

Table 15.1 Structure of industry

<table>
<thead>
<tr>
<th>Percentage shares (31 March 1986)</th>
<th>Of which Central Government units (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Private (%)</td>
<td>Public (%)</td>
</tr>
<tr>
<td>Number of units</td>
<td>92</td>
</tr>
<tr>
<td>Fixed capital</td>
<td>28</td>
</tr>
<tr>
<td>Working capital</td>
<td>58</td>
</tr>
<tr>
<td>Employment</td>
<td>62</td>
</tr>
<tr>
<td>Emoluments</td>
<td>53</td>
</tr>
<tr>
<td>Gross output</td>
<td>60</td>
</tr>
<tr>
<td>Net value added</td>
<td>57</td>
</tr>
</tbody>
</table>

Two-thirds of the power generation capacity and all the road transport corporations are in the provincial (state) sector, not the central government sector. Modern, capital-intensive units are relatively few and recent in the private sector, compared with the larger number of old units—mostly written down—as in cotton and jute.

Over the five-year period, however, the public sector share in fixed capital has come down by 5 percentage points and this trend is likely to continue. On the other hand, the share of the public sector in gross output has gone up by 5 percentage points (and that of the private sector come down). Another important trend is the shrinkage in employment in the private sector, bringing down its share from 66 per cent in 1981–2 to 61.5 per cent in 1985–6.

Indications of efficiency

Money

A popular yardstick of managerial efficiency is return on investment (ROI). But profitability is a function of many factors: gross output capacity utilization; cost (fixed and operating); product-mix; and price. A more disaggregated comparison of these factors is necessary to determine managerial efficiency. The three basic elements in financial management
that we wish to examine are fixed capital, working capital, and inventory in relation to net value added (NVA).

The heavy weight of capital investment is reflected in the NVA: fixed capital ratio of the public sector which is 4.61 average for the time series 1981–2 to 1985–6, compared with the private sector’s 1.24. The trend, however, for the public sector, is one of deterioration from the initial to the terminal year, being as much as 17 per cent for the private sector compared with 3.7 per cent in the public sector.

Over-capitalization is the one major cause of the low profitability of the public sector. A high capital base necessarily means a high break-even point nearer full capacity production and sales.

The relevant question on this issue is the extent to which the enterprise managements are responsible for capital investment decisions. Such decisions in both sectors are primarily made by the owners. Therefore, the advantages or handicaps flowing from the original investments should be set aside for a fair judgement on managerial efficiency. In the public sector, apart from the very nature of the products, a relatively higher capital investment happens to have been made because of the provision of employee townships, a funding pattern with a substantial bilateral aid component, delayed decision-making, and tardy implementation. There were also investments which appear, in hindsight, to have been imprudent financially, such as the Heavy Engineering Corporation set up on the expectation of continual growth and expansion of the steel and coal industry (which never took place), or taking over ‘sick’ textile mills from the private sector. The consequences have been borne by successive operating managers.

Within the time-series in view, the NVA/working capital ratio has improved from 1.53 to 1.01 in the public sector, whilst it has worsened from 0.76 to 1.04 in the private sector: the two sectors are approaching the same level.

A similar trend is evident in the NVA/inventory ratio, which has improved in the public sector from 1.57 to 1.19 during the period, when the private sector figure has dipped from 1.20 to 1.10.

Workforce

From the data available we can compare the numbers, the composition, the compensations, and the contribution of the workforce, men and women, in the two sectors.

We have already seen the diminishing share of the private sector in total employment, and this is sharply brought into focus by the decrease in absolute numbers. The average decline in the private sector between 1981–2 and 1985–6 has been 1.63 per cent, and as high as 4–5 per cent in some years. The public sector, on the other hand, has added on an average 0.9 per cent. Overmanning has been a common feature in both sectors,
understandably, in a country with great and continually increasing pressure of unemployment, and without social security; but whereas the private sector is able to shed its manpower through closures, etc., the public sector managements have been unable to do so, as the employees consider themselves as secure as government employees. This view has been strengthened by a recent ruling in the Supreme Court in which in substance the Court was unable to distinguish between the public sector and a government department.

Therefore, personnel costs tend to be more of a fixed nature in the public sector. It is a debatable point as to whether the ability to reduce employment in the private sector is to be considered as a measure of efficiency, and the inability to do so in the public sector a mark of managerial inefficiency.

There are interesting features in the composition of the workforce as well. The ratio of salaried class to wage-earners is about 1:4 in the private sector, whilst it is 1:3 in the public sector, reflecting the weight of unproductive paperwork and record-keeping stemming from governmental procedures and requirements of government audit and parliamentary control. The changes in numbers over the period show that in the public sector the growth in the worker category was 0.7 per cent per annum as compared to 1.5 per cent in the salaried category. In the private sector the reduction was also at a higher rate in the worker group (-1.8 per cent) than in the other category (-1.1 per cent).

There are differences in the rates of emoluments also. Wages (including benefits) per worker and salaries per employee are 1.63 and 1.19 times higher, respectively, in the public sector. The public sector had started with the explicit goal of being a model employer. Most of the projects being in greenfield sites, new townships with modern housing, medical, and educational facilities at subsidized rates were provided. With very few exceptions, private sector companies generally tend to incur minimal liabilities on this account Wages are generally indexed in the organized industries, and the annual growth rate has been around 12 per cent in both the sectors.

Fixed capital per employee was 6.7 times more than that in the private sector at the beginning of the period; by 1985–6 it had come down to 4.7 times.

As far as the measure of contribution of the workforce is concerned, it is better in the private sector in terms of the proportion of personnel costs to gross output and NVA—being an average of 0.08 and 0.45 respectively in the private sector, and 0.12 and 0.51 in the public sector. On the other hand, measured in terms of gross output and NVA per employee, public sector fares better, the former being 1.07 times and the latter 1.33 times more than the private sector. One cannot conclude therefore that the public sector is any more overmanned than the private, though the public sector
spends more on the employee. But with the move in the private sector to shed labour this position is changing.

Materials

The input/output ratio in the public sector and the private sector was 1.40 and 1.25 respectively, at the beginning of the period; at the end of the period these stood at 1.35 and 1.27 respectively.

Similarly, the ratio of NVA to gross output in the public sector was on an average 0.22 as compared to 0.18 in the private sector.

Some general conclusions and issues

On the basis of the available evidence over the period 1981–2 to 1985–6, it is safe to conclude that, barring the burden of the fixed capital over which the public sector management has no control, and despite higher wages and administered prices over which the management has no control either, public sector management efficiency is in no way inferior to the private sector or the national norm (which may itself be low in a developing country), except the ROI. Even in Britain, where the public sector was being liquidated as a matter of policy and ideology, the conclusion appears to be similar (de Jonquiess 1986).

Does ownership make a difference to profitability? Obviously it does. Basically, the task of the entrepreneur-owner is identical in both public and private sectors—to choose a viable project, arrange for funds, select a competent board of directors, and appoint a professional top management. On all these counts government has proved a poor entrepreneur. Over-capitalization and arbitrary capital structures have been mentioned (the Indian government has arbitrarily fixed a debt-equity ratio of 1:1 for all public enterprises, regardless of the size or nature of the undertaking: at the same time the State Electricity Boards have no equity base, only loan-capital). The non-official board membership appear to be more a matter of patronage and representation than adding experience or wisdom to the board. In the state-level enterprises a number of politicians of the ruling party find places not only on the boards but even as executive chairmen. Civil servants have withdrawn from most central government undertakings, but still dominate the provincial (state) level. From the rapid turnover of chief executives, unfilled positions at the top, and surprise appointments, it would appear that continuity and good management are the least of considerations; not to speak of the periodic experiments with the superstructure of the larger enterprises.
Why does it continue to happen? Where do we go from here? One is tempted to ask à la Professor Higgins, ‘Why can’t the government be more businesslike?’

Common problems
The public sector is truly at the crossroads today not merely in the capitalist West, but also in the socialist world. The common concern everywhere is with the burden on the exchequer or with persistent low productivity, or with both. Mild to drastic reform of the state enterprises is high on the agenda everywhere. The remedies sought in the West may seem surgical—closure, amalgamation, privatization, and the like—whilst the centrally planned economies are more therapeutic in their approach, concentrating on institutional reform. The emphasis everywhere is on entrepreneurial management, as opposed to an overcentral-ized bureaucratic methodology. The issues, as is to be expected, often acquire political overtones. Such events cast their shadows on developing countries with a large public sector like India.

In many ways, reforms in the socialist economies are of relevance to us not merely because the model on which our public sectors were based was somewhat akin, but because the changes that are coming about in these countries touch some fundamental issues concerning state-run enterprises.

The most incisive criticism of the management of state enterprises was made by General Secretary Gorbachev himself in his report to the CPSU Central Committee (Gorbachev 1985). His comments on issues like investment strategy, plan allocation, project formulation and implementation, and accountability, are startlingly similar to our own situation (though some features are different, due to the federal democratic structure of our polity and the mixed nature of our economy).

China has boldly articulated one of the fundamental problems of state enterprises thus: the egalitarian practice of eating from the same pot [total dependence on the state budget] of holding the iron rice bowl [job security irrespective of output] and the principle of iron chair [immobility outside the enterprise] should be changed, and a strict economic responsibility system set up²(Hong 1986).

The experience of both socialist and market economies have lessons for us, regardless of the ideologies propelling them.

First, no economic activity can survive indefinitely at low levels of productivity. Prices may or may not help surpluses, but intrinsic efficiency in absolute terms of the inputs of raw material, energy, manhours and capital per unit of production will show up. It has to face competition in
an open system, or in a closed system, if it proves too much of a burden on the state exchequer.

Second, a point may be reached when the state will have to take measures to lighten its burden as resources may be needed for other activities. Ideology may affect the pace or direction of such measures, but it is not necessarily the prime motive. India is approaching this situation.

Third, market economies may choose to embark on mild or on more socially ruthless strategies in such situations. In any case most such economies in the developed half of the world have a social security system to soften the miseries such adjustments cause. Fortunately, these countries have a declining birthrate with negative growth in the workforce. India is adversely place on both scores.

Fourth, centrally planned economies have little or no option but to strive for higher performance through improvements in technology, management, incentives, and work-discipline. The term ‘intensification of the economy’, as opposed to expansion, is this strategy in essence.

Fifth, the generic problems in state enterprises in any system appear to be bureaucratization and lack of motivation. If the implicit philosophy in the Western countries is one of ‘theory X’, then the socialist system seems to have pinned its faith on ‘theory Y’ —basically relying on the natural and self-actuated motivation of the state employee, since in theory it is a workers’ state. In the decades immediately following the Russian Revolution, the enthusiasm for socialist reconstruction seemed incentive enough to take the economy forward; but with the passage of time problems have surfaced, and measures are being taken—more pointedly in China.

In any event, the public sector in developing countries cannot mark time. It has to move faster, even to stay where it is. The two extreme stances possible are from ‘What cannot be cured must be endured’ to ‘What cannot be mended must be ended’. In systems like ours, where governments are likely to change every five years, the temptation is great to make the first choice. On the other hand, given a certain combination of forces, the latter choice can well be exercised (as witnessed, for example, in Pakistan, where the sweeping nationalization under the Economic Reform Order promulgated by the People’s Party government was as summarily reversed by a new government in July 1977, by the Transfer of Managed Establishment Order).

However, in the Indian situation it is hardly possible for governments to withdraw support from the public sector, not merely on grounds of political infeasibility, but on the sheer economic prudence of protecting the massive assets already created. At the same time, the reality is that governments, both at the centre and in the provinces, will find themselves less and less capable of providing open-ended budgetary support to all kinds of public enterprise. The popular perception of the public sector is
also a vital factor. This is likely to become negative if the services deteriorate, or prices continue to rise.

**Options**

*Privatization*

Let us consider the options in the Indian scene, and first, the privatization route, i.e., total or partial disinvestment. As far as profitable units are concerned, both are feasible, and the debate centres on desirability. Oil, for example, where natural reserves are limited, is a critical sector, where the strategy of exploration and exploitation has to be regulated in the national interest. Administered prices here serve to discourage high consumption, as well as help mop up substantial surpluses. It is doubtful if the private sector would want to operate under such circumstances. Privatization of ailing units is certainly desirable, but not likely to be feasible, because of the heavy liabilities, including the workforce, that goes with them.

Privatization, in the sense of opening the core sectors to private investments, will, however, take place because of the paucity of government resources. But it is doubtful if the quantum of such investment will be substantial. Take power, for example: the private sector conditions for entering are, predictably, higher return on capital and higher depreciation allowance, as well as more access to term loans from public financial institutions and a consequently higher unit price. The State Electricity Boards, charged with the responsibility of distribution and collection, with heavy subsidies for the agriculture sector, and no freedom to raise tariffs, will find it burdensome to guarantee offtake of expensive power from private generation. Of the three gas-based fertilizer plants licensed for the private sector in the Seventh Plan, only one is likely to come up. Likewise, a joint sector refinery project is yet to make a start.

There is also a bigger dilemma in taking privatization to its logical end, namely a free market situation, for a country like India where the overwhelming majority of the population has relatively low purchasing power. Yet a minority with higher income constitutes, in absolute numbers, a market as large as most of Western Europe. Private investment, in its relentless pursuit of ROI, is likely to cater mainly for this market, and penetrate the rural market as well with high-priced consumption goods. The task of planning for the production of low-priced wage goods will still remain with the state. Even now, for example, the production of cheaper textiles for the poorer masses has been thrust on the already failing public sector textile mills, originally taken over as sick units from the private sector—the obverse of privatization. Likewise, the task of providing relatively unremunerative products like billets or rails has devolved on
the public sector steel plants, the private sector having withdrawn from such production. Privatization as such has very little significance unless the fruits thereof are available for the solution of some of the larger national problems of a complex economy like India’s.

If the public sector has failed to generate enough surplus, it is now common knowledge in India that the private sector has generated inestimable amounts of undeclared income, a good part of which is believed to have found its way abroad. Given this reality, can there be sufficient confidence that there will be a convergence of private interest with public good? Judicious intervention and investment by the state are inescapable in our situation, independent of ideology. If liberalization of controls and a regime of trust are seen to be good for the growth of the private sector, it is all the more so for revitalizing the public sector.

**Improving the public sector**

Of the three major debates on the public sector two are set at rest, not by resolution of principles but by stark necessity, namely the criteria of profitability and a reserved domain for itself. The third issue of the autonomy of enterprises invariably reaches a stalemate. The argument for status quo runs on familiar lines. No serious change in controls or in the powers of intervention can be made unless the minister’s responsibility to the Parliament is delimited—something to which the legislators can never agree in principle. No change in the document-ridden procedures of accounting, tendering, buying or selling, and other normal commercial work can take place because of the requirements of propriety audit by the Auditor-General. These are rationalizations of a position the basis of which runs deeper. Very recently there is a move towards having a Memorandum of Understanding between an enterprise and its ministry, but as yet this is more in form than in substance.

The two major ills inherent in a public sector, as mentioned, are bureaucratization and lack of employee motivation. The first is to be negated, and the second can be made into a positive factor. But the various groups who can combat the one and foster the other continue to nourish their own interests and myths. Change could threaten one or other of the nests of comfort built over the years.

The myths originate with a phrase from the days of Gaitskill and the British Labour Party, with its overtones of Fabian Socialism and welfare economics: ‘the commanding heights of the economy’. This appealed to the Indian leadership of the day. However, it meant many things to many people—economists, bureaucrats, ministers, managers, workers, private business, trade unions, and the politicians at large.

The economist-planners saw in the public sector a stream of prosperity flowing from large investments, and increasing surpluses for national development. Despite rude shocks, this expectation is desperately clung to, Plan after Plan.
We have seen the weight of capital which is really crippling the public sector. Judgement on risk capital investment tends to become clouded in government by many other considerations, and the acid test of liquidity is remembered only long after the operation of the enterprise starts. It is then realised that assumptions regarding breakeven have proved wrong, as have those regarding markets and costs, and returns are nowhere in sight. No wonder many enterprises emerged with congenital defects, such as a high capital-output ratio, an adverse debt servicing capability, unremunerative products, irrational prices, and an organization ill-equipped to cope with the task. This situation is then sought to be remedied by tinkering with the superstructure, frequent changes of guards, and ad hoc pricing decisions swinging from ‘too little too late’ to ‘too often too much’.

All the motions of a sophisticated project appraisal are gone through, at least for large central projects; but that is all in-house, and can be and often is overruled by the actual decision-makers, the government. Who in government? Ultimately the minister and his secretary, a permanent civil servant. Government is impersonal, but a truer description is that it is intermittently personal. The personal judgement, commitment, and experience of the ministers and secretaries are crucial. Unfortunately they change frequently. The hierarchical channels of consultation keep issues spiralling till they find their way to the apex, with many unresolved issues. Delay and discontinuity are inherent in the system. Estimates and assumptions are only relevant to get a project through; they are out of joint even before the project is sanctioned.

Again one asks the question, why does it continue? It does because there is, in fact, no one accountable for delays or for the merits of their decision. None of the real decision-makers actually have to set up and run an enterprise on the ground. In any case, they are unlikely to be there by the time it is running. The answerability of the minister to Parliament is virtually a literal one, namely answering a Parliamentary question adroitly drafted by the secretariat. A minister is answerable only to the Prime Minister, or (in the provinces) the Chief Minister, who has the power to remove him, not Parliament. The secretary is answerable to the minister, but his job is protected by the Constitution. Only the chief executive of the enterprise, if not a civil servant, is on a short contract and is vulnerable. So why on earth should ministers and secretaries be motivated either to initiate or approve real reforms to a system which assures them power without accountability? No wonder that volumes of committee reports on the reform of the public sector gather dust in government archives and promised White Papers which do not see the light of the day, yellow with age.
How about the managers? The early executives in the public sector saw an unlimited vista of challenging opportunities, but the managers of today know that they cannot buy or sell, reward or punish according to their best professional judgement. A single mistake can cost them dearly. In a bureaucratic system, conformity is the safest way to survival, and survival ensures progress in career since proving merit is as impossible as proving incompetence. It is theoretically possible for public enterprise boards to change irksome procedures, subject again to the approval of the government and the Auditor General. Why then are such changes not initiated by the management themselves? First, by experience they have come to believe that changes at the margin may be brought about, but fundamental changes would never be approved by the government. Second, in the systems introduced within their enterprises by the civil servants, they too find safety and security without accountability for performance. Where there is no room for trust and encouragement there can be no motivation for change.

There is also a third factor. The public sector executives have a serious identity crisis. As public servants they find themselves lower in status than the civil servant. On the other hand, they cannot ever aspire to the pay and perquisites of their counterparts in the private sector. In these circumstances, top executives content themselves with the trappings of the private sector, like posh corporate offices, guest houses, lavish annual reports, and media publicity, whilst the middle and junior levels unionize.

The private sector has a two-way relationship with the public sector: as buyers of input products, and as suppliers of goods and contractors for projects. As buyers, the private sector is happy when administered prices are low, and lower than import options. When administered prices rise, they are free to raise their own prices, or press for imports. At the same time, private contractors and suppliers soon recognized in the public sector a steady widening flow of private income from public funds. They are well aware that dealing with public enterprises is no different from dealing with government departments. Decisions could rarely be expected within the validity period, costs would escalate, and claims be added on. Even political pressure could be brought to bear on tender awards. In this situation the public sector is likely, more often than not, to buy dear and sell cheap. Why should the private sector wish to see this system end?

For the average politician ‘commanding heights’ simply meant, in terms of realpolitik, the exercise of power and patronage to suit his own ends. He would be not the least interested in the autonomy of the public enterprises.
So we are left with the last group of actors: employees below the managerial level. They are numerically the largest and have the biggest potential to bring about change. But they are happily unionized. As long as their unions fight for increased wages, more manpower (i.e., less and less work for the individual), automatic promotion, and protection from discipline, they remain unconcerned about the fate of the dying golden goose.

Like all the other groups, the trade union leaders continue to nurse their old myths which serve to rationalize the groove they have fallen into. The omnibus argument used by left-wing unions is that the worker cannot give of his best until production relations change, following a socialist revolution. Till then no distinction need be made between a state-owned enterprise and a private one. Leftist unions justify this stand by saying that the state in India is not a workers’ state, and the moderate unions justify it by maintaining that they are independent of the ruling party. Thus both choose the public sector as the arena for competitive bidding and industrial action. The truth of the matter is that the trade union movement was a part and parcel of our freedom struggle, and each political party maintains its own union as a part of the subsequent trial of strength for political power. Behind the myth of recognized unions as sole bargaining agents is belief in the hegemony of a single union. The result is a bitter multi-union rivalry which is eating into the vitals of the work ethic in public enterprises. In these circumstances, the leftist dogma of the politicization of the workers through economic struggle has been reduced to a myth, and discipline at work is equated with revisionism. Even their basic tenet that organized industrial workers represent the vanguard of revolutionary change may become a myth if the large workforce in the public sector loses public goodwill and begins to be seen as a privileged elite, surrounded by a sea of educated, unemployed youth and landless labourers, both growing in numbers.

This is how one of the most potent forces for the redemption of the public sector has recoiled from its role as a change-agent. It would be totally wrong to lay all the ills of the public sector at the door of the trade unions. However, it would be equally wrong to say that they do not have their share of contribution to the unenviable situation in which the public sector finds itself today, nor that they have no role to play in its regeneration.

It is the legitimate duty of the trade unions to protect the real wages of the worker. But when a rise in the cost of living in part stems from the low productivity and high cost of production in the core sectors like power, coal, or steel, which affect the entire economy, and when the losses of the public sector add to budget deficit, are we not caught in a vicious circle? Is there a single function or programme of improvement in enterprise
operation which can be carried out by the management without the willing hand of the employee?

Change from within

It will be idle to expect real change to come from outside the boundary of the public enterprise, from the government, Parliament, or the public, because they have no strong motivation to bring it about. It can only come from those who are really threatened today—the managers and workers—coming together to save their enterprises. But it means shedding outmoded concepts, held both by the managements and unions, that the workers’ only responsibility is to work and the rest is the prerogative of the management. Participative management will become a reality when the workers also equip themselves with knowledge and understanding of the production, marketing, and financial problems of their enterprise, on a par with the managers.

Public sector enterprise is an endangered species today. Without the kind of managerial revolution from within outlined above, the public sector is unlikely to survive merely as an act of faith. It may become then, tragically, a lost cause. Speaking on the public sector once, I took the liberty of rephrasing Rousseau, to observe that the public sector was born free, but it is in chains everywhere (Bhaya 1983). Today (Bhaya 1987) my rhetorical question to the public sector—to its human constituents—is Quo Vadis?

References

Chapter sixteen

Divestiture in a developing economy: Pakistan

Riyaz H.Bokhari

In his masterly analysis of the process of privatization of public enterprises, Ramanadham (1988) identified three categories of measures—ownership, organizational and operational—which could be adopted to achieve the intended objectives. Divestiture falls amongst the ownership measures.

Divestiture may involve anything from off-loading part of a government’s interest in the equity of a public enterprise, through the sale/transfer of its shares, to complete liquidation by sale of its assets, piecemeal or in total. Governments are free to choose. What they choose will depend at least in part upon the particular circumstances, hopefully having examined the alternatives.

If continuing losses in an enterprise are due to its inefficiency, or because it is shackled by the government’s own bureaucratic controls (mostly unnecessary and often unproductive), one alternative would be to examine whether the original objectives of setting up the enterprise cannot be achieved economically and effectively by removing the basic cause of the losses. Where its plight can be traced back to an inappropriate selection of site or of technology, there may limits in what can be achieved by re-organization of management or of control. The best course may be for the government to cut its losses by full divestiture to a party willing to accept the challenge, and resourceful enough to bring about a turnaround.

The main problem is inertia. Even when the performance of a public enterprise has been demonstrably unsatisfactory for a prolonged period, remedial measures are either not initiated or are adopted so late that the situation becomes irredeemable. Both management and ministry may be apprehensive that proposals to divest may be seen as an admission of their own failure. The ministry of finance, for its own reasons, may also be unwilling to initiate early action. Much time and resources are spent on formulating and examining different alternatives and justifications for further assistance, protection, and subsidies from the government, in the hope that these measures will enable management to overcome their difficulties. The unpleasant decision may keep being postponed.
And when measures are decided, they are often neither sufficiently comprehensive nor bold enough. The committee work is considerable, and proposals have to be reshaped to accommodate conflicting points of view and interests. Meanwhile the deterioration in the enterprise’s affairs has been continuing at an inexorable pace, the remedial measures when taken being inadequate and too late.

An institution which could provide the basis for early action towards divestiture in clear cases could be the state audit, provided its independent reports are prepared by specially trained evaluators and are submitted to the government or legislature promptly.

In many developing countries however, there is a dearth of expertise about the mechanics and practicalities of handling enterprise sales. Capital markets and stock exchanges are usually underdeveloped. Workers’ unions are never convinced that divestitures will be of advantage to them or to society, and prospective purchasers will have to take the hostility of labour into account. The legal hurdles may also be great, and careful thought has to be given to avoid the entire operation becoming caught in long drawn out legal battles.

*The development of thinking on privatization in Pakistan*

*background*

The Pakistan Industrial Development Corporation (PIDC) was set up in 1950 with the primary aim of promoting industrial enterprises. It was required to submit schemes for setting up industries for government approval. These schemes were to be put into effect through public companies to be sponsored by PIDC. The capital required would be issued for public subscription, but if it remained unsubscribed PIDC was authorized to take up the shares on behalf of the government, to be disinvested as and when considered appropriate.

By 1959–60, fifty-three projects had been completed by the Corporation. Many of these were joint ventures with private industrialists in which the management was with the private sector and PIDC’s shareholding ranged from 6 to 75 per cent in the total paid-up capital. In the late 1950s and the 1960s a number of enterprises had been disinvested, and portions of shareholding of some lucrative PIDC projects had been sold to a few leading industrialists who were reported to be close to the regime.

*Performance of public enterprises (1972–7)*

A government committed to socialist principles of control and management of the means of production came to power in 1971. Among its very first actions was the large-scale nationalization of private sector enterprises. The thirty-one nationalized industrial establishments combined with twenty-two units of PIDC had capital assets totalling Rs 3,010 million.
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and their proper management posed many problems. The result was that the conventional indicators of financial performance, after modest increases for two or three years, started falling.

The poor performance of public enterprises—particularly in the industrial manufacturing sector—in terms of capacity utilization, increasing costs of production, low productivity, and deteriorating profitability, started becoming evident in the second half of the 1970s. There were many reasons for this: inability to set up a sound businesslike institutional structure of management of public enterprises, preoccupation of the administrative ministries with command and control aspects leading to centralization of decision-making, and non-availability of professional management. These were the most important.

Reviews and developments after 1977

Nationalization and the performance of public enterprises had become controversial issues. One of the first acts of the regime which took power in 1977 was to undertake reviews of the performance, policies, and organizational structure of these enterprises, and also to consider ways and means of reviving production by improving the investment climate for the private sector.

It was held that private industrial initiative had been paralysed by the fear of further nationalization and by constantly eroding profit margins. A series of policy measures had increased the cost of capital, enhanced wages and fringe benefits, established security of employment, and strengthened trade unions.

The new regime generally believed in the sanctity of private property. In the beginning it had no commitment to any definite economic programme. While it continued to avail itself of the advantages gained through control over a large public sector, its general approach was to try to revive the private sector and to restore its morale. In order to establish its credibility with private investors, the government promulgated the ‘Transfer of Managed Establishment Order’ in September 1978. This empowered it to transfer shares or proprietary interests of the establishments nationalized under the Economic Reforms Order of 1972 to persons in whom the management or ownership had been vested immediately before the take-over. The previous owners were debarred from making any claim for compensation of any nature against the government, and provision was made for assumption by it of the net losses incurred after the take-over until their transfer back to the previous owners.

Not many owners took advantage of this enactment, perhaps because the transfer was a complicated affair, subject to formal audit. Liabilities at the time of take-over were taken into account, and the valuation of new assets created during the period of public management. The processes involved in denationalization were so drawn out, and the financial valuation
so unattractive, that very few enterprises were handed over to their previous owners.

The government itself might perhaps have accepted the demand of the previous owners to transfer the enterprises to them through a sweeping law in the same manner as they were taken over, but during the period of public ownership and management, another vested interest (the workers and lower/middle management) had gained power and had developed a sort of ‘proprietary’ stake in these enterprises. They vehemently opposed any general move of wholesale denationalization.

Main considerations for privatization

During this period, the tilt towards a higher rate of investment by the private sector and for privatization by divestiture was justified by political leaders, government officials, and most of the press on a number of overlapping considerations.

First, continuing with public enterprises which register losses year after year would not strengthen government policies in the social sector. To the extent that the failure to earn satisfactory returns on investment in public enterprises limited the government’s capacity to extend the coverage of essential services, there was an implicit subsidization of some sections of the population at the expense of others. The low profitability of the public sector reflected, in part, the government’s concern with social considerations, including the desire to maximize employment opportunities, to develop backward areas, and to limit domestic inflationary pressures. If most of these were available only to small (often the more affluent) sections of the population, the long-term objectives of social policy would not be achieved. Therefore enterprises with low (or negative) returns should be got rid of.

Second, the government wanted to remove all unnecessary controls and interventions because they neither encouraged national output nor stimulated investment. Investment fostered by deregulation and privatization should be recognized as a better method of achieving the country’s social and economic objectives with equity, because a deregulated system puts greater responsibilities on managements who have to operate in a free competitive market.

Third, there was one fundamental need everywhere: the need to increase efficiency in the production and distribution of goods and services. Experience in industrialized Western markets had shown that efficiency was possible only in a general environment of decentralized decision-making, distribution, and investment.

Fourth, while some recovery in production can be obtained by improving the efficiency of existing enterprises, the achievement of sustained growth would require further investment. Given the continuing limits on resources there was little scope for the government to finance
more than a small proportion of this. Besides the argument that private enterprise was more efficient, a compelling reason for government to disinvest was that ‘sell-offs’ raise money—which was good for politicians who want to cut taxes, or not raise them, despite yawning deficits in their budgets. The way to relieve public budgets would be by meeting certain needs through the private sector, hopefully at a lower cost by a more efficient allocation of resources.

Finally, good and efficient management had become not only necessary for greater profitability, but essential for survival itself. Whatever incentives were provided to public sector managers, endeavours to improve performance would remain constrained by difficulties of attracting and retaining able managers and skilled manpower within public sector enterprises. In view of the constraints on management capacity, the government would have to consider a systematic divestment of at least the smaller public enterprises, because they require a disproportionate share of the limited resources of competent management, while contributing only a small share to the total public sector production.

The case for privatization acquired a fairly large following, although resistance—albeit ineffective—was expressed in some quarters, and attempts were made to rebut the arguments summarized in the previous paragraphs. There appeared to be a general consensus that the motive underlying the rejuvenated faith in the private sector was the government’s need to supplement the resources at its command.

**Divestitures in Pakistan—extent and methodology**

*Early disinvestments*

The first period (up to 1970) of early disinvestments related mostly to the operations of PIDC. During this period privatization was restricted to those industrial units or projects which had been set up and successfully operated by PIDC itself. In all these disinvestments, the primary consideration was not to get rid of any loss-making public enterprise, but rather to stimulate private sector investors to take interest in expanding the industrial base of the economy.

*Denationalization during 1977–83*

The second phase of disinvestment or denationalization of taken-over units took place immediately after the change of regime in 1977. In its first stage, the rice husking units were denationalized during 1977–8 under an ordinance, the object of which was to repeal an earlier Act promulgated by the previous regime to provide for their take-over. Similar ordinances were promulgated in respect of flour mills and cotton-ginning establishments which had been taken over by the government in 1976.
The thinking about these disinvestments had started towards the last days of the previous regime itself, which had begun to realize that the public sector simply did not possess the necessary administrative machinery and managerial skills to operate and control successfully such a large number of small units spread all over the country. The ordinances providing for the repeal of the previous Act empowered the government to deliver possession of a taken-over establishment to the previous management. In order to protect the financial interests of the corporation which had been set up earlier to manage and operate these units, the ordinances provided that no claim or legal proceedings arising out of the return of an establishment would lie against the government or the corporation. The terms and conditions of service of all full-time employees under the previous management and those who had been employed by the corporation were to be protected.

The second stage of this denationalization phase relates to the period up to 1982–3. During the fifth Five-Year Plan (1978–83), status quo in the new public/private sector relationship was maintained. Two loss-making units in the light engineering sector and a steamship company were returned to their previous owners during 1978–80, under the provisions of a Presidential Order, which provided that all persons employed in the transferred establishments would continue in such employment without any change in their terms and conditions. The units transferred under this Order to their previous owners were subjected to special audits by independent auditors, and the values of assets and liabilities as at the date of transfer were recast.

Divestitures since 1983

The third phase of disinvestment relates to the period after 1983. The sixth Five-Year Plan (1983–8) adopted privatization as a philosophy, limiting the role of government as a facilitator of the private initiative and as investor of the last resort. The central theme of the Plan was deregulation and privatization. A number of measures had been initiated earlier to ‘re-instil the virtues of endeavour, enterprise, discipline, and efficiency’.

Reviews of the working and management of public enterprises were carried out by Committees with wide terms of reference. After considering their reports, the government decided to rationalize and consolidate the management of the public sector, and to reduce its size to economically viable proportions. Noting that there were a number of uneconomic and non-commercial entities which were running into financial losses, it was agreed that mergers of business units, regrouping of corporations, and financial restructuring of individual public enterprises should be carried out after a thorough review. A standing committee of the Cabinet on Reorganization of State (Industrial) Enterprises was set up to oversee the implementation of these decisions. The number of corporations was
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reduced from eleven to eight through mergers, and a number of chronically sick enterprises, which after rehabilitation were not likely to become viable, were earmarked for closing-down or liquidation. A programme of financial restructuring of enterprises was drawn up and implemented after detailed studies.

Out of federal government public enterprises, four units belonging to PIDC were disinvested after 1983 because of continuing losses and inefficient operations. Another enterprise under the Ministry of Industries was liquidated for similar reasons. An inefficient and loss-making foundry/pipe-making unit was closed down and liquidated. Similarly, a small fertilizer project, the machinery for which had been imported but which had not been installed for a number of years, was also liquidated. In the provincial public sector three sugar and three textile mills were disinvested in view of their losses.

The national airline had set up small hotels and tourist inns in the Northern Areas of Pakistan, and in 1984 it was decided to dispose of them to private sector operations, to obtain better management. Negotiations for the transfer of these units were held with selected parties which had shown interest in their purchase.

Three units (cigarette manufacturing, textiles looms, and marble mining and processing) which had been set up by a federal government corporation for developing backward areas, were incurring heavy losses. In 1981–2 it was decided to lease these units to private parties. However, this arrangement did not work satisfactorily, and it was decided to close them down during 1985–6. The device of leasing the assets of loss-making units, for example milk and cold storage plants, to private sector operators was found to be full of problems and had to be abandoned.

Over these years, since 1983, out of nearly 350 public enterprises of the provincial and federal governments, thirty units have actually been disinvested or liquidated, and another twenty or so are under various stages of consideration for disinvestment. Whereas with the denationalizations carried out during 1977–83, the consideration and conditions of return, sale, or transfer were arrived at through direct negotiations with the previous owners, the process of divestiture of the units since then was initiated by inviting bids from interested parties. The total purchase consideration involved in the disinvestment packages finalized after 1983 adds up to more than Rs 1 billion.

In all cases of loss-making public enterprises, substantial amounts of loans from nationalized banks are outstanding. The banks’ aggregate credit exposure in public enterprises stood at Rs 42 billion on 30 June, 1987; as much as Rs 14 billion was in sick or defunct enterprises. Any proposal to disinvest, close down, or liquidate an enterprise is, therefore, a matter of great concern to the creditor banks. The Pakistan Banking Council (PBC), which administers and controls the nationalized banks, feels that it must
be fully associated with the process of disinvestment. It has drawn up, in consultation with government agencies concerned, a standardized and comprehensive procedure for adequately dealing with the different stages of disinvestment. These are the preparation of sale advertisement and standard offer pro formas, bid evaluation, establishing bidders’ creditworthiness, final negotiations with the responsive parties, and drawing up a standard disinvestment package. Offers are invited for fixed assets, and current assets are matched against current liabilities on the basis of a joint audit carried out by auditors appointed by the sellers and buyers.

The Standing Committee of the Cabinet referred to earlier was also required to analyse problems of non-profitable sick units. Their continuous losses are a source of concern both to their workforces and to the government. The government has declared that it has no intention of either closing down a factory or selling it unless appropriate arrangements have been made for its staff. At the same time, government cannot allow a drain on public resources to go on for ever. In pursuance of this line of thinking, in 1984 the workers of two loss-making units were offered either alternative jobs in other units or generous termination-of-service benefits—‘golden handshakes’—pending the sale of the assets. Unfortunately, due to litigation with ex-owners, it has not so far been possible to dispose of the units.

As a measure to rid itself of the responsibility of providing additional funds for investment, the government decided to ‘cast out’ of its budgets organizations like the Water and Power Development Authority (WAPDA), which would now be required to ‘raise their own funds to meet their requirements’. WAPDA floated government-guaranteed 13.5 per cent (tax-free) bearer bonds (5 years) to raise Rs 2 billion for the purpose of financing its power development programme. This was the single largest bond issue ever floated by a public body, and as much as Rs 3.02 billion worth of these bonds was taken up. The bonds have been listed on the stock exchanges and are expected to help in developing a broad-based and diversified capital market in the country. Encouraged by the response to this offer, recently WAPDA has issued a second series of bonds.

**Problems in carrying out divestitures**

**General**

The process of privatization has been proceeding in Pakistan both at the broad macro level of the economy, through efforts at deregulation and the creation of a climate favourable to private investment, and at the level of individual public enterprises, through efforts at their sale, disinvestment, and divestiture or exposure to the pressures of market discipline. These
approaches involve changes in the basic understanding of the role of government and the power structure of its bureaucratic machinery. Changes are required also in the procedures to be followed and responsibilities to be shouldered by various government departments and regulatory agencies. Difficulties of all types are therefore bound to arise in the implementation of the new policies.

Frustration is felt particularly by the planners when individual private sector entrepreneurs do not behave in consonance with the perceived overall interests of the economy, or even of the private sector as a whole. They may choose to place their own short-term gains above all other considerations by exploiting loop-holes or oversights in the privatization processes. This can lead to inequities in the distribution of national wealth, and generate tensions which might ultimately result in a policy swing.

**Disinvestment of individual enterprises**

The main experience with the disinvestment or divestiture of individual units has been that its progress has not kept pace with the government’s own plans. There are, of course, many hurdles. There is the fact that the government has tried to sell non-profitable enterprises which the private sector has not been eager to purchase at the indicated prices. Potential buyers usually have alternative investment opportunities, and they may be interested only in the best performing public enterprises with low risk and high profit potential. Public enterprises located in less developed and far-flung areas on social welfare considerations are usually in poor financial health and the inadequacies of infrastructure and other facilities do not make them attractive to private sector.

There is also the fact that ministries, enterprise managers, and labour unions are often reluctant to give up their hold over a public enterprise. The employees fear loss of (comfortable) jobs; unions do not relish the prospect of dealing with new and experienced management; managers and bureaucrats see an attrition of patronage and perquisites; and politicians are apprehensive of the consequences of unemployment.

Another strong factor responsible for slow progress is that the proper implementation of a disinvestment decision is itself a difficult and complex task. Procedures for according final approval are cumbersome — there are far too many tiers and bodies to be consulted for advice or for protection of genuine or imaginary interests. It is sometimes not fully realized in government circles that delays in these decisions only add to losses, further reducing the unit’s net worth.

Cases have also been reported in which the final approval to the ‘disinvestment package’ arrived at after long and tedious negotiations was withheld apparently because the purchasing party was not acceptable.
on political considerations. In the case of denationalization of a taken-over unit, the law requires that it should first be offered for sale to its previous owners, who may not even qualify on grounds of their present creditworthiness or managerial competence. This legal requirement may be removed by amendment in the law, but until this is done there cannot be much progress in cases which are sub judice.

Public enterprises generally have low capacity utilization and, as a consequence, high fixed cost of production per unit of output. This renders them unprofitable unless subsidies or high prices are allowed. If such enterprises are acquired by the private sector they will need to be operated at their full-rated capacities to become profitable at competitive market prices. For this purpose there has to be an adequate domestic market for the goods and services which can be supplied by the enterprises in question. Doubts about the existence of this market create an inhibiting factor in the bids for public enterprises.

The relatively under-developed state of the capital market could be another factor responsible for the slow progress in disinvestment or partial divestiture, particularly in the promised sale of shares in profit-making public enterprises. It may be necessary or convenient to place these shares on the stock exchange for gradual sale in a phased manner. However, a particular problem has to be faced: if the share prices rise after sale, government officials will be accused of giving the enterprise away ‘for a song’; and if the share prices drop, the charge will be that ‘the poor public was taken for a ride’. Thinking on these lines is not conducive to quick decision-making in bureaucratic circles.

Concluding remarks

Whether compelled by the sheer necessity of relieving strains on its budget, or whether attracted by the prospect of gainfully canalizing ‘black money’ into productive sectors, the Pakistan government appears committed to an overall policy of gradual privatization of selected public enterprises through divestitures. In a recent meeting with the members of Karachi Stock Exchange, the Minister of State for Finance, Commerce and Planning/Development reiterated that the government was committed to the programme of privatization of public sector units. However, he clarified that the schemes had to be carefully formulated with the objective of ensuring that such policies yielded maximum benefits to the economy, and led to promotion of the capital market with widest possible dispersal of shareholding. The government had, therefore, ‘decided to seek the services of consultants for studies to help identify the units which may be privatized and to formulate the most appropriate approach’.
Audit and performance evaluation of public enterprises are among the major responsibilities of the Pakistan Audit Department. Since the privatization of individual public enterprises involves the sale of valuable assets, these transactions need to be audited to examine whether public interests have been safeguarded. This work has not received the attention it deserves; only two audit reports on specific disinvestments have so far been prepared. While it is a comparatively simple task for auditors to satisfy themselves that a particular disinvestment transaction has been carried out with due regularity and propriety, it is a much more difficult task to review whether its intended benefits to the exchequer and the economy have been achieved at least cost.

In the case of divestiture of loss-making units, a straightforward conclusion can be drawn that at least the accumulation of further losses has been stopped. But in the case of divestiture of profit-making units the assessment of the advantages to the economy as a whole can be a complicated exercise. A great deal of effort, thought, and research are required to develop a suitable methodology and guidelines for this purpose.

References


Chapter seventeen

Public enterprise holding companies and privatization: the case of IRI, Italy

V. Ajmone Marsan

The organizational design of the public enterprise sector has evolved over time, and differs across countries. Whilst there is much diversity of legal form, the various types can be meaningfully classified in terms of the degree of autonomy which in each case is granted to public enterprises. The state-held joint-stock company operating under ordinary commercial law represents the most decentralized structure.

The recourse to this standard form of organization in the public sector implies that it is not singled out for special treatment vis-à-vis its private counterpart, nor that the state’s motive for engaging in production activities is the result of an ideological bias against a market economy. The political philosophy underlying this approach reflects an appreciation of the virtues of the market mechanism and of private enterprise, without being blind to the deficiencies and imbalances in the process of capital accumulation which laissez-faire cannot correct.

Up to a point, the state can achieve its ends by granting incentives to or imposing restraints on private enterprise. However, these may fail to call forth all the investment specifically desirable in the public interest, or may fail to avoid the emergence of an undesirable, sectorally dominant domestic or foreign enterprise.

The case for public enterprise is based on such premises. Its ultimate purpose is to improve the performance of the market in terms both of balanced development and competition. The problem for the state is to adopt an organizational structure which will best fit its general strategy, i.e., that will allow the exercise of entrepreneurship and thereby attract competent and dedicated managers to the public sector.

It is in order to contribute to an effective solution of this problem that the holding company concept has been adopted in the public sphere.

Italy has had the longest and probably the most successful experience with public sector holding organizations. IRI (Istituto per la Ricostruzione Industriale), the best-known among them, was established in the early 1930s for the control of a large portfolio of manufacturing and service undertakings taken over from three major banks in distress. This historical
origin explains the highly diversified array of activities which, from the very beginning, were vested in IRI. These characteristics soon became a structural feature, reflecting the development strategy which IRI was to pursue in response to public policy objectives.

In the interwar period only two other countries (Turkey and Spain) had recourse to holding companies to manage a large part of their respective public enterprise sectors. Since 1945 the state holding company model has spread both in Italy (where two more parent holdings are operating alongside IRI) and in a growing number of countries, some relatively advanced (Austria, Sweden), but most of them with problems of development. A recent and notable instance is the Indian government’s 1987 decision to establish two new holding companies in the public manufacturing sector as part of a comprehensive reform of India’s central government enterprises.

Needless to say, the performance of the holding type of enterprise in the public sector varies between countries. Specific cultural, political, and institutional factors explain inter-country differences which, although of considerable interest, this author cannot hope to do justice to here. The background for this paper is essentially the experience of IRI, which has a claim to be considered the prototype of the public sector holding company. IRI’s experience reflects a coherent institutional philosophy and organizational design of public entrepreneurship in a market economy. The ‘IRI formula’, as it is popularly called, was developed and refined over the years by P.Saraceno, a management scholar who has been also one of IRI’s key managers since its establishment.1

The holding company/state interface

The state (a term meant here to cover both the government and parliament) which decides to perform the role of entrepreneur is guided by considerations other than profit and a means of raising government revenues.2 Its purpose is to promote, to use Saraceno’s synthetic expression, a ‘balanced process of development’ (Saraceno 1981:37–9) in a market economy framework in which both public and private enterprise have an essential role to play. Balanced development, in this context, has an essentially political connotation, reflecting the values and preferences of the political forces which rule a country at a given time. As both political and economic circumstances evolve, new challenges and priorities can be expected to emerge that will call for new public policy objectives and strategies.

Their implementation cannot be entrusted to the state’s traditional administrative techno-structure, whose professional training and norms of behaviour are rationally designed to ensure
impartiality and predictability to activities that are not exposed to the discipline of the market. What is needed is a decentralized and specialized level of administration, as the state has done in areas such as justice, education, and public health. Along with judges, teachers, doctors, etc., the modern state needs to find and make use of managers.

The value of a public sector holding company

In this logic the state in Italy historically has adopted a typical managerial structure of modern large-scale enterprise—the group, with an apex unit which guides, supports, and monitors an array of legally separate operating sub-units in which the apex has a controlling stake. The competitive advantages of such organization design have significantly enhanced the growth potential and financial performance of the large multibusiness and multinational private companies that have come to characterize the structure of industry in all major market economies.

There are many ways in which a parent holding can be a source of competitive strength for its subsidiaries. Two are specially relevant to the present discussion of the potential contribution of a holding company to the autonomy of public enterprise. One is the greater credit capacity which a parent holding can achieve, because of the pooling of risks and large size inherent in the grouping of diverse activities under its control. In the public sector this avoids overdependence on the treasury for the funding of investment and other requirements, enhancing thereby the degree of flexibility with which public enterprises can be managed.

The other advantage is the improved utilization and development of top-level executive resources which a holding company can deploy across its subsidiaries, with the aim of providing each of them with the management best suited to its needs. And the fact of opening up career opportunities in a group, rather than a company, will attract executives of calibre as well as hasten the development of new generations of managers. In the public sector this critical responsibility devolving upon the holding company is closely linked with the peculiar role which it must play for the safeguard of managerial autonomy. Capable and motivated managers will hardly be attracted to the public sector if they feel that they would be changing profession when moving from a private to a public enterprise.

Autonomy is not synonymous with independence. An autonomous entity is part of a larger system within which it can legitimately pursue a goal of its own in ways that are congruent with the priorities of a higher level of the system.

The legitimate goal of public enterprise in a market economy is profitability, and there is little reason to fear that its managers will not strive to earn a commercial rate of return: satisfactory performance
establishes the reputation of a manager, with the associated financial, career, and psychological rewards. This of course should not be taken to imply a surrender to ‘technocracy’. Public enterprise is established in order to serve social and economic policy objectives, and the problem is how to overcome the apparent conflict with a profit-oriented conduct.

It is worthy of note that in the Italian experience the first impulse to evolve a set of decision rules which would be appropriate to the role of public enterprise managers came from the holding company’s level. The reason for this is the circumstance that the state holding is endowed with capital for which it is accountable; the same is true for all its subsidiaries, which, moreover, as joint-stock companies may have part of their shares in the hands of private investors or partners. On the contrary, the administrative ministry is not a ‘superholding’, but a public policy-maker, whose prime concern is to utilize public enterprise as a means of achieving state objectives.

When commercial and social policies collide

In certain cases, infrequent but conceptually important, government objectives and commercial principles do not conflict, so that public enterprise can operate without being burdened by any costs which market prices will not bear. Private capital and initiative simply may not be available because of the large size, long pay-back period, or high risk of an otherwise commercially viable project which is deemed to be in the interest of a country’s balanced development. Most of the time, however, public policy objectives do conflict with commercial considerations, and imply constraints on management decisions from which private enterprise is exempt, and which cause non-commercial costs.

The specific responsibility of the holding company in the latter case is first to satisfy itself, relying on the judgement of the management of the subsidiary concerned, that the priorities of public policy can be met without compromising the long-term viability and growth of the enterprise. Non-commercial costs must be of a temporary character and profitability should be achievable, albeit within a longer-term perspective than would be acceptable to private enterprise. If this test is passed, the holding company will then co-operate with the subsidiary’s management in assessing the amount of policy-induced costs which the state will be asked to compensate before the event.

Focusing on the costs rather than the objectives of public policy avoids those unresolved measurement problems which arise when one attempts to assess managerial performance against multiple targets with ambiguous priorities. Non-commercial costs can be calculated in terms of opportunity costs on the basis of a judgemental appraisal which is the specific skill and responsibility of managers. Once these
costs are singled out and compensated, the return on capital can remain the driving force of management in the public no less than in the private sphere.

The decision on how much a particular policy objective is worth to society belongs to the political institutions. And to them the estimate provided by the holding company of the budgetary cost of a particular policy which public enterprise can serve is a highly relevant starting point when comparing the alternative uses of public funds, within the overall budget constraint.

If non-commercial costs fail to be determined and compensated before the event, parliament is deprived of its constitutional right (and duty) to decide on the allocation of budgetary funds. Eventually the financial burden which policy constraints impose on public enterprise will show up in the latter’s profit and loss account, and will still be borne by the state, except for the part which will unduly be sustained by any private investors who have acquired shares in the enterprise concerned.

At the same time the latter’s financial performance will no longer be a reliable measure of managerial efficiency, as the impact of policy costs will be indistinguishable from that of inefficiencies in the conduct of the enterprise or of adverse business conditions. In a situation in which it is no longer clear who is responsible for what, the more dynamic managers will be frustrated and tempted to leave the public sector, while others will plead government interference to justify their poor performance.

As a result public enterprise will gradually escape from effective control by the legitimate political authority as well as by the market. Sooner or later it will assume the features of a ‘parasytic system’ which will distort rather than strengthen the functioning of a mixed economy (Saraceno 1977:441).

**Divestment: experience and problems**

The conclusion emerging from the previous section is that public enterprise in a market economy can play its role only if its necessary relationship to the political authority does not prevent it from operating on a par with private enterprise. A competitive environment is essential for the efficient conduct of both types of enterprise. For this reason, in order to achieve its policy objectives the state in Italy deems it unwise to acquire direct control of whole industries, the idea being that both private and public initiative must jointly concur to the balanced economic development goal. Ultimately the measure of success of the state’s strategy is a stronger growth of private investment and a greater degree of competition than would otherwise have been possible.
As an illustration, the case of Italy shows that the presence of a significant public enterprise sector has in no way retarded the country’s access to the EC which exposed Italian industry—starting in the early 1950s with the steel sector, a major share of which is controlled by IRI—to an unprecedented competitive challenge. In fact, in all the manufacturing sectors in which they operate at present, Italian public enterprises face private competitors, domestic and foreign. The same is now true also of IRI’s subsidiaries operating in the service area, with the only exception of telecommunications—and in a not-too-distant future this too will be deregulated within the Single European Market due to operate from 1993.

The already-mentioned rationale of public enterprise in a market economy implies that the state is ready to shift its intervention from one sector to another as required by the evolving objectives of a balanced development policy, taking into account the contribution which private enterprise is able and ready to make in each case.

As a consequence, every public enterprise will be divested sooner or later, unless divestiture is precluded by a public policy directive, or is impossible because private enterprise lacks the necessary financial and managerial resources for the takeover. In Saraceno’s words ‘what must be justified is why a public sector undertaking is not divested, not why it is’ (Saraceno 1981:40).

**Policies for divestiture**

For the public holding company divestment has two attractions: it allows a rationalization of its portfolio by the dismissal of peripheral undertakings which no longer fit the core strategies of the group, and it provides cash resources (possibly also profits) which can contribute without recourse to the state budget to the solution of the always-difficult problem of funding a growing public enterprise group.

The lesson of IRI’s experience is that the sale of a public sector undertaking which is no longer essential for the purposes of public policy is always subject to a number of conditions. The prospective buyer must have demonstrably both the capital (from sources other than bank borrowing) and the track record which warrant the expectation of a viable long-term future for the divested undertaking. Divestiture will be ruled out, both in the service and manufacturing sectors, if the public undertaking holds a monopolistic position, or if its sale would give rise to such a position. And (at least in certain critical areas) the takeover of a public undertaking by foreign interests may also arguably be precluded.

In principle, the policy guidelines for divestiture, in the experience of IRI, have afforded considerable discretion, except for the subsidiary banks and the telecommunications and electric power activities, which
the government considered not divestible from the start. As a rule the sponsoring ministry will have received prior information from IRI when an acceptable buyer of a divestible subsidiary has been identified. The ministry’s views are communicated to the holding agency within twenty days from the receipt of the information (which must include the motives and proposed modalities of the divestiture, and indicate why it appears consistent with public objectives). IRI must take note of the ministerial views, though these are not legally mandatory, except when a divestiture entails total exit from an industrial sector. The government does not enter into the determination of the price of a sale, which is left to the responsibility of the holding agency.

Most of the time the sales have been made through direct negotiations. For this task IRI has set up a specialized sub-holding company to which over the years all minor subsidiaries scheduled for divestitures have been transferred. For large undertakings divestiture would normally be handled directly by the sectoral sub-holding company concerned.

At times, in order to win the consent of the workers when a loss-making company has been sold in the framework of a restructuring plan agreed upon by the buyer, to ensure its implementation a form of gradual divestiture has been adopted, whereby the transfer of the shares is spread over the time period scheduled for carrying out the plan.

The record of divestiture

In practice the record of more than fifty years shows that IRI’s divestitures have been altogether limited in number and value, when compared to the aggregate of the group’s activities. Moreover they have been concentrated in the early years 1933–6 (when divestment was temporarily IRI’s institutional mission) and in the most recent period.

During the long interval in between, the sale of subsidiaries fell close to nil, notwithstanding the readiness on the part of IRI to divest peripheral subsidiaries or loss-making units without a potential for rehabilitation within the group. The general environmental conditions prevailing in this period go a long way towards explaining why divestiture was inhibited: a lack of interest on the part of private enterprise, in particular during the difficult years following the two oil crises, and a preconceived opposition to privatization on the part of organized labour which in those years the government chose not to question. It was only from the middle 1980s with the strengthening of the Italian growth rate that both the above mentioned restraints weakened, and a moderate recovery of divestiture activity proved possible. This confirms the considerable influence of the general business environment on the divestiture process.
Divestiture policy by Italian public sector holding agencies has included increasingly in recent years the sharing on a par with one or more private partners of the controlling interest in a joint subsidiary. The resulting equal division of risks and responsibilities is justified in these cases, apart from the advantage for the parent holding of a reduced commitment of capital, by the access which such partnerships afford to new technological opportunities, new markets, and advanced management techniques. For this reason partnerships between public and private enterprise are increasingly of the cross-frontier type in the technologically most dynamic sectors. The forms adopted often rely also on non-equity contractual arrangements, such as have become frequent in the international context.

Finally IRI’s record shows the valuable role that a holding company can play in promoting the partial divestiture of equity in the public enterprise sector. The sales of shares in subsidiaries when IRI had more than sufficient for retaining control date back to the 1930s—the very first years of IRI existence. Private shareholders were valued as a source of finance, a means of additional pressure on management for efficiency, and a shield against undue political interference. IRI’s distinct contribution was in the ability to adopt innovative forms of access to the equity capital market. Thus the first placements were achieved through the issue by IRI of convertible bonds, at the time without precedent on the Italian stock exchange. Convertibility was offered (to the extent of 50 per cent of each issue) into shares of one among IRI’s sectoral sub-holdings, rather than an operating company, so as to enhance with a spreading of risks (inherent in the subholding’s portfolio) the attractiveness of the convertibility clause. All such floatations were successful, and all available conversion rights were exercised in each case.

After the war, until the onset of the oil crisis with the ensuing years of poor performance of most industrial enterprises, public and private alike, the placement of shares by IRI and its sub-holdings continued in various forms and amounts, including a number of listings of companies with a good track record. Gradually the contribution of private shareholders to the consolidated equity capital of the IRI group grew larger than the amount supplied by the state in the form of IRI’s endowment fund. As with divestitures, the general business and stock exchange crisis of the 1970s and early 1980s ruled out all possibility for the IRI group of relying on the equity capital market. The sale of subsidiary shares, within the limits imposed for retaining control, was resumed on a significant scale only recently. Among others, new listings were added on the Italian market, and two sizeable placements of shares were well received on the London Euroshare market.
As a result, in the space of five years during which the consolidated equity capital of the industrial section of the IRI group increased 3.8 times, the private shareholders interest, which in 1982 had fallen to an all-time low of 21 per cent, by 1987 had climbed back to 36 per cent.

**Directions of change**

For a number of years now the debate on privatization has been broadening in Italy beyond the issues of divestiture of state-held enterprises or of the placement of minority shareholdings on the stock market.

The record of IRI and ENI (the other major holding agency), which have succeeded in restructuring and turning around the bulk of their subsidiaries after the grave crisis of the 1970s, could not fail to influence the direction of thinking on the general issue of privatization. The proposals which have emerged are both conceptually and practically rather different from those which have prevailed in other western European countries.

One major current of opinion supports the view that most of the public services now organized as departmental entities would gain from being shifted to a more ‘private’ setting, such as would be provided by vesting each of them in a public holding agency of the IRI type. This so-called ‘irization’ of traditional government activities has been advocated in particular for the state railways and for the postal service.

Organizing public utilities in the form of joint-stock companies under the control of a parent holding agency is not without precedents in Italy. Thus the telecommunications network and services, with the exception of part of the long-distance domestic and international telephone services, are entrusted to three IRI subsidiaries regrouped under a sectoral sub-holding.

The inclusion of public telecommunications (TLCs) in the setting offered by IRI rather than a conventional nationalized corporation has been justified first by the greater dynamism attainable in the framework of a multisectoral grouping (Saraceno 1977:421). The modernization of Italy’s TLCs has indeed considerably benefited from the cross-fertilization achieved within the IRI group between electronic manufacturing and research, specialized software activities, and the operation of the telephone, submarine cable, and satellite communications. A further consideration is that the link with the central administration represented by the public holding agency ensures a greater degree of visibility of costs and other relevant aspects of operations, and a greater responsiveness to policy directives.
than can be expected when a concessionary company is privately owned.

It is worthy of note that, according to a recent government decision, the section of the Italian telephone network at present still vested in a departmental entity will be transferred to IRI. This move is a revealing evidence of the present trend of political thinking on ‘privatization’ in Italy. One should recall that in 1962, in a rather similar situation of another public utility—electric power generation and distribution—in which both public (IRI) and private enterprise were operating, the unification of the network was achieved by creating a nationalized corporation, to which also the IRI section of the power network was transferred.

Another instance of ‘irization’ worthy of note is that of the toll-motorway network which was entrusted to IRI in the late 1950s. In this case the conventional construction contract in the field of public works was substituted by a comprehensive concessionary agreement. An IRI subsidiary took upon itself the responsibility for and the risk of the construction and the subsequent running of part of the national motorway network over a period of thirty years, with the right to charge a toll (regulated by the state) for the use of the facility. At the end of the period the network will be transferred to the state without charge. The construction subsidy contributed by the state has been limited to 10 per cent of the total expenditure. The users of the motorway will eventually pay for the remaining 90 per cent, but the toll rate in real terms has been falling by almost 50 per cent since the opening of the network to traffic. The funding of the project has been achieved for the most part by issuing bonds guaranteed by IRI: in 1986 the profit record of the motorway was sufficient to warrant the floating on the market of a 15 per cent share of its equity capital.

The record of these precedents explains the present popularity in Italy of the idea of extending the experiment to new kinds of public services. While such a proposal is stimulating, it must remain subject to a reservation regarding the requirement of a sufficient level of autonomy for the management of a public utility or service if it is to be run not just efficiently, but as a state-held joint-stock company.

It would be a brave man who denied that every organization, in the public as in the private sphere, must strive for efficiency. However, owing to compelling public interest considerations, the management of a would-be commercially oriented service may remain subject to extensive and unpredictable government interference, overruling previously agreed strategies and commitments. It will then be unable to plan the future with any
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certainty, and the service, notwithstanding the legal form which may have been adopted, cannot be run as a commercially successful enterprise. In this case a different form of organization should be devised (authority, agency, etc.).

The term ‘privatization’, as used lately in the Italian context, has recently acquired a further, more subtle, connotation. The idea is that the public enterprise sector could be considered ‘privatized’, even without being divested, if it could be exempted from any policy constraint causing non-commercial costs.

This position does not deny the state’s right to steer the spontaneous functioning of the market for the sake of specific policy goals. Rather it assumes that this can be achieved with recourse to general policy instruments (incentives, restraints, etc.) applying to all enterprises. It is difficult to see which country could warrant such a belief. Perhaps the United States could be thought to approximate such ideal situation, given the support to innovation which a large part of industry secures from government expenditure on defence, space, and other programmes, and considering the negligible role of the unions and the flexibility of the US labour market.

However the possible existence of an exception confirms the rule, which is that the pursuit of public policy objectives will all too often impose a burden (albeit temporary) on the commercial operation of public enterprise.

To assume away the problem of non-commercial costs is not very helpful when dealing with public enterprise in countries which face problems of balanced economic development, as in Italy. And it is equally unhelpful to assume that there is no way to tackle the problem. Institutions have developed—such as the holding agency historically associated with IRI’s experience—that mitigate the difficulty which would otherwise make it impossible to establish a mixed economy on a rational and efficient foundation.

The lesson of IRI is not an easy one. It shows, first, that any new institution, however well conceived, in order to take root and bear fruit must go through a social learning process. Its relationships to existing institutions and to society as a whole must be adjusted and tested to the point of making the presence and operation of the new institution fully functional. IRI’s experience proves further that most of the credit for such achievement must go to the men who were responsible for the management of the institution in its initial years, when the problem was to identify and adopt, among various possible alternatives, the line of conduct which will at the same time be faithful to the existing system and innovative.
Since his retirement in 1968, Professor Saraceno has been serving as economic advisor to IRI. His innovative thinking on public enterprise, even more than my personal experience as member of IRI’s staff for over three decades, is the mainspring of most of the ideas presented in this paper.

This is reflected in the legal form adopted in Italy and other countries for public sector holding organizations, which are statutory entities rather than joint-stock companies. Thus IRI has a controlling stake in its subsidiaries with the associated shareholder rights, whereas the government is not IRI’s shareholder, and its decision and control powers, defined in IRI’s statute and other pertinent legislation, are an expression of an essentially political responsibility.

In groups with a high degree of diversification, as in the case of IRI, the introduction of an intermediate tier of sectoral sub-holding companies can accommodate complexity while ensuring specialized technical and marketing competence.

By statute IRI has its equity capital in the form of an ‘endowment fund’ awarded by the state.

Or available only in the form of a foreign enterprise, which may be deemed undesirable in the given situation.

Cf., IRI’s postwar successful development of the ore-based segment of Italy’s steel industry, an option which at the time private enterprise rejected in favour of the scrap-based process, requiring much smaller-scale investment.

Familiar examples are: locating a new plant in an underdeveloped area; restructuring, in order to protect employment, a ‘sick’ firm abandoned by private enterprise; investing in a very high-risk research-based venture, etc.

In a number of cases IRI has successfully declined to take on the responsibility for salvage operations. This was justified either because of the small scale of the ailing unit, or of a lack of fit with the group’s core lines of activity, or of the unsustainable drain on IRI’s managerial resources which restructuring would have entailed.

In the process described a conflict may arise between government and the holding company: the latter may judge a given constraint unacceptable, or the two parties may differ in their appraisal of non-commercial costs. Most of the time such differences can be argued through to a shared conclusion; if not, an arbitration procedure should be arranged for with recourse to an independent professional body.

Since 1978 IRI’s investment plans submitted to the government and parliament have included estimates of the anticipated non-commercial costs caused by public policy constraints. Compensation has been granted in the form of direct subsidies.

The twenty-day term may be extended if the ministry requires additional information, or in the case of ‘exceptionally important’ transactions.

In a recent case, in which a number of private domestic companies of comparable strength were expected to be interested in buying a group of IRI’s subsidiaries operating in a specific industrial sector (in which they accounted for a considerable share of the Italian market in some product lines), IRI was asked by the government to sell by competitive bidding rather than through direct negotiations.

For a brief account of the factors which in those years contributed to the severe financial crisis of the IRI group, see Ajmone Marsan (1986:88–92).
References


Chapter eighteen

Public enterprise, privatization, and cultural adaption

Nick Woodward

This book, in honour of a personal friend, presents the opportunity of raising personal concerns. In a career of confronting managerial problems and preconceptions, in teaching, writing, and practice, I have been struck by the difficulty of raising and discussing what I consider to be important questions—about the roots of organization, about why organizational behaviour denies organizational rhetoric, and about organizational purpose.

So many managers (and academic reviewers) seem to yearn for technical solutions to human problems, to seek technical knowledge rather than practical wisdom. But the latent problems are manifest in the values, assumptions, myths, and metaphors of much contemporary managerial practice, which seeks solutions from specialists, from techniques, from consultants, from the latest fashionable writer, from any source but those with authority, namely managers themselves. Education, if it is to be worthy of a tradition going back to Socrates and beyond, must be concerned with values and assumptions—cultural assumptions, as well as those upon which theories may be built.

So this is an opportunity to question some of the assumptions which underlie privatization programmes. In the UK they have been presented as a structural solution (transfer of ownership, change of environment) to a problem of organizational functioning (see the next section). But organizational problems seem common to industries located in both public and private sectors (see the third section), and they raise questions of leadership and the nature of organization transformation (see the fourth section). What seems to be lacking, particularly in western materialist cultures which extol the role of the entrepreneur as hero, of profit as the standard of success, and of conspicuous consumption and social status as the end of life, is the moral dimension which produces genuine heroes, and the sense of community, purpose, tradition, time and place, which characterizes many ancient and economically primitive cultures (see the fifth section).
I conclude that privatization, if imposed without reference to social or cultural context, and with the rhetoric of free enterprise, may prove to be yet another fashion, rather than an opportunity for renewal, to refocus purpose and confront the real problems of organization.

If the reader seeks instruction on how to effect cultural change and corporate transformation, then guidance may be sought from books in the references to this chapter, with the caveat that both problem and solution have the same provenance—managerial culture and behaviour.

Some paradoxes in the UK privatization programme

The public rationale for the UK privatization programme implies a model of ecological adaptation by organizations in response to external stimuli—greater access to private capital, discipline exercised through stock market processes, the threat or reality of competition in product markets. These external stimuli would then generate a response in terms of prices, financial viability, operational efficiency, and customer sensitivity—as in other virtuous private sector industries.

Organizations, however, including the processes through which this responsive adaptation might occur, have implicitly been viewed as ‘black boxes’, or portrayed on the basis of a rather jejune stereotype (e.g., Moore 1986), which ignored the variety of practice and culture in both private and public sector organizations.

The process of privatization has revealed some anomalies in this rationale which, since they seem to go against publicly expressed doctrine, I have labelled paradoxes. The first paradox relates to the speed and process of transformation of the organizations and their staff; the second to the general welcome accorded to privatization by the supposed victims; and the third to the pre-privatization transformation of some organizations while still publicly owned. These will be discussed in sequence.

The speed of transformation

An extreme view, perhaps expressed more directly in Parliament and press than in ministerial utterance, has suggested that public enterprises have been staffed by incompetent bureaucrats more concerned with empire building and territory than with financial viability or customers. A more generous view sees industry managers as divorced from stock market discipline and other market signals. In either case, when the ground rules change, it is assumed that these organizations will become virtuous—good private sector capitalists. Yet, at least in the short term, the large privatized industries seem to have remained broadly the same, in staff, procedures, technology, traditions, albeit with different constraints and opportunities. The case is different where markets have been genuinely liberalized and organizations broken up.
A sympathetic view then would be that under privatization the conditions for organizational transformation have been laid, and change will take time. And perhaps this resolves the paradox, for transformation (cultural change) in the sense of genuine change of attitude and practice is a lengthy and continuing process (Kilmann et al. 1988). This then raises the question of how long it is appropriate to defer judgement on the organizational effects of privatization. And how long will the political market place be willing to defer judgement if the great utilities and service industries fail to deliver the behaviours demanded by voting customers? Confronted with this question, one must expect both industries and government, perhaps even regulators, to have an interest in publicly demonstrating improvements, or at least managing the indicators of improvement.

In a political context, however, performance indicators are likely to be selected and managed for public consumption (Woodward 1986a). And while they may indicate genuine improvement (number of call boxes out of order, response to complaints, etc.), customers will remain the ultimate judges of levels of service and sensitivity. If there is widespread perception of insensitivity/inefficiency, no amount of high value added product proliferations, marketing and other communications will deflect the reality of personal experience. In public relations terms, monopolies have the worst scenario—customers cannot exorcise their resentment by buying elsewhere.

Why is privatization welcomed?

A second and cognate paradox is that one would have expected the industries to resist the ‘chill wind of competition’. Yet most public enterprises—directors, managers, staff—seem, in varying degrees and ways, to have welcomed privatization. A cynic might say that natural monopolies would be unlikely to suffer much of a chill, and to welcome access to private capital. Undoubtedly the latter is true. But apart from this, and the shares available to directors and staff, the real impetus behind this welcome may have been the prospect of escape from arbitrary government intervention. Historically this intervention has been exercised through a variety of mechanisms for a variety of non-industry-related purposes—not the ‘dead hand of Whitehall’ (the Civil Service) but the too-lively fingers of Westminster (the politicians). ‘In forty years’ experience of nationalized industry, the UK has not arrived at an appropriate set of arrangements for “managing” government relationships with them’ (Woodward 1989). So it seems likely that the welcome accorded to privatization was rooted in the prospect of escape from incorporation in government financial constraints and processes, and from departmental sponsorship and ministerial intervention. And the chill wind,
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at least for the large monopolies, will blow from the temperate cheek of a regulator.

Transformation while in the public sector

The third paradox is that some organizations (notably Jaguar Cars and British Airways) transformed themselves financially and organizationally while still in the public sector—reducing staff, cleaning up balance sheets, improving quality and service. While in both companies the key factors appear to have been the appointment of new chairmen, emphasizing the role of leadership (discussed in more detail below), the paradox remains that this was achieved while these companies were publicly owned. However, both were operating in competitive markets, and perhaps the prospect of privatization promoted this transformation.

It should be noted that there is also a current demand for cultural change programmes from private sector firms, where the dynamics of bureaucracy, of managerial careerism, of power—in short of inappropriate culture—seem to have outweighed the dynamics of competitive pressure. We conclude that the stimulus to change may be externally or internally generated, or both, and that the model of ecological adaptation is not sufficient. Even in the private sector firms strive to influence and dominate their environment. And most privatized industries have retained substantial market dominance. This point will be considered in the next section.

A fourth oddity, or so it must appear to some consumers, is that privatization has been undertaken under the banner of efficiency, effectiveness, and improved service. But for some consumers the reality has been reduced service and increased prices. This may well be the result of cost-based pricing, the elimination of subsidization, and virtuous economic rationalization. But, particularly in the systems industries, the suspicion remains that there is scope for administered prices, and, in behavioural terms, substitution of an ethos of public service by a short-term, perhaps short-sighted, profit orientation. Ironically, evangelists of cultural change (e.g., Peters and Waterman, 1982, Hayes and Abernathy 1980) are especially critical of finance and accounting driven cultures; they extol the virtues of attention to operational basics and to customer needs, an ethos of quality and service.

A final point is that privatization, a transfer of legal ownership, does not remove problems from the public domain. Monopolies require regulation, and some industries, notably water and electricity, have substantial public policy/public good externalities which—even after privatization—will keep them firmly in the public arena.

To summarize, the UK privatization programme has removed from public ownership companies which fit naturally into the private sector and industries or parts of industries which are easy to sell, and the process seems to have been relatively smooth and successful. But closer inspection
of the process suggests that a major advantage of privatization has been the removal of industries and companies from government intervention and the public financing cycle—not necessarily improved efficiency, effectiveness, or service. The process has also revealed that organizations can be transformed while still publicly owned. So the causal link implied by government statements on the connection between privatization and effectiveness/efficiency is contingent, not necessary.

It is hoped that these organizations will transform themselves, adapting to the (somewhat) changed environment. However, a view from organization theory would suggest that, confronted with environmental change, organizations will seek to buffer their core operating systems, to manage their environment, to effect the public interface rather than transform their operations. This is likely to be so in the large systems industries characterized by interdependence, long lead times for investment, with a strong cadre of professional engineering managers devoted to the nurture and growth of the operating system. In short, the public perception may be managed, rather than the actual delivery of effectiveness and efficiency.

Privatization and effectiveness/efficiency

The point about relationships between privatization and organizational outcome can be simply illustrated (see figure).

The privatization rhetoric has implied that organizations will move from quadrant B to quadrant D. Yet in some cases we have seen a move from B to D via A. However, it is likely that escape from short-term political intervention will improve the context for industry managers with concern for long-term investment and technical viability. So apart from any market considerations this will surely be a ‘plus’. But for the essential utilities and services, providing goods or services central to the lives of most citizens, this will not be escape from the public arena; and for those actual or quasi-monopolies with limited competition in product markets, there is no certainty of improvement in effectiveness and efficiency, nor certainty of improvement in customer perception of quality, even though the indicators—under pressure from regulators—may demonstrate improvement in various dimensions.

So it is possible that in five years’ time, the move will appear as one from quadrants B to C, and this could occur despite a record of financial growth and a blue chip stock market rating. For even in the private sector there is no necessary relationship between economic/financial performance and managerial performance (Woodward 1986b:314). Indeed a refocusing on profit maximization and cost saving may undermine a service ethos, leading to a diminution of perceived service standards and an increase in public opprobrium.
Ironically, complacency, bureaucracy growth, and the destructive pursuit of power and control to the neglect of long-term external changes can be observed also in the cold-winded competitive private sector. How else does one explain the current fashion for management buy-outs, organizational unbundling, and cultural change programmes? So one may assert, along with Adam Smith, that operation in the private sector does not guarantee virtuous practice. A \textit{laissez-faire} view would see buy-outs, takeovers, and internal corporate transformation as a sign of the proper functioning of competitive markets. But the large utilities and service industries are well shielded from competition on the whole, and far less vulnerable to takeover and unbundling. Indeed, their history as industries demonstrates the transformation of highly innovative dynamic companies, opening up new markets (rail in the UK, telecommunications in the United States), through a process of competitive pricing and takeover/merger, into the mature natural monopolies of today.

After privatization there will be external forces working on them. Pressure from financial stockholders is likely to enforce a degree of financial viability (there has been no problem with privatized gas and telecommunications on this score), and surrogate market pressure will come from the political environment. Public perception and experience may be expressed via Parliament and media—from organized consumer
leadership, themselves perhaps with opposed interests, and from the relevant regulating body—at risk of capture by the regulated—perhaps generating a ritual of ‘defensive behaviour and an adversarial stance’ (Woodward 1986b:98).

These are external, non-market pressures which may be countered, captured, suborned, influenced, converted, or otherwise managed by the organization. So if these organizations so firmly in the public eye are to maintain their public legitimacy as well as their stock market rating, the model of ecological adaptation through competitive stimuli needs something further to close the circle—an internally driven corporate transformation (or reaffirmation of values) focused on customer sensitivity, and an ethos of service.

**Leadership, transformation, and change**

Concern with organizational transformation operates on a different level from writings on organizational design, which treat structure, behaviour, and psychological preference as contingent on the task environment. The issues in transformation lie deeper. They relate to qualities of interpersonal behaviour and cognitive style which apply across all organizations. Indeed it is recognition of the shortcomings of compulsive (or exclusive) reliance on structure or on rationality, authority and control which has contributed to the fashion for cultural change.

Cultural change focuses explicitly on symbols, emotions, and values—the affective and enabling side of organizational life—and on the moral qualities which lie at the roots of co-operative endeavour—integrity, consistency, and trust (Woodward 1988:90). Awareness of these internal shortcomings was reinforced by Japanese commercial success which led to an exploration of Japanese practice and culture (e.g., Ouchi 1981, and a host of subsequent articles and books of varying insight and quality), and legitimized the study of culture and values.

The normative writings on cultural change and transformation tend to have an American provenance, or prescriptions for internal revolution (e.g., Pinchot 1985, Peters 1988), and some advocate a managed revolution, providing both analytic frameworks and normative guidelines designed to assist senior managers to understand, design, and implement internal change programmes (e.g., Schein 1987, Kilmann *et al.* 1988, Tichy and Devanna 1986). Most, in assuming or underlining the role of senior management in recognizing the need for radical change and in instigating this change, proclaim the importance of leadership.

Leadership, though widely proclaimed, admired, and advocated, has proved an elusive quarry for researchers, through time and across disciplines. The researchers’ failure stems partly from their disciplinary blinkers. Those who have sought common traits have found few traits in
common; those who have conducted experiments have generated findings and theories on style, expectations, and fit, which, while providing some valid and interesting insight on their samples, seem to throw little light on the leadership attributed to deviants like Nelson and Montgomery, or on the careers of, for example, Alexander, Pericles, and Julius Caesar. And failure may stem partly from motive—an obsession with leadership, with an eye on selecting and training leaders, and improving the leadership skills of those in leadership positions. This has led to a narrow focus on the role of leaders, to the neglect of followers and context.

A recent critical review of leadership research (Smith and Peterson 1988) concludes by underlining the importance of cultural context and of shared meanings attributed to behaviours. The very concept of leadership cannot be divorced from its socio-cultural context. While the word itself (la parole) may be translated across languages, the connotations and the social dynamics will vary with the cultural assumptions expressed through language (la langue). Recognition of this point does not preclude comparative analysis, nor the investigation of leadership as a socio-cultural phenomenon, for both may lead to a deeper understanding of affairs, of humanity in all its variety, complexity, and simplicity, and of self. But it does suggest that the search for the essence of leadership, for instrumental reasons—even had one so clear and frank an insight as Macchiavelli—is like the search for the Philosophers’ Stone. Leadership turns everything it touches into gold, but none have found its essence.

So perhaps it is no accident that the fashion for cultural change has a predominantly American origin. For, if gross generalization be allowed, American culture is strongly materialist, sustained by a belief in progress, in science, technology, and business—in elevation of human over nature. Economic development and cultural development often seem to be inversely related. By culture here I mean the holistic sense of tradition, time, and place which gives meaning and purpose to the individual, and which seems innate in some more ancient cultures and religions.

A perceptive and passionate American critic of materialism (which he terms ‘European’ as having a European origin) attributes the problem to ‘the old European conflict between Being and Gaining… Being is a spiritual proposition, gaining is a material act’ (Means 1988:73). He sees the materialist tradition of ‘despiritualizing the universe as very similar to the mental process which goes into dehumanizing another person’. This is precisely what is achieved by much organizational analysis, with its search for respectable generality, and practice with its search for order and economy. Human components (or resources) become replaceable piece parts, with relationships which must be regulated and controlled. Yet ‘social organizations are incompatible with formality, distance and contractualism. They proceed smoothly only with intimacy, subtlety and trust’ (Ouchi 1981:93).
So the fashion for cultural change may also be symptomatic of a deeper spiritual need for symbols, rituals, and myths which can rebuild and nourish a sense of meaning and purpose in organizational life. For culture is rooted in meaning, in the connection between Being and Gaining. So at a deeper level, it is not transformation or change that is required, but renewal—an understanding of the roots of organization, and a subsequent continuous nourishing of these roots.

If such a transformation or renewal is to be achieved, then senior managers are likely to be the prime movers. They must first look to themselves, their own behaviour and assumptions, following the moral precept sculptured on the temple of Apollo at Delphi: ‘Know thyself’. There are a number of reasons for this.

First, their whole behaviour, not just internal memos and presentations, provides the signals read and interpreted and retold by their subordinates. Hence the importance of ‘symbolic management’, settings, and symbols (Deal and Kennedy 1982).

Second, they themselves are likely to have emerged successful from the culture they wish to change. They may have risen through the corporate structure with their integrity and understanding enhanced—and there are many such managers. But the dark side of the achievement culture and its psychological consequences, both for the individual (anxiety and self-doubt) and the organization (projection of neurotic behaviour), is well documented (cf. Kets de Vries and Miller 1984). If their implicit assumptions about achievement, performance, and reward are out of step with the task environment, which cultural change is designed to serve, then their proclaimed best intentions are likely to be denied by their behaviour.

Third, if the motive behind such change is solely instrumental and not grounded in a humanitarian understanding of social organizations, then the first setback or failure will trigger demand for the next solution—a tightening of controls, another change of values: not a Pilgrim’s Progress, a journey whose end remains clear, despite setbacks, doubts, and despair, but rather the behaviour of the spoilt child who always wants the latest toy. This is a common problem in materialist cultures which tend to seek external solutions to internal problems, and which are particularly vulnerable to pressure from external stakeholders. Might not cultural change, and privatization, prove to be just another stopgap?

At this point the practical reader might interject ‘What has this to do with the effectiveness and efficiency of privatized industry? Cultural change is fine, so long as it delivers the goods.’ But defensive assertion of the practical, of the ‘real world’, often indicates impractical failure to comprehend the dynamics of human relationship and motive—the connections between process and outcome. The metaphor sees people as machines, rather than organisms, and indicates the need for a value change.
In organizations the major challenge is reintegration of purpose across departments, specializations, and divisions, and up and down the hierarchy. Rationalistic controls, themselves part of the problem, have signally failed to achieve this integration. For they generate hollow myths and bad ritual. Profit, productivity, cost saving, and efficiency are proclaimed as gods, but scarcely inspire or sustain. Of course they are important, but they are the outcomes of organizational behaviour, of getting other basic tasks and values right. To think otherwise is like worshipping the stones of a church without understanding the significance of the beliefs, symbols, and myths which sustain its religious community.

**Heroes, community, and privatization**

Organizational cultures are, in a variety of ways, linked inextricably to the wider cultures in which they are embedded: all must find ways of managing the relationship between the private world of their participants and their organization roles.

The taken-for-granted assumptions about behaviour, relationships, and authority, from the trivial to the profound, are all part of this background culture. National cultures may differ radically in assumptions about social role and membership (Douglas 1978), hierarchy, sexual roles, risk, and individualism (Hofstede 1980), and indeed in all constructs on which anthropological studies focus. Furthermore the same evidence may be valued and interpreted differently by both observers and participants. So great differences may be discerned within apparent strong cultures, based on class, region, age, and so on.

In large Japanese corporations the employees’ sense of self is significantly dependent on membership and participation in these organizations (Alston 1986), and the continuing socialization process serves to reinforce this sense.

However, gross generalizations are frequently confounded by differences within the population studied. Thus Japanese will see great differences within the set of Japanese corporations. And while on Hofstede’s individualism scale both the USA and UK score high, suggesting that in both countries attitudes to organizational relationships might be similar, Pym (1980) sees characteristic differences in the way that this individualism emerges in cultural context. ‘When we point to the friendliness and approachability of Americans, we are also observing the closeness of their public and their private selves’, whereas, ‘unlike the Americans and Australians who proclaim their individuality, the British maintain a gulf between their private and public worlds. The preparedness to accept public subservience is conditional on our private world being sacrosanct’.
If this is valid, then it might seem that cultural change programmes aimed at generating performance through voluntary commitment, rather than extorting performance through control and contract, might have an uphill battle with such collusive subservience. But Japanese corporations with UK plants have achieved this feat. There seem to be a number of reasons.

First, they tend to be located in areas of high unemployment, providing motive and choice in the labour market. Second, they devote great effort to establishing the ground rules and expectations in employment, and to eliminating ab initio restrictive practices, demarcations, and status differences. Third, they take great care over selection, induction, socialization, training, and the subsequent continuous enforcement of appropriate standards and attitudes. Finally, their concern with the primary task—quality, output, and the technical and human side of manufacture—reasserts the critical importance of production values, often with employees who have occupied low status in a low-status occupation in UK firms (White and Trevor 1983).

If, as Pym (1985) asserts, ‘the British employee, for all the fashionable concern with participation and involvement, prefers a paternalistic boss who recognizes this public/private split’, then such subservience may harmonize with Japanese cultural paternalism. But there seems to be something more. The clear focus on task and values, for legitimate ends, the unquestioning recognition of the link between the social and technical, serves to rebuild self-esteem, as well as economic well-being, and to gain commitment. Of course the record is uneven. Japanese companies differ greatly in culture and competence; and British individualism emerges no doubt in jokes and stories about their Japanese masters, which serve to restore psychological equity. But on the whole, the genuine Japanese recognition of the importance of the humblest employee in serving their economic ends does constitute a positive value change in the right direction if one’s focus is corporate success.

The founder of Sony, interviewed on television, has stated that there is nothing wrong with British workers; the problem lies with managers — with their assumptions about, and treatment of, workers. And there is much evidence to suggest that pursuit of career, power, status, specialization, and privilege is divisive organizationally, and undermines the organization’s basic tasks. For it is the shopfloor employee who significantly influences quality in manufacturing, and in a service industry the operative who deals with the customer face-to-face. But it is managers who through their behaviour signal the relevant values and performance criteria. The frequent reference in American texts to ‘playing coaches’, to sporting metaphors, to teamwork, indicates a deliberate attempt to shift the mental set of managers. For if the public heroes, the shapers of culture in executive positions, both extol and are seen to practice a philosophy of
personal acquisitiveness, beyond the symbolic need to have one’s leaders display the trappings of success, then the moral basis of a call for commitment, co-operation, and endeavour for the common purpose is undermined.

In this light the rhetoric in privatization appears both right and wrong. The call for enterprise, for a market-oriented, culture touches a responsive chord. For who could oppose enterprise, efficiency, and a customer orientation? But enterprise and responsiveness will be easily undermined by exclusive focus on financial and related performance measures, and a philosophy of pay for performance. So the government’s language also reinforces the old managerialist values and assumptions which have damaged much of UK private industry. This point needs elaborating.

Financial rewards are clearly an important consideration in organizations embedded in a materialist culture, where symbols of status matter, where there is an open labour market—in short where earning power is a significant part of the individual’s self-esteem. But they are part of the problem which has to be managed, not the solution. Pay is indeed part of the recognition system for performance, and of status. But it is its symbolic importance, as recognition for achievement, that is critical. In organizations where there is substantial interdependence, with subtle requirements for co-operation and commitment, then pursuit of status and pay by symbolic leaders, and the managers who model themselves on them, can swiftly undermine the common endeavour.

The complexity of the links between expectations, attitudes, motivation, co-operative work, and effectiveness is evident in the literature on job and work design (Steets and Porter 1987). The problems in managerial work are qualitatively no different, though the failure of both management educators and practitioners to comprehend the cultural dynamics may have made the case more desperate. For pay and status are inextricably linked. Indeed Hunt (1981) suggests that obsession with status may be a distinguishing British disease: ‘whereas the German values might be seen to concentrate on task and minimize differences in status or roles, the British tend to do the reverse—to concentrate on the role and status and leave the task to sort itself out. Since Americans like to define both task and role, their despair over the British is understandable’ (Hunt 1981:6). Anyone who has had to deal with company car policy in British firms will say Amen.

One of the features of a good manager is the ability to focus on the task and its associated values, and then to support this focus with a variety of forms of recognition. Were the current movement in the UK for an Institute of Professional Management to take root, I would suggest that the slogan ‘money does not matter’ should be adopted. Unfortunately the motive for such an institute seems to be concern with status, vis-à-vis
accountants, lawyers, and estate agents, rather than with the practice of management in all its subtlety.

So the UK government seems to be advocating precisely those values which have proved most damaging to good organization, and which are noticeably lacking in Japanese managerial culture. One of the ways of uncovering implicit values in a society and in organizations is to look for the heroes—the recognized role models who serve as examples of practice and achievement. Are our heroes the leaders of our great corporations, courted by the priests of the media, ennobled for contributions to national and party wealth? If so, what is the nature of their heroic virtue, which can serve to inspire and educate? Is it just the fact of their success, that they have emerged victorious in the latest corporate power struggle, or—a harder question—is it their vision and integrity, their personal virtues and behaviour, their contribution to good organization and the nurturing of their economic community?

Pym (1985) in contrast, in a call for a refocusing of attention, proposes that ‘the mythical hero for our time and space is not the public visible individualistic entrepreneur, but…the private, invisible, personable *bricoleur’, who shapes good order. Pym’s concern is with the wider community where real national wealth (education, psychological, and physical well-being) is created, but draws on research in organizations where individuals who nourish and maintain the organization are often invisible, widely appreciated, but rarely formally recognized. Indeed one of their distinguishing features was a willingness to listen, advise, interpret, help and act, but not to seek credit, a *quid pro quo, or political capital: and they were invariably both wise and well informed. In contrast, the public heroes, ‘the leaders of this commonwealth of dunces, look for solutions to the most pressing problems of industrialization. They define our problems as economic, and seek to revive a past where the entrepreneur was king.’

If one looks back in time to the classic domain of heroes, to the epics of many cultures, one finds that in their different ways heroes, in their epic struggle against human, bestial, and divine adversaries, physical barriers and fate, are invariably distinguished by an inner code of appropriate behaviour, with deep educational import. ‘In Homer the real mark of a nobleman is his sense of duty’ (Jaeger 1939:7): Achilles, in his virtue (*arete) and his sense of doom and duty, provided a deep text for contemplation. The middle ages were similarly characterized by a chivalric ideal which informed the web of art and life (Huizinga 1976). Examples can be found throughout recorded history. Ironically a contemporary equivalent may be seen in the old Stock Market, where a gentleman’s word was his bond, a system based on exclusivity and privilege, but which on the whole worked on trust and honour, reinforced by its very exclusivity.
Of course it rewarded its members, and was out of step with an egalitarian social philosophy and with a liberal economic ideal.

Currently this strong personal code seems to be undermined, in the name of liberalization and efficiency, by a philosophy of rampant acquisition, and characterized by the bending and breaking of rules, and the growth of legal contract and litigation. In the USA, corporate raiders and the issuers of ‘junk bonds’ were the new public heroes—John Waynes of the financial world—until found out. Of course establishments regroup and protect themselves against upstarts, but the point about the quality of heroes, and of inner codes of duty and behaviour, surely remains. In the UK Central Electricity Generating Board, the medium-term planning system is sustained by a system of trust and commitment and subtle promises, supporting a technical imperative (Chambers 1984). The effectiveness of this process is likely to be undermined through the breakup of the industry in the name of competition and efficiency.

In the panorama of time, as societies and cultures evolve and decay and essay new solutions to the recurring and re-emerging problems of moral and social order and of the purpose of life, so the role of the old myths changes, and their educative and moral lessons are reinterpreted. The epics of Homer never lost their transcendental, educational role, as Plato comments in the Republic (606E), not only as art, but through the great moral dilemmas whose contemplation provides guidance on how to live. In the same way writers on organizational culture extol the importance of myths of the founder in providing a sense of common purpose and a guide to appropriate behaviour.

But our contemporary myths of enterprise and wealth creation lack insight into the internal dynamics of organization and society, of human existence, and signal lack a sense of educational import or of a moral code. They focus on Gaining, rather than Being. Their poverty is indicated by the paucity of their language. The connection between profitability and managerial performance dissolves on closer analysis (Woodward 1986b), and I have never discovered a meaningful general operational definition of efficiency or productivity. These abstractions only become meaningful, like the components of organization performance, when applied in cultural context, and this requires subtle and careful confrontation of a variety of dilemmas and choices. Their power then draws strength from particular context. Yet these are the terms which are used to legitimize and inspire—a church without religion.

Solon, the founder of an Athenian political system based on equality before the law, rather than on class privilege, wrote ‘our city shall not perish by the edicts of Zeus and the counsels of the blessed immortal gods…but in their folly the citizens themselves would ruin it through avarice’ (Frg. 3, 2, ap Diehl). Thucydides’ History of the Peloponnesian War reveals the tragic working out of this doom. Plus ça change. As Jaeger
(1939:256) comments, ‘good fortune very quickly changes into deepest misery, since it leads men directly into hubris. The daemonic danger lurks in greed, which is never satisfied, but always wants twice what it already has’.

The second precept on the temple of Apollo at Delphi was ‘nothing in excess’: for excess brings hubris—to the person, and its most valued possessions. The unseen hand of Adam Smith’s economic theory, with its implacable suspicion of human motive, may belong to a more ancient body. Are our heroic exemplars, whose moral qualities provide instructive guide to conduct, to be successful financiers, who privately transfer residence and citizenship for tax purposes with the same public sense of community and purpose with which they buy and sell corporate assets?

It is ironic that the Greek word for ‘private’ is ‘idios’, the stem of the noun ‘idiot’, which in classical times connoted a layman, an unskilled person. Pericles, expressing his vision of Athenian culture in the great funeral speech set out in Thucydides (Book 2, Ch. 40) says:

> We see wealth as an opportunity for achieving something concrete, rather than as a basis for empty boasts, and admission of poverty is no shame, shameful rather is failure to take concrete steps to escape it. Here we exercise stewardship over our domestic business and over the business of the city…. We alone consider that a man who takes no part in public affairs is not just minding the usages of his own business, but rather that he has no use.

While the term idios is not used here, the Athenians would surely have comprehended the deeper implications of the literal translation of privatization as idiocy.

In conclusion, if enterprise connotes organizational unfettering, a culture of customer sensitivity and service, then that is good news. But if it connotes pursuit of profit and personal reward, to the destruction of good organisation, then the unseen hand of hubris is likely to become visible. For herein lies another irony. In lesser or greater degrees, the great public enterprises have been characterized by an ethos of public service, of the very kind which cultural evangelists have preached to the private sector—an unflagging devotion to standards, to internal mastery of the operating system, and its links to customers. With long lead times for investment and the existence of a strong professional cadre whose careers are devoted to the technology and its application, they have taken a necessarily long-term view, often perhaps to the neglect of the customers they serve and of the short-term political environment. If this ethos is undermined by short-term devotion to profit, cost, and efficiency, and the moral order vitiated by the hollow myths and rituals associated with the
disconnected managerial pursuit of power, status, and reward, then in privatizing the problems, the problems will have been amplified. I would argue that, at least in the UK context, privatization offers the opportunity for renewal, rather than transformation—for a refocusing of purpose and a rebuilding of the roots of organization, or, to use an evangelical phrase, for getting back to basics.

Conclusions

In the UK, privatization will not solve the problems of public enterprise—not for the great utilities and services. But it does facilitate access to capital markets and weaken the instruments of government intervention for short-term political purposes: and it may provide a symbolic opportunity and a liberating context to renew and rebuild a sense of purpose. And some enterprises—at least in mature developed economies—belong naturally in the private sector.

For developing countries, lacking developed capital markets and with limited scope for competition, the case may be different. Even manufacturing industries may lack competitive potential. So transfer to the private sector of bureaucratic complacent industries, characterized by financial deficits and politically expedient decision-making, may merely reinforce monopolistic, insensitive behaviour. The UK experience may be instructive. What is required for long-term organizational health is insulation from political influence, and a refocusing on the basic tasks. And this may be achieved by other means than privatization. The issues of organization effectiveness need to be divorced from issues of political ideology.

In all nations, the cultural context cannot be ignored. It constitutes both challenge and constraint. Methods of managing appropriate to, and respectful of, local cultures and traditions, must be found. The Western belief in technological progress, transmitted through agencies, banks, and corporations resembles a form of cultural imperialism, and perhaps has done more damage than good, in destroying appropriate traditions and ways of life built up over centuries. Privatization, applied unthinkingly without reference to or respect for culture and tradition, may prove to be the latest in a succession of instrumental solutions to deeper problems, deflecting attention from the real problems of organization and social functioning.

Myths of unfettered enterprise and individual reward are problematic even in the developed market economies. *A fortiori* they are likely to be even more out of place in nations with different cultural traditions, unless enterprise is interpreted in the enabling human sense of ‘making things happen’, and unless wealth is used according to the Athenian tradition, as an opportunity for achieving something concrete.
For the leaders of enterprises, if they are to be seen as exemplary heroes, whose deeds provide instruction rather than invite destruction, the conflict between Being and Gaining needs to be resolved. The old Greek adages are surely relevant—know thyself, and nothing in excess; their sense of duty and integrity must be made manifest, lest privatization be translated as idiocy.

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