II. THE TURN TOWARDS PRIVATIZATION

At a technical level, a country should privatize a State-owned enterprise if this would result in a positive net change in social welfare. This occurs when the social value of the privatized firm and the net social value of the public sector's proceeds from the sale are greater than the social value of the firm under public ownership (Devlin, 1993). Thus, the effect of a different regime of asset control, in this case a shift from public to private control, must lead to an improvement in asset management for it to be superior to the previous asset control regime. Governments, however, do not necessarily embark on detailed cost-benefit valuations of the SOE sector to determine whether privatization is appropriate. Instead, they often rely on an informal framework to decide whether a privatization programme should be initiated. The main factors supporting the privatization process have been more general in nature, although important differences between regions and countries exist.

Despite the difficulty of measuring public enterprise performance, one of the main reasons for the drive towards privatization has been the poor financial performance of SOEs. Privatization today is being driven by a pragmatic reaction to over three decades of poor financial performance by SOEs. Private ownership is thus favoured, on the grounds that returns to capital are lower among SOEs and they generally have a poor reputation for innovation, diversification and quality of goods and services (Cook and Kirkpatrick, 1995). Echoing the general view on the subject, Vining and Boardman (1992) argue that while the introduction of product market competition can improve performance, there is strong empirical evidence that "ownership matters and matters a lot". This view is based on a rigorous study of public and private enterprises in developed economies. However, there is also the argument that privatization is neither a necessary nor a sufficient condition to improve enterprise performance. It is not necessary because enterprise performance can be improved through management reforms in SOEs, deregulation and liberalization. It is not sufficient because privatization in and of itself, in the absence of an adequate regulatory and legal framework, can cause loss of welfare, as the Chilean privatization experience in the 1970s painfully demonstrated (Yotopoulos, 1989).

An important reason for restraining the growth of the SOE sector and initiating privatization was concern over the macroeconomic situation. In the early 1980s, many non-oil developing countries faced a difficult adjustment process owing to the second oil crisis and the ensuing world recession. Protectionist measures intensified in the industrialized countries, the flow of official development assistance continued to stagnate and private capital flows leveled off, adding greatly to the burdens imposed on the developing countries. The debt crisis forced countries to adopt draconian policies to control their budget and balance of payments deficits. Privatization appeared as a process

that could stem the fiscal drain caused by the SOE sector, while immediately providing money in the form of privatization proceeds. Thus, it is not so much concern over microeconomic efficiency and improving the financial performance of firms through a change in ownership as the need to quickly control fiscal deficits that led many countries, particularly in Latin America, to proceed to divestitures. Privatization proceeds were used as a financing instrument in Chile in 1985-1986, Argentina in 1989-1990, while the fiscal surpluses of Venezuela and Mexico in 1991 would have been deficits without the receipts from divestiture (Devlin, 1993). In Asia, the fiscal crisis was an important reason for privatization in Malaysia and the Philippines (Ng and Toh, 1992). Thus, the attention given to the financial situation of SOEs has often been more in response to the macroeconomic consequences in the form of a large budget deficit rather than a concern with profitability as an indicator of enterprise performance. The fiscal crisis meant that there were less funds available to invest in public enterprises. Even profitable SOEs were to postpone investments in the name of fiscal rectitude. Through privatization, a firm could escape from the central Government's fiscal restraint.

External pressures also played an important role in limiting the growth of the SOE sector. IMF conditionalities affected the public sector in so far as they incorporated policies aimed at achieving fiscal restraint. Conditionality is here understood as the policies which IMF expects a country to adopt in order to be able to obtain access to the Fund's resources. Access to such funds is typically contingent upon stabilization programmes encompassing budgetary, monetary-credit, wage and foreign trade policies that meet with IMF approval. A successful IMF agreement could unlock significant amounts of additional commercial bank lending and contribute to the early resolution of external payments difficulties through a mixture of adjustment and financing. The countries which seek financial assistance are thus encouraged to limit the growth of SOEs or privatize as a means to fulfil the macro fiscal target. World Bank adjustment programmes, which usually stipulate enhanced microeconomic efficiency, more directly foster privatization. World Bank lending for divestiture began in 1981, supporting privatization through structural adjustment and technical assistance loans (Kikeri, 1992). These funds have been used to prepare for privatization, implement liquidation, strengthen the regulatory framework, restructure SOEs prior to privatization and alleviate the social impact of privatization.

The World Bank's endorsement of privatization resulted in part from the poor record of SOE reform.[3] Such reforms aimed to correct deficiencies of public enterprise performance through changes in policy, incentives, and institutions, so that ownership change was not needed. Implemented in times of economic crisis, experience often showed that reforms did not last when crises passed or regimes changed. A World Bank study (1995) tried to assess the effectiveness of public enterprise reform. With a sample of nine developing countries and three transition countries, and using three indicators, financial returns, productivity and savings-investment deficit (defined as the difference between the SOE sector's current surplus and investment) the study looked at the impact of several aspects of SOE reforms. A negative assessment of the impact of various mechanisms to improve SOE performance led the World Bank to conclude that outright divestiture was necessary.

Technological progress has also made the logic of a large public enterprise sector less compelling and called into question the existence of natural monopolies. Alternatives to State provision include the depackaging of public services, the division of monopolies (thus enabling competition) and building and managing public infrastructure through regulated private concessions (Devlin, 1993). This is particularly true in sectors such as telecommunications. The liberalization of trade makes it more likely that deregulated markets are contestable and that foreign competition will cause the number of monopolies to decline. Reliance on market forces and, where necessary, an appropriate regulatory institution can reduce the need for direct provision through public ownership. Whether this is optimal will ultimately depend on the maturity of the financial markets and the institutional capacity of a country.

Mobilizing private-sector resources for infrastructure development, made possible by changes in technology, has been an important force behind privatization in a number of countries (ESCAP, 1997). The existence of important forward and backward linkages means that deficiencies in the provision of infrastructure services can threaten the sustainability of high economic growth. In the 1980s, the pressure on existing infrastructure services together with the size of the infrastructure investments necessary to sustain high economic growth rates created a resource gap between the availability of government resources and investment requirements. Severe resource constraints faced by Governments of developing nations forced them to turn to the private sector to finance a part of their countries' physical infrastructure requirements. Thus, the need to attract funds for new investments has often been a potent reason for encouraging private participation.

[3] Interestingly, in 1983 the World Bank maintained that the "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 kinds of incentives that will maximize efficiency under any type of ownership" (quoted in Cook and Kirkpatrick, 1995).

During the 1970s, SOEs in many countries absorbed large loans from international financial markets. Starting from the late 1980s, privatization of

SOEs was undertaken in many instances through debt-equity swaps in which foreign investors' participation was also sought. Even otherwise, privatization has been seen as an instrument to attract foreign direct investment (FDI). While privatization contributes directly to overall FDI flows through the sale of assets to foreign investors, it also has an indirect effect. Privatization can have a signalling effect, indicating an increased openness towards private business and an increased willingness of the Government to support the private sector. It can thus have a strong effect on additional FDI inflows in the expectation of an improved investment environment. Sader (1993) examines the determinants of FDI to developing countries and finds that privatization is a very important element in the FDI decision. The anticipation of privatization-related FDI inflows can be a significant reason for encouraging divestitures by a Government facing financial constraints and underinvestment in key infrastructure services.

Economic development has also made the arguments in favour of the SOEs less compelling. Economic growth coupled with greater integration into the world economy has transformed the domestic private sector, which, in many middle-income countries, has become more mature and can thus operate in sectors formerly dominated by SOEs. Thus, many large enterprises can be successfully operated by private enterpreneurs in sectors that were previously the prerogative of the SOE sector.

An important reason for privatization is ideological in nature. The belief in the efficacy of government interventions in the economy has been partly replaced by the belief in bureaucratic failure. The State is perceived as a vested interest group and some economists associate the directly unproductive rent-seeking activities with public interventions, particularly in developing countries. The success of the East Asian economies was initially seen by many to be a vindication of export-oriented growth with minimal government intervention. This perception of the relative role of the State and the market in the economic sphere had direct repercussions on the public-enterprise sector, as privatization was perceived as one of the mechanisms for reducing the role of the State in the economy.

This paradigm change became embodied in the catchphrase "Washington consensus", coined by Williamson in 1990.[4/] The Washington consensus embodied a list of 10 policy recommendations for reforming countries: fiscal discipline, redirection of public expenditure, tax reform, financial liberalization, adoption of a competitive exchange rate, trade liberalization, elimination of barriers to foreign direct investment, privatization, deregulation and the protection of property rights. Coinciding with the collapse of the Soviet Union and its ideological apparatus, the Washington consensus came to represent a rediscovery of economic orthodoxy. The adoption of "consensus reforms" was further underpinned by IMF conditionality. Debt reduction initiatives were predicated on the condition that the indebted countries reform their economies in line with the Washington consensus. Countries often had no choice, as the large public sector, coupled with macroeconomic imbalances, became unsustainable.

Politics also played a role in the privatization drive. This was most evident in the case of the former Soviet Union and Eastern Europe, where privatization was not only an economic policy to change the Socialist pattern of State ownership, but also a political instrument to remove power from the hands of former Party bosses. In the market-oriented economies, new regimes attempted to realign political allegiances and to reduce the power of labour unions in the political scene through privatization. Governments have also used privatization programmes as a signal of their commitment to the new development paradigm centred on market forces.[5/]

[4/] For a discussion on the Washington consensus, see Naim (1999).

[5/] Credibility was an important factor in Argentina's first round of privatizations in 1989 and 1990. The announcement of the privatization of ENTel and Aerolineas Argentinas was driven by the need to transform a formerly populist image of government.