Competition and Privatization: Ownership Should Not Matter - But it Does

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1. The benefits of competition, in terms of promoting both efficiency and consumer welfare, are clear and unassailable. In neo-classical economic theory, competition is king; it is the concept that explains how the pursuit of individual self-interest yields outcomes of benefit to society as a whole. All those who have spent time working in private firms and particularly in state enterprises, can cite numerous positive examples of competition's effects, and even more numerous cases where the suppression or absence of competition has led to inefficient and welfare-reducing results. The power and desirability of competition is now solidly established “common ground” for the vast majority of observers of economic life, regardless of their ideological point of departure.

2. I begin with an illustration of the positive power of competition. In the mid-1980s, in the very poor West African Country of Niger, the government owned and operated a company called Copro-Niger. It's function was to import foodstuffs and supply retail outlets around the country - and especially in the rural areas. Copro-Niger’s performance was consistently poor. It lost large amounts of money on what was supposed to be a commercial, paying proposition; moreover, it frequently failed to make deliveries, particularly to those very rural shops that it was designed to favor.

3. Copro-Niger faced no competition. When government created the company it granted it a monopoly on the importation and distribution of a set of products, ostensibly to assure that these products were distributed in a socially acceptable manner. This objective was not achieved. Faced with growing discontent over the persistent and obvious poor performance of the firm, government in 1985 took the bold step of ending Copro-Niger's monopoly.

4. And that is all it did. Government did not privatize Copro-Niger; it did not restructure Copro-Niger; it did not create a supplementary government agency or company; it did not give grants or create training programs for private entrepreneurs - it simply, and with the stroke of a pen, eliminated Copro-Niger's legal monopoly on importation and distribution.

5. The results were numerous, rapid and positive. Many small private traders at once entered the market and began, competitively, to wholesale the range of products previously handled only by the government

company. Retail prices of most of the products began to fall, some quite significantly. Rural shops which had rarely seen Copro-Niger or its products suddenly had these products on their shelves, as traders spread out into the bush to open new markets. Perhaps most impressively, Copro-Niger's response to competition was to cut its costs, bring in new and dynamic management, and launch a major effort to stabilize and then recapture its diminished market share. It did this by offering better service at lower prices; in short, by becoming more efficient.

6. Here then is a story enthralling to liberal economists - and to those critical of privatization and “neo-liberal” development approaches as well. It suggests that competition will by itself move mountains; that ownership is a secondary if not irrelevant consideration in the determination of performance. It implies that governments can effect reform without going through politically painful ownership changes. The Copro-Niger case produced financial gains, increased efficiency and improvements in consumer welfare. When I last looked at the Copro-Niger case (though I must admit that was some years ago) the outcomes looked ideal.[1]

7. To generalize: economic theory views market structure and the nature of incentives as the factors that really count in producing efficient or inefficient outcomes. Indeed, it is sometimes surprising to non-economists to discover the touch of agnosticism the profession possesses concerning ownership.[2] According to economic theory, it makes little difference to efficiency if a firm is privately or publicly owned, as long as:

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[1] There are several parts of the Copro-Niger case that require amplification.

-Niger was unusual in that there existed experienced private traders ready and waiting to seize the opportunities opened by the ending of Copro-Niger's monopoly. These traders had learned their business and built up their inventories and capital through illegal trading activities.

-The cost-cutting actions undertaken by Copro-Niger's management involved extensive lay-offs and other cutbacks; the process was hardly painless.

-There was lots that could have gone wrong. In neighboring Mali, when a similar attempt was made to end the monopoly of an importing/trading company, its management retaliated by halting all sales of sugar and salt. Unlike in Niger, the Malian traders had no inventories to tide them over, nor means of obtaining imports. The resulting public outcry over the manufactured shortages of essentials led the government to reinstate the public firm's monopoly. Copro-Niger could not have used this tactic, even had it wished.

These factors nuance the story but do not change its central conclusion - competition is in and of itself an important determinant of economic performance.

[2] For example, in a recent major speech, Joseph Stiglitz reminded his audience “how restrictive the conditions are under which privatization can ensure a welfare improvement.” See Joseph Stiglitz, “An agenda for development for the

- It operates in a competitive (or contestable) market, without major barriers to entry or, just as important, exit;
- He owner instructs management to follow the signals provided by the market and gives management the autonomy to do so; and
- Management is rewarded and sanctioned on the basis of performance.[3]

As the Copro-Niger example, and dozens of others that could be cited attest, when these conditions are met the theory can indeed apply in practice.

8.So, why is this not the end of the story? That is, given competition's accomplishments, why do governments simply not renounce the so often tortuous - both technically and politically - process of privatization; why do we not concentrate the bulk of our efforts on competition enhancement? The answer of course is that there are a number of reasons why a policy of exclusively promoting competition would be sub-optimal.

- First, and obviously, there is a set of activities in which normal market operations lead inevitably to a single producer or supplier; this is the case of natural monopolies.[4]
- Second, worldwide experience, and plenty of it, indicates that government owners find it exceedingly difficult to enact the complete set of conditions required to place the firms they own and operate in competitive situations. In essence, governments persistently refuse to allow publicly owned corporations to suffer the consequences of competition;[5] regardless of performance, public firms do not fail. This is a problem of implementation; it is not conceptual in nature. This has led many to think the problem can be overcome by concerted government effort; but experience has generally proven them wrong.
- Third, in those quite rare instances where the complete set of required conditions is met, it tends to stay met for only a while. This is the

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twenty first century," World Bank, Annual Bank Conference on Development Economics, Washington, 1997, p. 12.

[3] These three points, and much of the argument and wording of the following section, is taken from or based on my **Is privatization necessary?** Viewpoint, The World Bank, FPD Note No.7, May, 1994.

[4] Technological change and what may be termed "market engineering" (Stiglitz [op. cit.] refers to "regulatory redesign") have steadily reduced the number of authentic natural monopolies in the past two decades.

[5] Or. what is just as damaging for efficiency, in many instances where they do allow state and private firms to compete, government rig the market to allow the least efficient producers to cover their costs.

"backsliding problem." The economic landscape, in OECD, developing and transition countries alike, is littered with public enterprises that have been momentarily or temporarily exposed to competition - and they usually respond positively to it - but all too often the exposure to competition cannot be sustained. Some external event or political pressure arises that leads to the restoration of price controls, protection or restrictions on competitors. The point is simple if depressing: the conditions necessary to sustain competitive forces cannot be made to endure. Governments have multiple and conflicting objectives; public enterprise profits can be and often are sacrificed to broader political purposes. [Illustrations from New Zealand, Korea, Pakistan & Japan]

9.Hence privatization. Given the difficulties governments have in exposing their public enterprises to competition, or in sustaining this exposure once it is in place, ownership change becomes important, partly indeed to effect performance improvements, but even more importantly to *lock in the gains*[6] so hard won under reforms of market structures and incentives. As Vaclav Klaus in the Czech Republic has repeatedly said, the first purpose of privatization in his country was not to improve efficiency, but to cut cleanly and permanently the links between the enterprise sector and the state.[7] Privatization's utility thus stems from the fact that it allows competition to work, by inoculating firms against political interference, the most common disease of public corporations.

10.Is there evidence that this inoculation works? Yes. A growing number of recent and rigorous studies have looked at firms before and after privatization. They show general and impressive improvements in performance after sale.

1. One study compared the pre - and post - privatization financial and operating performance of 61 companies in 18 countries and found increased sales, profitability, investments, operating efficiency and, surprisingly, employment.[8]
2. Applying the method of the 1st study to 79 privatizations in 21 developing countries, a second analysis documented generally increased profitability,

[6] I first heard the "lock in the gains" phrase from Sir Roger Douglas; he was describing the approach pioneered in New Zealand by the Labour government, in which he was minister of finance in the mid-l980s.

[7] Paradoxically, one could argue that the Czech economy's - and Mr. Klaus's - present difficulties stem from a failure to sufficiently put this policy into effect.

[8] W.L. Megginson, R. Nash and M. van Randenborgh, "The financial and operating performance of newly privatized firms: An international empirical analysis," *Journal of Finance* 49, pp. 403-452.

efficiency, investment, output, dividends and - again, and again surprisingly - employment.[9]

3. The World Bank looked particularly closely at 12 privatizations (9 of them in developing countries) and concluded that improved firm level performance, and positive welfare effects for society as a whole, occurred in 11 of the 12 cases.[10]
4. A second World Bank review - of the determinants of successful industrial restructuring in Eastern Europe - looked at financial and operating data for 6,300 firms (from 1992 to 1995) in seven countries. It concluded that privatization was the major determinant of positive restructuring: "On average, a firm that has been privatized for four years will increase productivity 3-5 times more than a similar firm that is still in state ownership."[11]
5. Two Harvard economists analyzed post - privatization performance (1983-1991) in 218 non-financial sector divestitures in Mexico and found on average "...a 24 percentage points increase in the ratio of operating income to sales."[12]
6. A detailed analysis of the privatization of Britain's Central Electricity generating board found "a permanent cost reduction of 4 % per year, equivalent to an extra 25 % return on assets."[13]

12. In short, every study that I can find that looks quantitatively at firms or sets of firms before and after privatization has concluded that post-sale performance is on average and significantly improved, by a variety of financial and economic measures.[14] I can find no rigorous examination of pre - and post - sale data that reaches negative conclusions on privatization.

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[9] N. Boubakri and J-C Cosset, "The financial and operating performance of newly privatized firms: evidence from developing countries," unpublished draft Faculte des sciences de L'administration, Universite de Laval, Quebec, 1996.

[10] Ahmed Galal *et al.*, Welfare Consequences of Selling Public Enterprises: An Empirical Analysis (NY: Oxford University Press, 1994).

[11] Gerhard Pohl *et al*., "Privatization and restructuring in central and Eastern Europe," **World Bank Technical Paper No. 368** (Washington, D.C.: The World Bank, 1997). p. v.

[12] Rafael La Porta and F. Lopez-de-Silanes, "The Benefits of Privatization: Evidence from Mexico," mimeo, Harvard University, 1997, p. 1.

[13] D.M. Newbery and M.G. Pollitt, "The Restructuring and Privatization of the CEGB - was it worth it?" University of Cambridge, Department of Applied Economics, DAE Working Papers, No. 9607, 1996, cited from the Abstract.

[14] A few more examples from the burgeoning literature: D. Hachette and R. Luders**,** **Privatization in Chile: An Economic Appraisal** (San Francisco: ICS Press, 1993); R. Ramamurti, ed**., Privatizing Monopolies: Lessons from the**

13.What I certainly have found is interpretations that dispute the conclusions of the authors of the positive studies. For example, one conclusion in the detailed World Bank study was that there was no instance in its 12 cases where the workers in a privatized firm were made worse off by the sale. Several commentators disputed that claim.[15]

14.More sweeping is the argument made by a very careful economist, Pankaj Tandon (himself the co-author of one of the works cited above). Tandon argues that no privatization study to date - his own included - demonstrates that ownership was the determining factor that accounted for improved efficiency. Since just about all countries undertaking privatization are also making improvements in competition policy, Tandon concludes the perceived performance improvements stem more from exposure to competition than from ownership change. For Tandon, "privatization....depends upon the creation of competition in order to be successful."[16]

15.This statement is true. But it seems to me to miss an essential part of the issue. My position, and the central and simple point of my presentation is as follows: governments find it easier - much easier - to promote and enforce competition when *the firms to be exposed to competitive forces are privately rather than publicly owned*. I find compelling the logic as to why this is the case; and I find the empirical evidence in support of this position absolutely overwhelming.

16.Professor Tandon then is correct to say that "competition policy seems critical to the success of privatization."[17] But the statement begs the crucial question, which is: is privatization needed to effect and sustain good competition policy? I believe the answer is yes; I believe that ownership matters; and I believe that the reason that it matters is the simple one that divestiture increases the odds that governments will leave the firm alone.

Telecommunications and Transport Sectors in Latin America (Baltimore: Johns Hopkins Press, 1996); Hafeez Shaikh *et al.*, **Argentina Privatization Program: A Review of Five Cases** (Washington: The World Bank, 1997); and Jacques Rogozinski, **La Privatizacion en Mexico: Razones e Impactos** (Mexico City: Trillas Press, 1996).

[15] In particular, Brendan Martin, **In the Public Interest: Privatisation and Public Sector Reform** (London: Zed Books, 1993), p. 144.

[16] Pankaj Tandon, "The efficiency of privatized firms: Evidence and Implications," unpublished draft, Boston University, 1994, p. 31.

[17] Tandon, *ibid.*