The answer is a decided “yes.” Privatization is necessary, and not simply to improve the performance of public enterprises—though the evidence is striking that it can and does improve performance. Privatization’s essential contributions are to “lock in the gains” achieved earlier in reforming public ownership or in preparing a firm for sale, to distance the firm from the political process, and to inoculate it against the recurrence of the common and deadly ailment of public enterprises: interference by owners who have more than profit on their minds.

Performance and ownership—the debate

Market forces
Neoclassical economic theory suggests that the relationship between ownership and performance is tenuous; efficiency is seen mainly as a function of market and incentive structures. In theory, it makes little difference whether a firm is privately or publicly owned as long as:

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

Evidence shows that the theory does indeed apply in practice— with two crucial qualifications. First, the full set of necessary conditions is only rarely met. And second, even when it is met, it tends to stay met for only a while; the necessary conditions cannot be made to endure.

Principal and agents
There are a number of modern amendments to neoclassical reasoning that attempt to establish a clearer relationship between ownership and efficiency. These come mainly from public choice theory and the literature on principal and agents. Operationally, this reasoning says that private ownership will produce superior efficiency outcomes because of five factors:

- Private ownership establishes a market for managers, leading to higher-quality management.
- Capital markets subject privately owned firms to greater scrutiny and
discipline than they do public enterprises. Public enterprises often operate on Janos Kornai’s famous “soft budget constraint.” Because of explicit or implicit guarantees from the state, public enterprises can borrow capital at less-than-market interest rates, and they often enjoy outright subsidies and other concessions from the state (meaning that they don’t pay their taxes, their utility bills, their accounts payable to other public enterprises, customs duties, or the like).

- Private firms are subject to exit much more often than public enterprises. Private firms are more subject to bankruptcy, liquidation, hostile take-over, and closure than public corporations. When exit is a real possibility, there is a greater likelihood that owners and managers will take active, efficiency-enhancing measures to avoid it.

- Politicians interfere less in the affairs of private than public firms. Political interference is a major cause of efficiency-reducing conditions in public enterprises; it manifests itself in overstaffing, undercapitalization, inappropriate plant location, wrong use of inputs, and many other costly acts.

- Private firms are supervised by self-interested board members and shareholders, rather than by disinterested bureaucrats, and are thus more likely than public firms to use capital efficiently and to maintain it.

Practical solutions
The problem with all five of these arguments is that one can readily conceive of mechanisms to correct the perceived deficiency—without changing ownership. For example, if finding and rewarding excellent managers is the issue, enterprises could recruit outside the public sector, or even internationally, and offer incentive packages equal to private sector scales. If the soft budget constraint is the problem, governments could eliminate all guarantees and stipulate that public enterprises must turn to commercial capital markets and act, and be treated, like any private sector borrower. If exit is the constraint, governments could liquidate persistently poorly performing public enterprises. If political interference is the difficulty, then the owner and the enterprise could sign a performance contract specifying the mutual obligations and responsibilities of the principal and the agent; or the owner could constitute and empower a new and more independent board of directors and give it explicit instructions to maximize commercial profitability; or the owner could name a powerful and independent chief executive officer, and give him or her a free hand. The fifth factor—better representation of the interests of capital—is more difficult to resolve without some change in ownership, or at least some privatization of management—through management contracts, leases, franchises, or concessions. But even here performance agreements and other mechanisms to create surrogate capitalists are imaginable: for example, establishing a holding company or companies and instructing them to act like private owners, or fragmenting ownership among several different levels of government or state agencies and making them dependent on the income generated by the enterprise. Both institutional approaches would presumably diminish the saliency of noncommercial objectives.

Tried and tested?
All of these theoretically applicable solutions have indeed been tried, or are presently being tried, around the world—with some highly positive responses. New Zealand’s “corporatization” efforts of the mid-1980s achieved efficiency and financial gains in ten of eleven enterprises studied by Duncan and Bollard in Corporatization and Privatization: Lessons from New Zealand:1 Korea’s performance evaluation system for twenty-six of its government invested enterprises reduced, for a time, financial losses to zero. These financial gains were accompanied by a declining ratio of costs to sales, indicating efficiency gains. Korea’s reform program relied heavily on a goal setting and review system—complete with rewards—and a massive change in the boards of directors that reduced civil servant membership to a small minority.

The most powerful recent empirical evidence to support the thesis that reform can work without ownership change comes from China. There are now about 1.3 million township and village enterprises employing 90 million people. They account for more than 20
percent of China’s industrial production and are growing far more rapidly than the traditional state-owned enterprise (SOE) sector. Their financial and economic performance surpasses that of the traditional SOEs by two or even three times. They are a stunning example of how positive performance can be achieved by firms that are not privately owned—but that are made to act as if they were.

Added to these positive cases are the findings of a fairly extensive literature, most of it dating from the early 1980s, that tried to measure public versus private performance. This was done basically on a “with and without” basis; that is, comparisons were between roughly similar public and private enterprises in operation. The conclusions reached were by no means unanimous, but more often than not the literature suggested that, after correcting for market structure, there are no real differences between public and private ownership. The policy implication is that perceived deficiencies of public enterprise performance can be corrected by changes in policy, incentives, and institutions, and that ownership change is not necessary.

In light of all this, how can one still reasonably contend that ownership matters?

Why ownership matters

Probability
The first strand of the case is probabilistic in nature. While private firms do not always outperform public enterprises, the evidence shows that they usually do. For example, over the years, the World Bank has noted that rates of return on equity invested in industrial or commercial public enterprises often are about a third of those in the country’s industrial private sector. The overall contention is that there are two spectra of performance from good to bad—one for public enterprises, one for private firms. There is a fair degree of overlap between the two. But the private sector performance spectrum extends somewhat to the right of the public enterprise performance spectrum—and mean performance for private enterprises is also somewhere to the right. That leaves a variance to explain—and ownership is a strong candidate for a good part of the explanation.

Empirical work
The second strand of the argument is empirical. It is based on several recent and rigorous studies that have looked at firms before and after privatization. These recent studies show generally, and impressively, improved performance after sale. A Journal of Finance article—by Megginson, Nash, and van Randenborgh—compares the pre- and postprivatization financial and operating performance of sixty-one companies from eighteen countries in thirty-two industrial sectors. The study shows strong postsale performance—increased real sales, greater profitability, increased investment spending, improvements in operating efficiency, and, most surprising, a slight increase in work forces.

A second study, on the welfare consequences of selling public enterprises, was conducted by the World Bank in collaboration with Boston University economists. This study looked at pre- and postsale performance in profitability and productivity in twelve firms in four countries. It went on to construct an elaborate counterfactual, to determine what would have happened had the enterprises not been privatized. The authors then were able to say “here is what was actually happening before sale, here is what actually happened after the sale, here is what we reason would have happened under continued government ownership.” In constructing this scenario, they did their best to isolate and neutralize the gains and losses due to factors other than divestiture. They then subtracted the hypothetical from the historical, and thus derived a measure of the gains due to ownership change. This study quantifies the welfare gains and losses of the various actors in the process; that is, the costs and benefits to the selling governments, purchasers—domestic and foreign—workers, consumers, and competitors. The results are as follows: in eleven of twelve cases studied, there were positive welfare effects for society because of the sale, and improved performance at the level of the firm.
Compromise and backsliding

The third and final strand of the argument for private ownership is political and organizational in character. The idea is twofold. First, as noted, most governments find it difficult if not impossible to apply the entire package of qualifying conditions that are essential for reforms short of ownership change to work. The landscape, particularly in developing countries, and now in ex-socialist countries as well, is littered with partial attempts to impose reform where the government owners hadn’t the will or the fortitude or the knowledge or the capacity or the luck to impose the whole of the reform package—and the results were minimal, modest, or nonexistent.

There are innumerable examples in which government owners kept prices for the products of supposedly reformed public enterprises too low to cover costs, out of fear of the political consequences of price increases. Governments may shut off direct budget flows to public enterprises, but few then go on to block concessory transfers from the banking system. Governments grant operational autonomy to managers, but not with regard to hiring and firing, or plant location, or from whom to obtain inputs. Technically innocuous board of director reforms have been halted in Kenya, Morocco, and elsewhere because board membership is a lucrative core part of the patronage system. The list is endless, and the point is obvious: most governments have noneconomic objectives for their public enterprise systems. While they want them to be profitable and productive, they are most often unwilling or incapable of allowing these commercial aims to take clear precedence over the noncommercial. Thus, their reform efforts tend to be partial.

Second, in the few cases in which governments do establish and maintain the precedence of commercial over noncommercial aims, the results are, as we have seen in China, very good. But they tend not to last. In most instances there is pronounced backsliding. The common story is that bad times make for good policies—in crises governments do establish the precedence of commercial objectives, they do impose a harder budget constraint, and they do give autonomy to public enterprise managers to achieve commercial aims. But again and again, when the crisis fades, or when the regime changes, or when some major political claim arises, commitment to the priority of commercial aims and to noninterference in day-to-day management of the firm fades with it. Examples of backsliding include the New Zealand Post Office, the Japanese National Railway, Pakistan public industrial enterprises, and some of the Korean government invested enterprises.

Conclusion

Based on this reasoning and evidence, it is clear that ownership matters—that it is a significant determinant of the profitability and productivity of an enterprise. Political and organizational factors are fundamental to the reason why. Ultimately, as Oliver Williamson is fond of saying, “politics trumps economics.”

4 There is much else that is striking in this study. For example, it shows clearly that policy matters as well as ownership, that macroeconomic liberalization in conjunction with privatization is a powerful combination, and that effective regulation must accompany (preferably precede) the privatization of infrastructure firms if divestiture is to yield its full potential.

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