The arguments for privatization

Privatization is transfer of state owned enterprises to private ownership. William Megginson and Jeffrey M. Netter(2000) defined privatization politically and economically, " as the deliberate sale by a government of state owned enterprises(SOEs) of assets to private economic agents". According to Charles A Ntiri (2010); " Privatization has been defined by economic scholars and jurists to encompass a wide range of options for involvement of private capital and management in the running and operations of public enterprises" It may involve the total transfer of public ownership and assets structures to private companies or conversion of public enterprises to private entities or incorporation of new private entities in place of public enterprises which can be by management transfers etc. He also quote Heydare Kord-Zanganeh (2001) on privatization to refer to all initiatives designed to increase the role of private entities for applying society resources to produce products and services by decreasing and restricting government or official roles.

Lumbini Kulasekera (2001) in his article on ' Restructuring stated-owned enterprises through privatization explain that, " the system of state enterprises was established to provide support. Support for consumers in form of better products and services at less cost. Support for workers in form of rewarding and meaningful employment . Support for the government in form of revenues. Many state enterprises can no longer provide this support . In fact they are in need of support themselves . These institutions in fact, should be productive national assets, making a contribution to the progress and welfare of the country. But years of politicization, corruption, mismanagement, inadequate investment, lack of vision and discipline have

stripped them of their potential making them colossal liabilities. Over the years enormous amounts of money have been spent to sustain ailing state enterprises. Governments borrow heavily from the state banks and from foreign financial institutions. Aid donors will no longer support wasteful expenditure . Therefore either unproductive state enterprises will have to be shut down or the entire economy will go bankrupt. Privatization therefore is inevitable and necessary.”

This essay explain the arguments for privatization of state owned enterprises in emerging markets and why state owned banks in emerging markets have not been privatized. The essay comprises of three sections; Introductory part, arguments for privatization of state owned enterprises and why state owned banks have not been privatized in emerging markets, conclusion has been done respectively in each of the second and third section respectively.

Arguments for privatization

There are different arguments for privatization of state owned enterprises in emerging market in support of different researches done earlier concerning the privatization in emerging economies.

William L. Megginson & Jeffry M. Netter(2000) argue that, Contracting ability impacts the efficiency of state and private ownership. Government ownership of firms results in problems in defining the goals of the firm. He also quote Hansmann and Kraakman(2000), “ While the shareholder-wealth maximizing model of corporate organization is becoming increasingly dominant in part because of the advantages of having a well-defined corporate goal”, he continued that governments have many objectives other

than profit or shareholder-wealth maximization. Further, government objectives can change from one administration to the next. The inability of the government to credibly commit to a policy can significantly reduce the efficiency of a firm's operations and governance. Even if the government does attempt to maximize social welfare, for example, welfare is a difficult thing to measure and use in guiding policy. In addition, the government's goals can be inconsistent with efficiency, inconsistent with maximizing social welfare, or even malevolent (he quoted Laffont and Tirole, 1993 and Shleifer, 1999). In addition, even if the government and the nation's citizens agree that profit maximizing is the goal of the firm, it is difficult to write complete contracts that adequately tie managers' incentives to that goal. Shleifer (1999) argues that the owners of public firms (the nation's citizens) are less able to write complete contracts with their managers because of their diffuse nature, making it difficult to tie the managers' incentives to the returns from their decisions. This is a subset of the broader arguments based in property rights and agency costs that there will be differences in performance between government and privately held firms because there are a broader range of monitoring devices under private ownership.

William L. Megginson & Jeffry M. Netter (2000) argue that, Ownership structure affects the ease with which government can intervene in the operations of a firm. Of course, governments can intervene in the operations of any firm, either public or private. However, the government's transaction costs of intervening in production arrangements and other decisions of the firm are greater when firms are privately owned. Thus, to the extent that

government intervention has greater costs than benefits, private ownership is preferred to public ownership (Sappington and Stiglitz, 1987).

William L. Megginson & Jeffry M. Netter (2000) also argue that, a major source of inefficiency in public firms stems from less-prosperous firms being allowed to rely on the government for funding, leading to “ soft” budget constraints. The state is unlikely to allow a large SOE to face bankruptcy. Thus, the discipline enforced on private firms by the capital markets and the threat of financial distress is less important for state-owned firms. Kornai (1998, 1993), Berglof and Roland (1998), and Frydman, Gray, Hessel, and Rapaczynski (2000) all suggest that soft budget constraints were a major source of inefficiency in Communist firms. They also note that supposedly “ hard” budget constraints imposed by a government on SOEs are not very effective either.

William L. Megginson & Jeffry M. Netter (2000) also argue that, Privatization can impact efficiency through its effect on government fiscal conditions. As noted in Section 1, governments have raised huge amounts of money by selling SOEs. Such sales have helped reduce the fiscal deficit in many countries. Though important, examining the efficiency effects of reducing government deficits is beyond the scope of this paper. Davis, Ossowski, Richardson and Barnett (2000) show that privatization has significant positive effects on governments’ fiscal conditions.

William L. Megginson & Jeffry M. Netter (2000) also argue that, At a macroeconomic level, privatization can help develop product and security markets. One important motivation for privatization is to help develop factor

and product markets, as well as security markets. As discussed above, welfare economics argues that efficiency is achieved through competitive markets. Thus, to the extent that privatization promotes competition, privatization can have important efficiency effects. Inevitably, the effectiveness of privatization programs and markets themselves are simultaneously determined. It has been clear in the transition economies that the success of the privatization program depends on the strength of the markets within the same country, and vice versa. Thus, the impact of privatization will differ across countries depending on the strength of the existing private sector. The empirical evidence shows that this is the case.

Market Socialism: The opponents of privatization argue that neoclassical economics welfare theorems should also work in an economy with public ownership . Instead of a soviet type economy with public ownership and planning, one can imagine a market socialism (Barone 1908; Lange 1936) system where firms are publicly owned, but exchange occurs in competitive markets, and SOE managers are incentivized via performance contracts. Some adherents of market socialism argue this is exactly what has been successfully implemented in China (

Critics of this idea argue that is very hard for the government to commit not to intervene in markets . Under market socialism, the government is omnipotent and can directly control all the prices. Therefore , it is hard to protect market competition from the government monopoly , which would not only expropriate the consumer surplus but would also undermine efficiency . It is also hard for the government to commit to the strict antitrust policy that weakens the market power of state-owned firms. Even in an open

economy which “ imports” product market competition , the government still wields a monopoly in the labor market and in markets for nontradeables. The government is also unable to commit to abstain from political pursuit s while designing and enforcing managements contracts.

Another problem of government ownership is the liability to ensure the exit of failing firms. Governments (or government banks) often bail out firms, private or public, in order to preserve employment. This problem is especially severe in the case of public firms . It is essentially impossible for the state to commit to not bailing out its own firms. The resulting soft budget constraints further aggravate the incentives problem for state owned enterprises.

Yet another argument in favor of private ownership is the importance of innovation; Shleifer 1998 argues that innovation can only prosper under private ownership . While inventors can come up with great ideas independently of the predominant ownership forms; further development commercialization of innovative ideas is certainly more likely under private ownership.

Government revenue: Privatization helps to raise revenues for Government. State owned enterprises comprises of multiplicity of goals, they wants to maximize profit but they focus more on social security for the citizen, increase of employment might lead to overstaffing hence increase more cost on operations, Insufficient quality of facilities like machines for production , leads to poor and incompetent products which cannot lead to generation of more profit.

According to Sergei Guriev and William Megginson (2005) comments that private ownership strengthens the incentives for profit maximazion and therefore should lead to increased productive and allocative efficiency.

Market failures. SOEs (State owned Enterprises) lack innovation that leads failure in the market. This is due to the fact that government aids compensate them even when they make losses so that they continue to operate and avoid the large number of unemployment.

Sergei Guriev and William Megginson (2005) said that market failure even when they exist, do not have to be collected through public ownership. Much can be achieved through regulation, taxation, and private provision of public goods (through profit maximizing firms or nonprofit organizations. They also say that Public ownership may not resolve all the relevant issues both in democrat and in non regimes politicians are often concerned with issues other than economic efficient and social welfare; they may be either driven by political motives or simply corrupt. Privatisation reduces the ability to pursue political objectives.

Megginson and natter (2000) argue that, Privatization tends to help the greatest positive impact in those cases where the role for the government in licensing the market failure is the weakest.

By conclusion, There is growing body of empirical evidence on all aspects of privatization that uses detailed datasets and up-to-date methodology this empirical evidence provides solid evidence that privatization “ generally” works both for the firms that are privatized and for privatizing economies as a whole. While privatization usually results both in increased productivity and

reduced employment in privatized firms, fears of negative overall effects at the economy level are not justified.

An important caveat here of those benefits of privatization depends on market institutions being in place. The countries that manage to ensure property rights protection and the rule of law, impose hard budget, increase competition, and improve corporate governance reap the largest benefits. If appropriate institutions are not in place, privatization often fails to improve performance at the firm level and for the economy as a whole.

Empirical evidence provides a strong case for openness in privatization . Virtually all point to a positive role of foreign investors. Firms privatized to foreign owners exhibit the highest productivity increases . Moreover, as foreign owners usually buy the assets in a more competitive biddings process, they are likely to pay a high price for privatize assets and the threat of competition from foreign bidders also tends to raise the bids of domestic investors. Receiving a high net privatization price is important, not only for fiscal reasons but also for the political legitimacy of emerging private property rights and the sustainability of reforms.

Why have State-Owned Banks not been Privatized in Emerging Markets?

Many emerging markets have not privatized their banking systems or face some challenges after privatization. Panicos Demetriades et al (2010) argue that, “ governments should not feel pressured to re-privatize the banks. Once the black sheep of high finance, government owned banks can reassure depositors about the safety of their savings and can help maintain a

focus on productive investment in a world in which effective financial regulation remains more of an aspiration than a reality”. Privatization of banks has been done in some of emerging markets for example Mexico, India and China. Mexico face banking crisis in 1994, India face some challenges as private owned banks could not meet their pre-privatization objectives, while China face crisis but were able to maintain.

Privatization can cause banking crisis. Times of India, article on Privatization can cause banking crisis of by TNN, 16 November 2001; Prof V. S. Vyas, chairman of the governing board of institute of development studies, Jaipur, has given a call for preventing banking crisis through reckless privatization. He was delivering the valedictory address at the recently held national seminar on `privatization of banks’ at Mangalagangothri, organized by corporation bank chair in bank management. Vyas, also a member of the central board of directors of the reserve bank of India and Nabard, said the content and phase of the economic reforms are different in different countries. Therefore, any sweeping measures to privatize banks would cause a severe banking crisis. On the banking crises in south-east Asian countries, he said the government should not give absolute freedom to the private financial institutions and foreign banks. Any move to give market orientation to ownership of financial institutions like banks must be judged by applying three criteria; better initiative and transparency, better efficiency, better capital accumulation and growth. There is no conclusive proof to show private banks is better than the public sector banks when these criteria are applied, he said.

Mexico has been cited as having to privatize its banks and face financial Crisis. Haluk, Unal & Miguel Navarro (1999) said that shortly after their privatization, Banco Union (BCH), Cremi, Grupo Havre, and Banpa is failed. Following the peso devaluation of December 20, 1994, the entire banking system needed to be re-privatized at great cost to the tax payer. What went wrong? It is safe to argue that the lack of a previously enhanced legal and regulatory framework was a major obstacle in the full achievement of objectives relating to bank privatization in general. Although several attempts were made to overhaul the banking system, efforts were insufficient at the beginning of the bank privatization process to increase supervision. Changes in the legal and regulatory framework of the financial sector should have begun long before the privatization process started, as they usually are a slow and gradual process. The newly privatized banking system in Mexico operated under an outdated regulatory environment and with a set of supervisory agencies unable to implement new regulations or enforce existing rules.

Performance of private owned banks could not outweigh the performance of government owned banks. Times of India, article on Privatization can cause banking crisis of by TNN, 16 November 2001, Prof Vyas lauded the achievements of the public sector banks in India in the last 36 years, particularly in reaching out to the masses in the hither to neglected villages. Even in china, the banks could not reach the level of rural penetration which the Indian public sector banks have been able to. The solution to the stagnation of banks is minimizing bureaucratic control, not hasty privatization, he argued. Former syndicate bank chairman and Thingalaya

alleged the government made the proposal to privatize banks to satisfy the international monetary foundation (IMF) and the World Bank. Thingalaya, also a member of the Karnataka state planning board, said while the private sector banks in India account for just 6 per cent of the rural lending, it is the public sector banks which have been helping the rural masses in a big way. P. V. Subbarao, Chief General Manager, reserve bank of India, Mumbai, said while the private sector banks in India operate only in limited areas with very little staff, these banks are serving numerous villages and towns. The new generation private sector banks, the old private sector banks and foreign banks have yet to develop the mass participation approach, he observed.

According to D. Beim and C. Calomiris (2001) If banks are privatized before SOEs, bank owners may engage in buying more companies and become industrial empires. Foreign banks may out-complete domestic banks and leave them seriously weakened.

D. Beim and C. Calomiris (2001) added that Capital inflows (short term loans and portfolio flows) can easily go into reverse (e. g. outflow) and create liquidity crisis.

In conclusion we cite Panicos Demetriades et al (2010), at the moment, there is calm among bank depositors but premature privatization of government owned banks could change that. The empirical evidence suggests that the very existence of government owned banks has its roots in bad regulation. Privatizing banks without fixing the underlying cause could result in greater financial instability, not less. Moreover, as experience and other research shows, privatizing banks can only increase the power of bankers which can

create fertile ground for more bad regulation. And if you thought that government owned banks are bad for long run growth, you need to think again. The empirical evidence suggests that government ownership of banks during 1995-2007 has, if anything, been associated with higher growth rates.