CHAPTER - VII

GOVERNMENT CREDIBILITY AND PRIVATIZATION

INTRODUCTION:

Continuing from the preceding chapter VI, the discussion in chapter VII follows that the government faces time path, bound objective to minimize the revenue loss termed as Bayesian trajectory. The experience of privatization is to demonstrate two ways in which governments have attempted to minimize revenue losses: the first approach involves signalling strategies which increase the slope of the Bayesian trajectory, the main examples here concern the underpricing of shares and the sequencing of sales. The second method is the use of instruments through which government can short circuit the gradual reputation trajectory. The strategies here are government precommitment and consideration of post-default punishment options.

7.1 ACCELERATING THE REPUTATION PROCESS THROUGH THE DESIGN OF PRIVATIZATION:

A) UNDER PRICING AND SEQUENCING:

As demonstrated above, under Pricing of shares in the primary market is an endemic feature of the privatization process in a large number of countries. While it is true that underpricing is used to achieve a number of objectives (has discussed in the previous chapter), it is also widely viewed as a way of enhancing government's credibility. Credibility and Reputation are perceived to be made on the basis of 'successful' sales, where success is measured in terms of the over-subscription
for shares and the premium revealed on first-day trading. The implicit argument is that the first-day trading premium generated fry pricing shares below the Bayesian trajectory in the initial sale will serve to signal the government's reputation and therefore raise the price. The private sector is prepared to pay for later sales more rapidly than otherwise. Using under pricing in this manner is problematic, however, since it has adverse effects on other privatization objectives and also is often an inefficient strategy for creating a reputation. First, it can have a number of serious distributional effects, since it represents a cumbersome method of effecting a lumpsum cash transfer from the issuer to lucky share applicants implemented through the equity market. Second, it may have adverse effects on the development of the capital market operating principally in terms of moral hazard and adverse selection effects. Third, and more importantly for the discussion here, there is the problem that underpricing may become self-defeating in that, as a result of either the adverse selection problem or political dynamics, it becomes locked into the privatization process. It is then possible that the 'under-pricing' trajectory never crosses the Bayesian trajectory, and thus the government must accept a permanently low level of revenue.

If the price itself cannot be relied on to signal reputation sufficiently, an alternative route may be to use the sequencing of the sale of assets, by concentrating in the early stages on the sale of assets in sectors where the scope for default is more
limited. Typically this would entail competitive as opposed to monopolistic sectors, sectors open to greater foreign participation, and also sales of relatively small assets. In our study, there were 95 privatizations, 63 were in the manufacturing, commerce and services sectors; and only in two countries where privatization was well entrenched in the policy corpus, had the programme moved significantly into the sale of utilities. This pattern of sales is corroborated by broader reviews of privatization.¹

Sales have tended to affect SOEs that are small in terms of assets and employment (and) privatization appears to have occurred most frequently in manufacturing and services sectors, predominantly reflects the weakness of the domestic private sector, it is also a response to the private sector's unwillingness to commit large investment funds in an environment of policy risk. This unwillingness is one aspect of the difficulty for government's careful sequencing that may bring a return by allowing privatization of these larger enterprises.

B) PRE-COMMITMENT:

More fundamentally, through, using the sale price both to indicate the intrinsic value of the asset and to create confidence through reputation may not be possible (or if possible may operate too slowly). When neither the quality of the asset nor the quality of the seller is known the private sector faces a

signal extraction problem, since it observes only one piece of information, namely the price. Faced with this signaling problem, the government can well offer the easiest way of the information overload problem of price signalling and allowing it to jump to almost immediately.

These non-price instruments can be divided into precommitment by the vendor (legal or otherwise) against further default, and punishment options by the seller or by other agents in the event of such default. Although these are conceptually separate, it is natural to see them as linked issues, on the grounds that only if the buyer is able to penalise the vendor after the breaking of a pre-commitment will that punishment be credible. Thus, it may be optimal (i.e. intertemporally revenue maximizing) for the government to introduce full or perfect punishment possibilities into privatization sales in order to make its pre-commitments credible. As suggested above, this is essentially a method of circumventing the reputation problem by eliminating the uncertainty that asymmetric information introduced into the sale process.

Broadly, pre-commitments and punishment possibilities can be classified into two main sorts, 1) those are instrumented through third parties, 2) those that are implicit or explicit to a bilateral contract. An example of the general form of third party pre-commitment is the recently created Multilateral Investment guarantee Agency (MIGA) and other investment promotion schemes which provide insurance against loss of earnings as a
result of non-commercial risk (including re-nationalization). In privatization, though, these would mostly impact only on sales to foreign investors. Another more common example comes through the Agencies of IMF and World Bank adjustment lending which attempt to bind government policy actions.

In general, for reasons such as these, third party strategies are rare. More typical are pre-commitments and punishment possibilities built into the individual sale contract. However, although these offer the most rapid way of dealing with the reputation problem, they frequently compromise other objectives of the privatization programme. To document this point, we present two examples of explicit pre-commitment / punishment provisions from the Jamaican privatization programme.

The National Commercial Bank (NCB) of sale, as noted earlier, was critical to the whole Jamaican privatization programme. The ramifications of political controversy for the design of the sales have already been analysed, here we focus on the government's methods of pre-commitment with respect to potential buyers. While the NCB itself was a consistently profitable institution (implying that, as a private firm, an appropriately priced share issue would have been enthusiastically received), the Jamaican Government still had a reputation for extensive intervention in the private sector. Thus one of the key means in persuading individuals to buy shares would consist of designing a visible and credible method of locking the government out of future interventions in the running of the NCB. This was made
all the more important by the decision to sell only 51% of the equity, leaving the government in control of 49% after the sale. Hence, reputation issues would be central to the success of the privatization programme in Jamaica.

Ultimately the government chose a pre-commitment option which tied its hands by rendering certain entrenched provisions of the company virtually immune to alteration. These were 1) that the government's remaining 49% share was declared non-voting, and 2) that any individual's share holding could not exceed 7.5% of total equity. These provisions could only be changed by unanimous agreement at a meeting of more than 90% of shareholders with voting rights. The Memorandum of Association of the bank was similarly entrenched. These restrictions, which far exceed normal private sector practice in Jamaica, indicated the seriousness of the government's desire to signal its intention not to default. This conclusion is under-scored by the fact that when the government was considering the inclusion of a 'golden share' arrangement, its advisers warned that such an action would raise fears of future intervention and thus render the NCB unsaleable. The Government consequently dropped the idea.

If the privatization of NCB was significant, the sale of Telecommunications of Jamaica (TOJ) was regarded as crucial for economic growth, since by 1988 telecommunications was regarded as critical bottleneck in the restructuring of the economy. In order to obtain the necessary quantity and high quality of capital investment required to overhaul the telecommunications
sector, the government had to sell the company to a foreign operator. Given the size of the new investment proposed (approximately US $ 300 million over a 5 year period), the government needed to convince the buyer that the investment would not be jeopardized by default in the future (either by way of re-nationalization or through price controls), even if there was a clear short-term economic incentive to do so. The methods chosen in this case were a combination of legal pre-commitment and the prescription of a punishment process. In brief, these were as follows:

a) TOJ was granted an exclusive (i.e. monopoly) 25 years licence for domestic and foreign telecommunications in Jamaica which would be renewed automatically for another 25 years, unless, with the 2 and 1/2 years notice, the government acquired all TOJ assets at a fair market value as determined by a firm of valuer acceptable to both parties.

b) In the vent of a revocation of the licence, TOJ was allowed two years to sell its assets. If it was unable to do so, the government would be obliged to purchase the assets at a fair market price.

c) In the event of such a repurchase, the government was obliged to pay either in cash or upto 95% of total in promissory notes denominated in US dollars or UK Sterlings over a period of 15 years at 2% above London Inter-Bank Operating Rate (LIBOR) for similar deposits.

d) TOJ price setting regulations guaranteed the company, an
annual 17.5 - 20% return on shareholders funds. Further, the
design of the regulatory regime made no attempt to impose cost
savings on the firm.

Essentially, these provisions offered the foreign owners to
TOJ an investment free of expropriation risk, with a guaranteed
return. These extraordinarily detailed agreements, in fact,
offer a example of almost perfect pre-commitment since the
Jamaican Government specified a punishment strategy that would
leave the putative owner of TOJ indifferent, between holding TOJ
equity and accepting government compensation.

Interesting as these transactions are in themselves, the key
point for the discussion here is that these precommitment /
punishment strategies, motivated by the revenue maximization
objective of the government, served to reduce economic efficiency
below the optimal position. In the case of the NCB, share holder
control of management was compromised by the entrenched
provisions, while for TOJ a 50 year monopoly position was locked
in under the simple rate of return regulation, that these
punitive pre-commitments were deemed necessary to establish the
government's credibility in the privatization programme. Is the
Jamaican government had been eroded during the previous decades.
It also suggests that there are costs to poor reputation other
than bad economic performance, namely the costs of the problem of
lack of credibility. These costs may emerge as explicit
trade-offs in the implementation of privatization programmes,
especially in countries where governments have interventionist
reputations but wish to embark on privatization programs of substantial size.

The second form of bilateral pre-commitment / punishment strategies are implicit commitments, the main one being the creation of a wide share ownership base. Put it simply, the larger the number of shareholders, the greater will be the cost of default. Wider share ownership binds the government into a large number of individual contracts with its electorate, each of which is able to punish default. The logical implication of this is, of course, the 'give-away' option, now popular in Eastern Europe, through which shares on SOEs are distributed free to all taxpayers, voters or citizens. This form of privatization can be seen as a means of effectively achieving a number of the main objectives of privatization. Aside from the creation of a near-perfect reputation and important reputation externalities in other areas, the method also facilitates a rapid and cheap divestiture on the part of the state. In doing so, it quickly allows for a private market valuation to emerge, with consequent implication for the development of capital market trading and optimal resource and risk allocation, it avoids the re-concentration of wealth in hands of these investors who have the liquidity to purchase privatization shares, and it represents a 'pure' form of privatization by giving back to the private sector the freedom to choose how to allocate the asset bundle which was hitherto (nominally at least) been held in its name.
While, in many of the countries which have sold enterprises through public issues, wider ownership has been used as a political and reputational tool, no government in our country studies have explored the 'give-away' option.

The impact of reputation and policy credibility issues on the design and implementation of privatization programmes has rarely been explored in other studies of privatization in developing countries. This may once again be the result of the importation of developed country models where credibility in government policy is not such an important issue to the developing country context. However, this analysis suggests that, though often unremarked, governments are obliged to take account of policy credibility considerations when implementing sales—especially when divesting large enterprises and / or involving foreign buyers. In as much as a number of countries are seeking to expand their programmes and start privatizing utilities, we would expect methods of securing private sector credence in government policy to become more important. However, as noted above, across the scope of our study, the use of pre-commitment and punishment contracts have emerged as the most widespread and most effective methods for enhancing a government's reputation. While these may be revenue maximizing (when compared to the base case of reputational updating), they run the risk of locking in inefficiencies over the long term and hence vitiating the key objective of the sale.
C) OTHER CONFLICTS IN OBJECTIVES:

In the earlier sections, discussed the ramifications of the innately political nature of privatization, and examined the ways in governments attempts to fulfill objectives of privatization that have shaped both programmes and individual sales, and analysed strategies which governments have employed to overcome reputational constraints that are outside their direct power to change. In both cases, these actions caused friction with other public professed, goals of privatization and that, in general, political aims were those chosen to be directly instrumented. As the distinction between the trust of political and other objectives increases, so the achievement of the main aims of privatization is made increasingly less likely.

A fundamental conflict facing all governments is that of achieving the economic objectives of privatization in the light of ancillary objectives, particularly the desire to improve fiscal balances (often in response to external pressure).

This is particularly troublesome in developing countries whether privatization often takes place in the midst of a fiscal crisis in which the government is confronted simultaneously by the urgency of loan conditionally on the one hand, and growing domestic political dissatisfaction on the other. Given this framework, the temptation is for governments to emphasize the short-run liquidity transformation (i.e. cash for equity) aspect of privatization.
Thus, an overriding goal of programmes tends to be the rapid reduction of fiscal deficits by the quick sale of enterprises, and the decision to sell a function of the forces leading a government to prefer cash to equity. This clashes in a number of ways with the rationale most often put forward for privatization, namely the enhancement of efficiency. Firstly, often the most profitable enterprises are sold, since they are the easiest to divest quickly. Not only are these enterprises generally net contributors to current revenue, but they are likely to be operating efficiently (in an internal sense).

Sale of these enterprises is unlikely to result in greatly enhanced efficiency, the limiting example of this type of dynamic was the fourth tranche sale of TOJ, which gave the foreign shareholder a majority equity stake for the first time. This sale was carried out solely to earn foreign exchange so that the government could pass a quarterly IMF Performance test.

Second, we find that in a number of cases the profitability of SOEs is a function of their monopoly power (either natural, strategic or administratively determined). As stressed earlier sale of public sector monopolies to the private sector invariably means a transfer of monopoly profits to the private sector, there are no efficiency gain in this case. Too often the desire to bring enterprises to market and maximise immediate revenue has resulted in pressures to proceed with the divestiture of monopolistic enterprises, while the issue of the post-privatization regulation of private monopolies is either
ignored until after the sale has occurred are at best inadequately considered.

The specific problem of conflict between revenue maximization and efficiency enhancement forms one part of a broader conclusion on the attainability of these two goals. Although improvements in public finance and gains in efficiency are exposed as the two most important objectives of privatization, to suggest that in many developing countries they have at best been only partially fulfilled. In countries studies, efficiency gains and revenue improvements have not been, or not be, substantial, for a variety of the reasons expounded above (as a result of the types of enterprises sold, the lack of regulatory systems to accommodate the widespread presence of market dominance, or more basic political pressures).

The majority of firms that have been privatized are ones which have already been running relatively efficiently, either over a long period of time, or due to pre-privatization clear-ups. This is especially true of share sales to the public, where it is generally assumed that the offer for sale of loss making SOEs would not attract private investors. In these cases, it may well be that the net long run impact on public finance will be negative. On the other hand, there are clear examples of genuine and measurable success in terms of post-privatization efficiency gains, although these are more common in other types of privatization efficiency gains, although these are more common in other types of privatization (i.e. direct sales to the
domestic and/or foreign private sector, and management leasing), such as the textile mills in Sri Lanka, Iron and Steel Company of Trinidad and Tobago (ISCOTT) and hotel leasing/sales, Bus route tenders, and Agricultural marketing board sales in Jamaica. In these cases the net long run impact on public finance has been and will be positive.

A second conflict concerns revenue maximization and private sector development. The pronounced dualism of privatization sales was emphasized in our review of the experience of privatization to date. Concentration on the sale of large enterprises through public share sales or foreign purchase may result in higher revenues in each budget, but as successive country studies show, they will do little to 'crowd in' the small and medium scale domestic private sector, which lacks the resources to become a player in this type of programme. The problem is reinforced by the fact that short term revenue maximization involves the sale of monopolies as they are in many cases, governments have let stop the opportunity of creating competitive markets or breaking up Leviathan enterprises through a strongly pro-competitive policy, though both would have a positive effect on the development of the domestic private sector. A more common occurrence, however, is the creation of private sector entry determining oligopolies and monopolies.

There is also a tension in privatization programmes caused by the necessity of meeting adjustment conditionalities. This tension is made manifest through pressure from external agencies
to proceed with divestiture as rapidly as possible. However, speed of sale is seldom conducive to the full realization of the potential of privatization. First, there is pressure on governments to privatize enterprises before they are ready for sale. Increasingly multilateral agencies have come to realize that both SOE reform and privatization programme issues are time consuming and that three year adjustment loans are excessively blunt instruments of implementing privatization.  

It has been noted that most attempts to reform public enterprises have used SALs (Structural Adjustment Loans)… Yet public enterprise problems are complex and SALs generally have been selective and macro-oriented… It has also been noted that several components of public enterprise reforms take longer to implement than permitted under a typical SAL disbursing period. Second, privatizations undertaken at high speed or under intense pressure are often poorly designed. For example, in Kenya the Uplands Bacon Factory sale was pursued in response to the moratorium on disbursements of a previous adjustment loan. Though UBF’s sale was not directly part of any adjustment conditionality, and ultimately was not successful, the government clearly felt it would restore its credibility Mosley, 1991)  


In the event, however design faults arising from excessive haste caused the sale to fail. Similarly in Jamaica, privatization of the Caribbean Cement Company (CCC) was undertaken with extreme rapidity. Design problems are not only caused by external pressure. In the case of the land leases in Jamaica, failures arose where there was a conflict between improving the yield on agricultural land (an efficiency objective), and the government's desire to diversify the agricultural sector through the promotion of non-traditional interpreted.) This last trade-off reasserts itself in another way. In some countries, the goal of private sector development has been concerned with involving the private sector in projects which have previously been the province of the state, rather than being entrepreneurial (i.e. more dynamic, risk-taking) behaviour through the encouragement of competition. Thus, 'crowding in' the private sector can take the form merely of enticing the private sector into new underwriting of commercial risk. The classic example of this is the Malaysian Build operate Transfers (BOTs), where the creation of 'safety net' guarantees by government to protect private sector operators against future revenue shortfalls effectively undermines the whole purpose of BOT in the first place. The implication of such transactions is that competition is stifled and hence expectations of efficiency gains are downgraded.
CONCLUSION

Analysis of the privatization in countries selected shows that actual outcomes had been quantitatively disappointing. Privatization to-date has played a small role in reform of the SOE sector, and in India the pace is slower and the role of privatization is not significant in SOE sector reforms. It is in progress, not completed. However, aggregating across the programmes revealed certain common salient features.

Most importantly the analysis delineated how the design and outcomes of individual transactions and privatization programmes are strongly influenced by (1) the attempt by governments to address political issues, or gain capital from privatization, 2) the need to ensure credibility in privatization policy and 3) the intrinsic tensions in the broad goals assigned to privatization. The satisfaction of these constraints, however, can result in a failure to attain other objectives. Specifically, it is the goal of improved efficiency - which after all provides the central economic argument for privatization which is most often sub-ordinated (whether deliberately or through oversight) when trade-offs occur. Governments in developing countries could adopt far more rigorous competition and regulatory policies. The adoption of such policies could result in a stronger concern with efficiency enhancement in privatization transactions, even if privatizations purely around economic issues, the nature of economic structures in developing countries would often have a powerful limiting impact on the potential of privatization.