Privatization:

Lessons for Oil Exporters

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ملخص

تعمل الكثير من الدول النامية على تنفيذ برامج خوصصة طموحة في إطار إصلاحاتها التي تهدف فيما تهدف إلى إنهاء ملكية الدولة لقطاع عمومي غير كفء سيكون في هذه الورقة بإعادة النظر في بعض المسائل المتعلقة بالخوصصة في بلد مصدر للبترول، ألا وهو الجزائر، كما يمكن اخذ التجربة الاندونيسية بعين الاعتبار هنا لما تتوفر عليه من دروس يمكن الاستفادة منها في حالة الجزائر، إن وجود قطاع واسع للبترول قد أثار العديد من المسائل المتعلقة بتلك البرامج سواء من حيث التطبيق والاستفادة منها.

Abstract

Within the framework of their market-oriented reforms, many developing countries have embarked on programmes of privatization aimed at ending state ownership of an often-inefficient public sector. This paper reviews privatization issues for an oil-exporting country such as Algeria. Indonesia's experience, being considered in this context, provides interesting lessons, which could prove quite relevant to the ongoing process in Algeria. The contention is that the existence of a large oil-sector raises particular problems in implementing and benefiting from such programmer of privatization.

1 Introduction

This study starts with a general background that includes a number of privatization issues, and some noteworthy conclusions that have been reached from observations of the many privatization exercises around the world. As Algeria has often been compared with another oil-exporter, Indonesia, the paper looks at Indonesia's experience with privatization. The interesting feature here is that Indonesia's privatization programmer has been judged to be very unsuccessful.[1] Finally, this paper draws together the key issues for Algerian privatization, emphasizing those that arise from Algeria's position as an oil exporting country.

2 Privatisation Issues

2.1 Theoretical considerations

As views of effective economic management have changed, so privatization has emerged as an economic policy. In the early industrializing countries many enterprises, now associated with public ownership (water, railways, electricity and gas generation), began as private sector operations. Once a framework of peace and security, property rights and legal enforcement of contracts provided the foundation for the Industrial Revolution, private enterprise became the driving force of the remarkable expansion of western economies and the improvements in the living standards of their citizens that has occurred since the past two centuries.

Yet the early part of the last century saw doubts begin to arise. Economic theory argued that monopolies charged higher prices, produced less output and generated excessive profits for their owners. It was clear that some private enterprises had monopoly powers. There were two broad approaches to the problem. In countries like the United States many monopolies remained in private hands, but were the subject of regulation which set their prices at levels that were interpreted as being in the public interest. Consumers were protected, and the owners had incentives to be efficient in their production by reducing their costs, thereby increasing their profits. In countries like the UK, monopolies were taken into public ownership, and the government ran the enterprises, again in a manner interpreted as being in the public interest.

In the last two decades of the previous century doubts began to arise about the effectiveness of publicly owned enterprises, and moves began to return these enterprises to private ownership. For the most part dissatisfaction arose from experience of high prices and poor service. Apart from the problem of monopoly (which is an argument for public ownership or regulation) economic theory had little to say regarding the effects of different types of ownership.

For that reason a theory of incomplete contracts has been developed. In essence this argues that when it is not possible or feasible to formulate contracts that deal with every eventuality, or contracts cannot be made applicable for the future period covering the life of assets, then there are advantages in the ownership of the enterprise being vested in the agents responsible for management. Otherwise the agent will not have sufficient incentive to manage efficiently since not all the benefit of efficiency will come to this agent, and less effort will be invested in efficiency than is desirable. A major consideration is that the day-to-day managers of the enterprise know more about its management than the non-managing owners. This adds to the problem of drafting an efficient 'contract' between owners and managers. Managers will use the lack of information on the part of the owners to put in less effort, or to use the firm's resources for their own purposes.

Of course management and control can be distributed in various ways between the public and private sectors. One extreme case is when an enterprise both owned and managed by the government. At the other extreme is a firm wholly owned and managed by the private sector. In between it is possible to have a 'commercialized' enterprise which is run by the private sector on commercial lines, but in which the government has some, or all, ownership. Or there can be a 'regulated firm' which is owned by the private sector, but which, ultimately the government controls through regulating such things as outputs, price and employment.

The degree of difficulty in framing contracts affects the suitability of public or private management of enterprises. In general, privatization is desirable if cost saving cannot take place at the expense of quality; if innovation is important; if the competitive environment is vigorous; if consumer choice can be exercised effectively; and if the reputation of the enterprise is important and such reputation is affected by the performance of the enterprise.[2]

2.2 Political Considerations

Privatization will invariably affect the distribution of income. In some cases it can increase inequality. State-owned enterprises are sold off cheaply to the already wealthy, and the income earned is at a high rate of return. On the other hand, the privatized enterprises cut their labour forces, further reducing the incomes of a low-income section of society. But privatization need not always increase inequality: assets of the enterprises can be given to the employees or to the disadvantaged, as in Sudan.[3]

Much of the political economy discussion in the literature assumes a democratic government, and a ruling group concerned to meet the general welfare requirements of the community in an altruistic manner. In this context, the government is usually concerned to ensure that modest prices, adequate output and satisfactory quality are maintained, while at the same time taking care that there are safeguards to ensure sections of the population are not unfairly disadvantaged (as for example, through increased unemployment).

What is not much discussed is privatization where the government is not democratically elected and is not much concerned with general public welfare but more with the well-being of the ruling elite. A ruthless government can then determine privatization issues in a way that will enable the ruling elite to benefit. The government's only concern is to ensure that it will not be overthrown by a military coup or by urban unrest. Invariably in such circumstances the government ensures the military are a privileged group. The urban population (in Africa, for example, often representing 30 per cent of the population) is a privileged minority favoured at the expense of the rural majority. The existence of oil deposits makes this situation much worse. Oil royalties provide revenues which the ruling elite can easily capture and use largely for their own purposes. Public sector revenues do not depend on raising taxation which provokes much more careful scrutiny of what happens to public funds.

State-owned enterprises (SOEs) are one of the ways in which ruling elites capture oil revenues for their own purposes and critically maintain the support of urban populations. The government sector is often the main employer in urban areas, and the state-owned enterprises expand their labour forces to maintain the support of the urban population. But more than this the SOEs are a key source of

corruption. Contracts are awarded to associates of the ruling elite at well above their market value. Further, what is provided by the contract is well below the quality specified, but is approved after the contractor makes a payment to the government official responsible for signing off the contract. Resources of the SOE are used by the elite for their private purposes without payment (airlines are a common example).

In these circumstances there is an extreme reluctance to privatize SOEs as to do so will impede the oil royalty capturing activities of the ruling elite. Furthermore, the ability to provide privileges for the urban population through SOE employment or low prices for SOE products – a key element in remaining in power – will be limited.

These conditions can also exist in newly democratized countries, where a ruling group has come to power, and is bent on accumulating as much wealth as possible during its term of office. If there is an active opposition, they often do little to reign in the financial mismanagement of the rulers. They might be bought off, either financially or through a government post. In extreme circumstances, anti-corruption campaigners are eliminated. The opposition will frequently want to keep the process alive in the event that they come to power themselves.

3 - Privatisation in Practice

3.1 Disposal methods

Auctions can ensure that the business goes to the most efficient manager providing there is enough competition among bidders. However, the State may not raise the maximum revenue, as the price will be set at just above the price the second most efficient manager is prepared to pay. The most efficient manager will be prepared to pay more. Securing a competitive auction may, in many cases, requires that foreign bidders be also allowed to tender a bid.

3.2 - Credibility

A successful privatization requires that the purchaser be fully aware of the conditions under which the newly privatized enterprise will operate, and that these conditions are stable. Also the purchaser needs to be confident that the enterprise will not be re-nationalized.

A privatization, which leads a government to be explicit about the terms on which enterprises generally operate, can enhance confidence, by reducing policy and legal uncertainties. Sales to foreigners also

serve to improve credibility as international agreements and the possibility of sanctions provide some measure of security that might not be afforded to domestic purchasers.

It is suggested that credibility can be enhanced if government sells the enterprise in tranches, with the first tranche under-priced so that there is wide participation and popular support for the sale. Buying back the tranche at market prices to re-nationalize will involve a loss. The government might not honour a market-price re-purchase, but if it does so, and there is wide participation in the original sale, this will not prove popular.[4]

3.3 - Financial Markets

Privatization can provide significant encouragement to financial markets. Liquidity is enhanced by diversification, as is the ability to reduce risks by spreading investments, and confidence rises with a large pool of financial assets.

Enhancing the financial market and encouraging foreign participation can be helped by a large privatization programme, which raises the profile of the privatizing country in the international financial markets.[5]

3.4 Ownership and Control

In only 47 per cent of privatizations is the majority shareholding sold. The reasons are varied: fiscal conditions do not create compelling pressure to raise revenue; in non-democratic systems it reduces risks to purchasers or shareholders to have government involvement; financial markets are not able to absorb a full sale. In many cases government retain a degree of control over and above that conferred by their shareholding. This can be done through 'golden shares' that can provide for board membership, veto powers on acquisitions and disposals and so forth. These provisions can be reinforced by legislation on ownership limits and measures allowing for government control in the national interest. Such 'golden shares' are a feature of more than 50 per cent of privatization in defense, telecommunications, utilities and transport. These conditions constrain the management and reduce profitability, and expectation of this will affect the purchase price.

3.5 Monopolies

Given the welfare implication of monopolies (higher prices, lower output, and excessive profits) and the complexities that prevent the handling of these problems by contracts, and the inefficiencies of public ownership, it is necessary to introduce regulations.[6] Designing a suitable regulatory framework is a demanding exercise, and this provides a particular challenge for developing countries – even more so if there are doubts over the probity of the regulators.

Vertically integrated monopolies can prove difficult to privatize as separate units since it may be unclear as to whether there is cross-subsidization. One practical approach is to split up the enterprise ('unbundling') for a period prior to the sales.

4 Privatisation Experience

4.1 Extent of privatization

Some privatizations were launched in Germany in the 1960s and in Chile and Ireland in the 1970s, but the major phase of privatizations has been in the 1980s and 1990s. The main phase of privatizations in the developed world is now completed and the contribution of SOEs to GDP has approximately halved. The impact of privatization in developing countries has been significantly less, and the process is, in principle, continuing with many major enterprises in banking, electricity, water and telecommunications still to be sold.

Table 1: Percentage of privatization by sector, 1977-2001

AREA	Agr and Ind	TLC	ENERGY	FINANCIAL	TRANSPORT	UTILITIES
W. Europe	63	46	49	56	59	64
MENA	39	36	42	37	33	42
Asia	49	32	38	51	42	42

Source: Bortolotti and Sinisalco (2004).

It is clear from Table 1 that the extent of privatization is higher in Europe than in Asia. In the Middle East and North Africa privatization has generally been less extensive than in Asia, although in telecommunications and energy it has been greater. Everywhere private sales have been more important than public offers.[7]

For instance, some observers have contended that not much has in fact taken place in terms of actual privatization of SOEs in Algeria.[8] Launched in 1994, they argue that apart from the initial privatization-liquidation process of several hundred of local public enterprises and the opening up of 20 per cent of the capital of Eriad (agro-food industry), Saidal (pharmaceuticals) and the El-Aurassi Hotel on the 1999 established Algiers Stock Exchange, there have been only a handful of major divestiture operations subsequently. These included the acquisition of Enad, a state-owned detergent company, by the German Henkel; the transfer of a major part of the assets of Sider, the national steel producer, to the Indian Ispat; and the privatisation of Fertial, a subsidiary of the state-owned Algerian fertiliser company Asmidal, to the Spanish Grupo Villar Mir. Other transactions involved the opening up of the telecommunication sector through the sale of new cellular telephone licences to private foreign firms. Most recently, the Aberdeen-based energy services Wood Group bought a majority stake (55 per cent) in Somias, a maintenance and fabrication support firm serving the Algerian oil and gas and petrochemical industries.

The fine-tuning of the legal and institutional privatization framework in 2001 was meant to move the process steadily and quickly. But the government fluctuating policy priorities along with resistance from some stakeholders – particularly the bureaucracy and the trade unions – can be held responsible for the lack of progress in this respect. Even so the government has recurrently stated its resolve to privatize virtually all public enterprises.[9] Moving privatization beyond the point of stated intentions calls for a coherent policy that takes on board both the particulars of the process and its overall aims and implications within the broader economic reform agenda. For instance, making the privatization conditional on maintaining the public enterprises' activity and workforce may well act as a disincentive to would-be investors/bidders. The IMF, on its part, recommended the introduction of a safety net as an alternative to cushion against potential job losses.[10]

4.2 Determinants of privatization

Generally the extent privatization increases the greater the development level. It has been observed that privatizations are more likely to occur with right-wing governments in power; when there is a problem with a budget deficit; when there is a booming stock market. Democratic countries with first-past-the-post systems are more likely to privatize than those with proportional representation where it is

easier for a veto power to be exercised. Also countries with common law, which give better protection to shareholder and creditor systems, seem to find the mechanics of privatization easier than do countries with civil law systems.[11]

4.3 Impact of privatization

Most public equity sales around the world appear to have been under-priced, emphasising the need to secure political support for privatization. Privatizations generally widen share ownership, enhance the credibility of government (poor performing SOEs are no longer their responsibility) and develop stock markets. Most privatizations are incomplete, with less than 100 per cent of stock sold, and in many cases governments retain control in excess of their share ownership by means of regulatory requirements or 'golden shares' (including cases when privatization is partial).

Overall evidence appears to show that privatization has improved productivity and profitability in comparison with remaining SOEs; reduced employment, at least in the short-run; improved the transparency of enterprise governance.[12]

5 - Indonesia's Privatization Experience

Indonesia has some important structural similarities with Algeria, the most notable being the existence of a significant oil sector. However, Indonesia's economic performance over the period since 1950 has been noticeably better than that of Algeria,[13] (Hodd 2004) and superior economic policies have been credited as the cause of the better performance. It is interesting in this context to examine Indonesia's record with regard to privatization.

5.1 Indonesia's economic background

Indonesia benefited from high oil prices in the 1970s, but when oil revenues began to fall in the 1980s, government revenue was maintained by revenues from income tax and value-added taxes. As one of a series of liberalization measures, it was announced in 1989 and again in 1993 that 52 SOEs would be privatized, but little eventuated.[14] Such formal privatization as has occurred has involved partial sale of equity with minimal influence of private sector management as a result.

After the onset of the banking crisis in 1997 and the float of the currency, an assistance package from the IMF included privatization as

a condition of support. Indonesian SOEs have been described as instruments of personal gain and patronage – buying at high prices; selling at low prices; creating unnecessary employment; granting cheap loans.[15] Indonesian SOEs have generated low or negative profits.[16]

A new urgency to privatize was presented by the government bond issue to support the banks, with the consequent interest payments creating a fiscal problem. Agencies such as the IMF consider involvement of outsiders necessary for a successful privatization. However, there is strong opposition in Indonesia to foreign ownership, and in the face of this hostility, foreign interests are reluctant to become involved, as, at the very least, it adds uncertainty regarding the long-term commitment to privatization. Added to this is a lack of confidence in the legal system, combined with concern over corruption and incompetence.

Such privatization as has occurred has been through economic liberalization allowing private enterprises to enter the market or expand their market share. Experience of increased private participation is now examined for three major sectors.

5.2 Airline sector

Until 1990 the state airline Garuda had a virtual monopoly over long-haul routes, as private airlines were not allowed to operate jets. In the 1990s this was relaxed, and a privately controlled company, Sempati Air, began to expand and gain an increasing share of Indonesia's airline business. However Sempati, previously owned by the military, took advantage of the SOE and banking culture to build-up substantial debts to a SOE petroleum supplier, an SOE airport authority and state-owned banks.

During the 1997 crisis Sempati's costs rose dramatically as its major costs (aircraft leasing, borrowing, and fuel) were denominated in US dollars. It needed to raise its fares to continue operating, but the government put pressure on Garuda not to raise fares (the government incurred even heavier losses on behalf of Garuda as a result) and Sempati was declared bankrupt with substantial debts to the state banks and supplier SOEs.

The problem here was the environment in which Sempati operated. It was able to raise bad loans from the state banking sector and build-up debts with state owned suppliers. Responsible behaviour by the state banks would have been to require suitable collateral from

Sempati in the form of the capital and assets of the private sector owners. The behaviour of the state-owned suppliers was symptomatic of patronage culture, which allows irresponsible use of state assets to further private gain.

5.3 Electricity sector

Up to 1990 grid-delivered electricity was effectively the monopoly of state-owned Perusahaan Listrak Negara (PLN). PLN had a poor record of reliability, and many electricity users had installed their own generators. PLN's poor reliability is a direct consequence of the culture of SOEs acting as a source of private gain from oil royalties. As well as the familiar failings of purchasing at inflated prices and failing to charge key customers, the suppliers of generators and fuel had every incentive to encourage PLN to maintain its poor supply record. However, in 1990 the government commissioned 26 privately owned generating plants to supply PLN, and around 30 per cent of grid-delivered electricity now comes from these sources.

Alas, the expansion of the private supply was also within the revenue-capturing culture, and the contracts with PLN required the state-owned PLN to purchase at a high price from electricity supply companies owned by the ruling elite.[17] PLN was obliged to take power supplied by private companies, and the price was denominated in US dollars. Thus, by 1998 the local price of supply to PLN had risen by over 400 per cent. As not all the costs of the private suppliers were for imported inputs, the profits of the private suppliers rose dramatically. As a footnote it should be observed that PLN was prevented from raising its prices and therefore sustained huge losses, covered by the government. Keeping electricity prices low enabled the government to maintain public support.[18]

The problem in this sector lies in the nature of the contracts signed by PNI under political pressure. Had PNI itself been a private sector company, responsible to its shareholders for its assets, these contracts would have caused the losses to be incurred by the shareholders rather than by the state, and this situation would have provided a significant incentive to draw up contracts on sensible commercial terms. As it was, PNI served to channel public funds to the profits of the elite owners of the private generating companies.

5.4 - Banking sector

Prior to the crisis of 1997, the only State divestment in this sector was a minority shareholding (25 per cent) in one financial institution Bank BNI. This did little to improve this bank's management. Indeed under political pressure Bank BNI granted over 1 billion US dollars to a single corporate borrower, which has now defaulted and its debts have been taken over by the Indonesian Bank Reconstruction Agency. The problem here was the partial nature of the privatization, with private interests not in full control and not taking full responsibility for the bank. Provision of banking services in Indonesia has seen significant privatization through private bank expansion relative to state-owned banks. From 7 per cent of the total bank assets in 1982, the private banks had expanded to 24 per cent by 1988. However, the 1997 crisis saw these private banks experiencing a run on deposits. The central bank began by providing emergency lending against assets so that banks could repay depositors, but it soon became clear that a large proportion of the bank's assets were bad loans. In the event the government took the responsibility for the banks' liabilities, closed some banks and provided new capital for others.[19]

As with Bank BNI, the problem does not arise from the expansion of the private sector but the manner in which the banks were allowed to operate. Clearly the banks were not properly regulated such that they maintained adequate reserves and maintained a sound portfolio of loans. The culture of banks serving as a conduit for oil revenues to the ruling elite and their associates allowed this situation to arise. Proper regulation was not in place when the private banks expanded and the managements made bad loans, often to their associates. When the crisis revealed the situation, concern to preserve confidence in the banking system led the government to take over the debt – as in effect it had been doing with the State-owned sector.

6 - Implications for Oil Exporting Developing Countries

Oil-exporting developing countries face a special set of problems if they are to benefit from the efficiency improvements that privatization can bring about. Firstly, the presence of enormous oil royalty revenues in the economy has a profound effect on the political economy of privatization. Economic policy is invariably conditioned by the need of the ruling elite to maintain or introduce structures that will divert these oil revenues for private gain.

Table 2: Electricity sector sales, 1977- 1996

Country	Number of Sales	Revenue (million US dollars 1996)
Chile	2	538
Colombia	2	937
India	0	0
Indonesia*	0	0
Malaysia	0	0
Mexico*	0	0
Pakistan	1	214
Peru	3	686
Philippines	0	0
South Korea	0	0
Sri Lanka	0	0
Thailand	1	180
Venezuela*	0	0

Source: Bortolotti and Sinisalco (2004). (*): Oil exporting countries.

Secondly, if the oil-exporters introduce privatization, either by divestment or liberalization to increase the share of private suppliers in the market, it may well be done in ways that continue to squander state revenues. One mechanism is for the new private firms to be awarded privileged commercial relationships with SOEs, which enable them to make excessive profits. Another mechanism is for the private firms to be given actual or tacit guarantees, which enable them to make private gains for their associates by incurring debts that, eventually, the government will cover. Of course there are the risks of these abuses occurring in all countries. But they are significantly greater in oil-exporting developing countries that have a patronage and elite-serving culture.

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[9] SOEs excluded from the privatization plan are Sonatrach (oil), Sonelgaz (gas) and Sntf (railway transport) in view of the fact that they are considered as 'strategic' companies.

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